DISTRESSED M&A TRANSACTIONS

Chance

BANKRUPTCY

DO NOT PASS GO,
DO NOT COLLECT $200

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Chris Manderson of Ervin Cohen & Jessup

Distressed M&A Transactions, or How I Learned to Stop Worrying and…

- Buy assets at a discount,
- Leave creditors, liabilities and complications behind, and
- Make money and not pay taxes.

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Your client wants to buy the operating assets from a distressed company.

- Debtor has good assets, bad balance sheet.
- Secured debt exceeds asset value.
- Secured lender has an all-asset security interest.
- Unsecured liabilities include litigation, trade debt, insider loans, etc.
- Your client wants the assets but not the liabilities.
  - How do you advise the client to do this deal?

Distressed M&A Tools

- Bankruptcy with 363 sale
- Assignment for the Benefit of Creditors
- Article 9 Foreclosure and sale by lender

Bankruptcy Asset Sale under Section 363

Section 363 of the Bankruptcy Code authorizes a debtor, after notice and a hearing, to sell the debtor's property outside of the ordinary course of business. A 363 Sale allows the purchase of the assets free and clear of liens.

363 Sale Process

- Debtor files bankruptcy
- Court establishes bid procedures and may approve "stalking horse" bid
- Assets are marketed, soliciting additional bids
- Sale approval hearing; court evaluates bids and chooses winner
- Closing: assets sold "free & clear" of liens.

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363 Sale Tactic: DIP Loan, Stalking Horse Bid

Buyer can fund a pre-negotiated super-priority Debtor in Possession Loan ("DIP Loan") at debtor's bankruptcy filing.

<u>Debtor submits buyer's "stalking horse" bid</u>

- DIP Loan can be used to credit bid.
- Stalking horse bid subject to overbid in an auction but can include a break-up fee.

363 sale advantages

- Assets are generally transferred free and clear of liens and claims.
- The process provides greater flexibility in structuring the transaction.
  - buyer may acquire only desired assets, and leave behind unwanted assets.
- The sale requires only the approval of the Court, not creditor committees.
  - shorter process; creditors cannot block the sale.
  - does not require shareholder approval.
- Faster and less expensive than negotiated purchase of debtor's business from Chapter 11.

Assignment For Benefit Of Creditors

An Assignment for the Benefit of Creditors (ABC) is a voluntary, out of court alternative to bankruptcy under state law

- The debtor transfers its assets to a third party (the assignee) to liquidate the assets and distribute proceeds to creditors.
- The assignee acts as a fiduciary for the benefit of the creditors.
- The assignee will manage, liquidate, and distribute the debtor's assets.

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ABC Process

- **Asset Liquidation:** The assignee takes control of the debtor's assets, evaluates them, and sells them in an orderly manner to maximize value.
    - Sale is generally a public auction or process; Assignee seeks the highest bidder
- **Distribution of Proceeds:** After liquidating the assets, the assignee distributes the proceeds to creditors according to their priority.
- **Winding Up Debtor:** The assignee then winds up the corporate affairs of the debtor.

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ABC Advantages & Disadvantages

Advantages:

- Faster, less formal and less expensive than a bankruptcy
- Generally occurs out of court

Disadvantages:

- No automatic stay for litigation or collections against debtor
- Unlike a 363 sale, the assignee generally cannot sell assets "free and clear" of liens and security interests
- Secured party must be paid in full or agree to release its lien

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Article 9 Foreclosure

Article 9 of the Uniform Commercial Code allows a secured creditor to repossess and dispose of collateral assets

After repossessing collateral, the lender can sell the collateral, and apply the sale proceeds to amounts owed

Article 9 Foreclosure Sale Process

After debtor's default, the secured creditor must:

- Repossess the collateral
- Give notice of intent to sell the collateral to debtor and other secured parties
  - Generally, 10 days' notice
- Attempt to maximize the proceeds of the sale
- Properly apply the proceeds of the sale
  - 1st to costs of sale and legal fees
  - 2nd to the secured creditor
  - 3rd to junior interests in the collateral
  - 4th to the debtor, if there are any excess proceeds

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Advantages of Article 9 Sale

- Fast, efficient and cost-effective
- Only secured creditors participate in process
  - Lender not required to notify customers, vendors, unsecured creditors or stockholders
- Does not require court process, trustees, litigation
- Buyer can often acquire assets for the value of the secured debt, or less, in Article 9 sale
- Secured creditor can also purchase the collateral through the sale
- A good tactic for "loan to own" transactions
  - Buyer can acquire secured loan from creditor at a discount, then foreclose on assets and purchase them in Article 9 sale

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Disadvantages of Article 9 Sale

- Cooperation from debtor essential to smooth process
- Cannot sell entire operating business, only secured assets
- No automatic stay
  - Other creditors or litigation parties can attempt to interfere
- Requires close adherence to Article 9 requirements and process
- Fraudulent transfer risk
- Assets are not sold "free and clear", unlike 363 sale
  - may be subject to other liens

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Want to Make Money and Not Pay Taxes?

Take over a debtor with Net Operating Losses ("NOLs") in bankruptcy.

NOLs can be preserved in a chapter 11 bankruptcy and carried forward by the reorganized debtor.

NOL carryforwards can be applied to shelter future earnings.

A new investor can take advantage of NOLs by:

- acquiring a stake (less than 50%) of a company reorganizing in chapter 11, and
- After emerging from chapter 11, use the NOL company as an acquisition platform for profitable companies.
- The NOLs can shelter earnings going forward

Examples of Companies Built on NOL Shells

- **Jeffries (Leucadia National Corporation)**
  - Former Talcott National Corporation, incurred major losses in 1970s before takeover and renaming by Ian Cumming & Joseph Steinberg in 1979
  - Held $3.4 billion in NOLs upon merger with Jeffries Group in 2013
- **Covanta Holding Corporation**
  - Operates waste-to-energy plants
  - Former Danielson Holding Corporation, an NOL corporation that formerly operated in insurance (Zell)
  - Sold to EQT Group for $5.3 billion in 2021
- **Anixter International Inc.**
  - Distribution of wire and cable, security and networking products
  - Formerly Itel Corporation, an NOL holding company that owned rail and container leasing businesses) (Zell)
  - Sold to WESCO International for $4.5 billion in 2020

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Great, I want to buy an NOL Company and not pay taxes!

- Not so fast. You can't buy the whole company. **Section 382** limits the use of corporate NOLs following an ownership change.
- An ownership change is generally a 50% or greater change in the ownership of stock among certain 5% shareholders over a three-year period **(Sec. 382(g))**.
  - Most tax lawyers recommend acquiring 45% or less in a 3-year period.
  - Derivatives such as warrants and convertible preferred are deemed exercised when issued under **Section 382**.
  - After 3-year period, buyer can increase ownership.
- **Section 382(l)(5)** can enable creditor holding "old and cold" debt to acquire 100% of the equity ownership in a bankruptcy.
  - This technique is rarely usable and highly likely to be challenged by the IRS

Continuity Of Trade Or Business

Carryforwards disallowed if continuity of business requirements are not met.

Generally, if the new loss corporation does not continue the business enterprise of the old loss corporation for two years, the Section 382 Limitation will be zero.

- The NOL corporation should continue *some* of its historical trade or business after reorganization
- The company can also initiate new lines of business, including acquisitions.

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How To Monetize Tax Assets

Use NOL shell to acquire performing assets and shelter tax payments

Ideal targets are:

- Assets/companies with no natural tax protection (e.g. without depreciation, amortization, interest payments)
  - Royalty streams
  - Services companies
- Companies that would benefit from tax-sheltered reinvestment
  - Lenders/finance companies (sheltering and reinvesting interest payments)
  - Equipment leasing companies

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Partner & Chair of the Business, Corporate, and Tax Department

310.281.6374

cmanderson@ecjlaw.com

linkedin.com/in/chris-manderson

Ervin Cohen & Jessup LLP

9401 Wilshire Boulevard, 12th Floor

Beverly Hills, CA 90212

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