LEGAL *Bulletin*

Why Up-Market, Down-Market Acquisitions Are Different

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Buyers like distress sales because "distress" translates into "value pricing." Similar to used cars, which sell at significant discounts in part because of the risk of buying a lemon, distressed companies sell at significant discounts in part because of the risk that the buyer inherits unknown liabilities. The key to completing a successful distressed acquisition is handicapping and then limiting the risk of those unanticipated liabilities.

Today's robust market in distressed acquisitions creates a ripe opportunity for a refresher on the legal reasons why distress sales are complex. The acquisition of a healthy company, by comparison, can seem relatively straightforward. This is because there are only two parties at the table — the buyer and the seller. To be fair, there may be a couple more — the seller's shareholders (who have to approve the deal or exercise dissenter's rights), and the buyer's bank that is financing the purchase — but that's usually about it.

The acquisition of a distressed company is often much more difficult because of the numerous additional parties at the table, all of whom are looking for a share of the purchase price. When a company becomes insolvent and its proposed sale will not generate enough money to satisfy all of its creditors, these creditors become parties with a keen interest in the sale. They may include the seller's secured lender holding a lien on the major assets, suppliers who are owed for unpaid invoices, landlords who are owed rent, customers who are owed inventory for which they have paid, government authorities that are owed taxes, and employees who are owed wages, benefits, and retirement contributions.

Potential Risks

Traditional methods for acquiring a healthy company include mergers, stock sales, and asset purchases. Mergers and stock sales usually do not work in distress situations, because buyers in those transactions always assume the seller's liabilities. The whole point of buying a distressed company is to acquire it without the liabilities.

No reasonable buyer is willing to purchase assets subject to a lien. Either the bank must be paid, or it must consent to accept payment of less than all of its debt (a "short sale").

An asset purchase, on the other hand, is intended to allow the buyer to acquire a company's assets without acquiring its liabilities, so it is much more appropriate for a distressed purchase. But the traditional asset purchase is rarely used by itself in the purchase a distressed company. Instead, the buyer usually wants the assets "cleaned up," for example, through a foreclosure or bankruptcy sale. Why? A buyer can get stuck with a number of liabilities in an asset sale when the seller is insolvent. They include:

1. Fraudulent Transfer Liability. When a company becomes insolvent, its goal is supposed to be maximizing the value of its assets to pay back creditors as much as possible. Therefore, all states have "fraudulent transfer" laws to prevent the owners of a corporation from selling assets for less than their fair value while the company is insolvent.[1] This insures that the assets aren't sold at fire-sale values to the owners or their friends in an attempt to hide them away from creditors.

If a company's assets are sold at less than fair value, the sale can be unwound after the fact, or the buyer can be required to pay the difference between the purchase price and fair value. Even if the buyer is a completely unrelated company and believes it is paying fair value, whether the purchase price was "fair" is likely to be the subject of significant second-guessing and scrutiny after the fact with so many parties at the table. So, the buyer takes a huge risk that it will end up in litigation about the purchase price after the acquisition.

Importantly, *any* creditor can bring a fraudulent transfer lawsuit, and no bankruptcy filing is required.[2] One spoiler can change the equation dramatically by initiating a protracted legal battle. Even if the buyer wins, the legal defense costs can quickly turn success into a mere Pyrrhic victory. If the purchaser is related to the seller, such as the current management team or current shareholders, and is trying to buy the company's assets without paying creditors in full, the likelihood of having the purchase price second-guessed in a subsequent lawsuit is even higher.[3]

2. Liens. If a company's assets are subject to a bank lien that is not paid off at the time of the sale, the lien follows the assets into the hands of the purchaser. The result is that the bank can seize and foreclose on the assets despite the purchase.[4] No reasonable buyer is willing to purchase assets subject to a lien. Either the bank must be paid, or it must consent to accept payment of less than all of its debt (a "short sale").

And banks are not the only parties with liens on a borrower's assets. Others may include the Internal Revenue Service (IRS) and state taxing authorities (tax liens), landlords (landlord liens), suppliers or customers who have received judgments (judgment liens), suppliers who recently shipped goods (reclamation liens), contractors (mechanics' and materialmen's liens), transportation companies (carrier liens), and, in the case of some businesses, food providers (agricultural liens).[5]

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Liens work the same in all of these contexts — if the party holding the lien is not paid in full and does not consent to the sale, the lien follows the assets into the hands of the buyer.

Because all existing liens are not equally easy to discover, a buyer may not learn about expensive, high-value liens until too late — after it has completed the purchase. The result can be financially devastating.

3. Title. Although it should come as no surprise, distressed companies often do not keep the best financial records and inventory lists. A buyer may find out after the fact that it has bought assets that the seller did not actually own and that are instead owned by a third-party. Ascertaining true ownership can be very difficult and time-consuming, and again, a miscalculation can be disastrous — the true owner may suddenly pop up many weeks or months later, wanting its property back.[6]

Discovering after the fact that there was a mistake or even fraud by the seller is probably irreparable, because an insolvent seller will be unable to repay the buyer or to provide meaningful indemnity. Instead, money from the sale will have been distributed, probably to pay off creditors, and there will be nothing left to pay back the buyer for the pain it suffers.

4. Successor Liability. One of the most risky issues for buyers is the potential of being tagged by a creditor with "successor liability." This is a legal claim that allows a creditor of the seller to assert its claims against the buyer when the seller is unable to satisfy the creditor's claims.

To establish successor liability, a creditor typically must prove that the buyer is a "mere continuation" of the seller — in other words, that the buyer is carrying on the same business with the same employees, the same assets, and usually, similar ownership or management.[7] The idea behind "mere continuation" successor liability is to prohibit the owners of a company from simply starting a new company and transferring all the assets while leaving all the liabilities behind in the old shell. Even an arm's-length buyer can get caught up in a lawsuit for successor liability, and legal fees for fighting such a claim can be prohibitive, no matter the final outcome.

In some states, a buyer can also be subject to successor liability under a much more liberal claim known as the "products liability doctrine."[8] Under this theory, the buyer is liable to creditors if it continues to manufacture the same product line as the seller. The purpose is to make sure that individuals injured by the product have a place to recover for their injuries, whether from the prior manufacturer (the seller) or the current one (the buyer).

Most creditors will couple successor liability lawsuits with other claims, such as piercing of the corporate veil (a close cousin of successor liability), and interference with contract (because the purchase rendered the seller incapable of performing the contract).

When a company is in distress, following the adage "buyer beware" is not enough.

5. Tax Successor Liability. In addition to successor liability claims available to common creditors, state taxing authority claims for successor liability can quickly become a buyer's worst nightmare. Most states provide that if a seller owes sales taxes, the buyer is liable for all of the sales taxes up to the full amount of the purchase price paid unless the sale proceeds were paid directly to the state taxing authority.[9]

So, for example, if a distressed company owes $500,000 in sales taxes and the buyer pays $1 million to purchase the company but does not ensure that part of the purchase price is used to satisfy the taxes, the buyer will owe the $500,000 in taxes to the state after the sale, making its total outlay for the purchase $1.5 million rather than $1 million.

Sales taxes are not the only taxes for which states impose successor liability. Another example is unemployment taxes, for which most states have liberal rules providing that a buyer inherits the unemployment taxes of the seller. Often, all that is required for the buyer to inherit the unemployment tax liability is doing business at the same location with 51 percent of the same employees.

6. Individual Liability for Seller's Management, Shareholders. The seller's management takes on significant risks when it sells the company at less than the value required to pay all creditors. If the price is too low, or the sale benefits management, creditors may very well bring suit against the seller's management.[10] If management is sophisticated and looking to avoid this risk, it will be unwilling to go through with an asset sale unless it receives significant protection — something a buyer is not likely to offer in a distressed scenario.

Cleansing the Assets

So, when a company in distress has valuable assets and a willing buyer, what are the parties to do? They should "cleanse the assets" in a process that protects the buyer and the management of the seller. There are several ways that buyers can do this.

The first is the "short sale," in which the buyer convinces the secured lender to release its liens in exchange for less than its full debt. The problem with the short sale is that while it erases the bank's claim, it does not address the other potential liability traps in a distress scenario. Short sales are more appropriate for simple real estate transactions, and are usually insufficient in scenarios in which operating companies are involved.

The second is the foreclosure sale, in which the bank forecloses the assets and the buyer bids the highest price at the foreclosure sale to buy them. A close relative of the foreclosure sale is the receivership sale, in which the bank has had a court install a "receiver" to take charge of the seller's assets to protect their value. The receiver then auctions the assets similar to a foreclosure sale, and the buyer bids at the sale to become the purchaser. In some states and some courts, the receiver also can sell the assets in a private sale rather than through a public auction.[11]

In both a foreclosure and receivership sale, the buyer can obtain the assets stripped of most of the liabilities. As another alternative, buyers sometimes purchase the debt from the bank at a discount prior to the foreclosure or receivership sale in what is known as a "loan-to-own" strategy. The buyer then uses the debt as leverage to help ensure the likelihood of winning the auction.[12]

The third option is the bankruptcy sale, in which the company files bankruptcy and then sells its assets under the authority of the Bankruptcy Court. The process is known as a "363 auction" and is named after the section of the Bankruptcy Code that authorizes such sales.[13] The buyer receives an order of the bankruptcy court (the distress sale equivalent of Kevlar) stating that the assets are purchased "free and clear" of any liens, claims, encumbrances, and usually, successor liability. Thus, the buyer knows that it is likely to avoid being subjected to the claims of the seller's creditors.

The fourth is the "REO" (real estate owned) sale, in which the bank has foreclosed the assets of the seller and now owns them.

The buyer then purchases the assets from the bank instead of from the original seller, so that the buyer is even one step further removed from the seller's creditors.

Extra Diligence

When a company is in distress, following the adage "buyer beware" is not enough. A buyer usually must carefully diligence the assets and then, in many cases, develop a specific strategy to cleanse them to enjoy the benefits of the "distressed pricing opportunity." Cleansing the assets in a distress sale usually increases the transaction costs, and an open auction creates some risk that the buyer could lose the desired acquisition to another bidder.

Traditional asset purchases can work in some instances, especially in scenarios in which the assets are clearly worth less than the bank debt, the seller has market-tested the value of the assets, or the buyer is able to get a professional to issue a "fair value" opinion. But in the absence of these, the traditional asset purchase in many cases is simply not worth the risk. Distress sales are more complex than healthy company sales, and unless the circumstances are appropriate, smart buyers usually employ additional strategies to protect against inheriting the liabilities of their distressed seller. CR

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[1] See, for example, 11 U.S.C. Section 548 (applicable in bankruptcies); Uniform Fraudulent Transfer Act (UFTA)(promulgated by the Uniform Law Commission and adopted in at least 43 states and the District of Columbia). States that have not adopted UFTA generally use its predecessor, the Uniform Fraudulent Conveyance Act (UFCA) or a similar statute.

[2] *Id.*

[3] UFTA identifies certain "badges of fraud" which suggest that a transaction may be fraudulent, including that the sale is to an insider. See UFTA, cmt to Section 4 (available on the internet at www.law.upenn.edu/bll/archives/ulc/fnact99/1980s/ufta84.pdf). See also *Boyer v. Crown Stock Distribution, Inc., et al.*, 587 F.3d 787 (7th Cir. 2009)(leveraged buy-out found to be a fraudulent transfer); *In re Iridium Operating LLC*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007)(payments under contract attacked as fraudulent conveyances for alleged lack of fair value); *Lumpkins v. McPhee*, 59 N.M. 442, 286 P.2d 299 (1955) (while transfer of all assets indicative of fraud, transfer held not fraudulent because full consideration paid).

[4] See Uniform Commercial Code Section 9-315(a)(1) ("a security interest or agricultural lien continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest or agricultural lien"); Section 9-509(c) ("By acquiring collateral in which a security interest or agricultural lien continues..., [the buyer] authorizes the filing of an initial financing statement, and an amendment, covering the property [by the creditor against the buyer]); Section 9-102 cmt 2(a) ("By including in the definition of 'debtor' all persons with a property interest..., the definition includes transferees of collateral").

[5] For examples of frequently overlooked liens, consider the Perishable Agricultural Commodities Act, 7 U.S.C. Section 499a *et seq.*, the Packers & Stockyards Act, 7 U.S.C. Section 181 *et seq.*, and even IRS liens, which the 6th Circuit found in *In re Spearing Tool and Manufacturing Co. Inc.*, 412 F.3d 653 (6th Cir. 2005) can sometimes be secret liens. Also, consider the potential for constructive trusts, which effectively constitute secret liens. 76 Am. Jur. 2d Trusts Section 168.

[6] See, for example, Uniform Commercial Code Section 507 and comment 3 thereto (stating that "any person seeking to determine whether a debtor owns collateral free of security interests must inquire as to the debtor's source of title").

[7] See Marie T. Reilly, "Making Sense of Successor Liability," 31 *Hofstra Law Review* 745 (2004). Another potential theory for imposing successor liability is referred to as the "de facto merger" theory, which is similar to the "mere continuation" theory, and often is difficult to distinguish.

[8] For a discussion of the products liability theory, which originated under California state law, see *Nelson v. Tiffany Indus., Inc.*, 778 F.2d 533 (9th Cir. 1985) and *Ray v. Alad Corp.*, 19 Cal.3d 22, 28, 136, Cal.Rptr. 574, 560 P.2d 3 (1977)(noting that justification for imposing strict liability upon a successor to a manufacturer under the product line theory rests upon "(1) the virtual destruction of the plaintiff's remedies against the original manufacturer caused by the successor's acquisition of the business, (2) the successor's ability to assume the original manufacturer's risk-spreading role, and (3) the fairness of requiring a successor to assume a responsibility for defective products that was a burden necessarily attached to the original manufacturer's good will being enjoyed by the successor in the continued operation of the business").

[9] See, *e.g.*, *Whelco Industrial, Ltd. v. U.S.*, 503 F.Supp.2d 906 (N.D.Ohio 2007)(buyer at receivership sale is successor for purposes of federal law and federal tax liens); *LKS Pizza, Inc. v. Com. ex rel. Rudolph*, 169 S.W.3d 46 (Ky. App. 2005) (buyer at foreclosure is not a successor for purposes of state tax law); *Continental Ins. Co. v. Schneider, Inc.*, 810 A.2d 127 (Pa. Super. 2002) (finding successor liability possible despite UCC sale); *State v. Standard Oil Co.*, 313 N.E.2d 838 (Ohio 1974) (no successor liability for deed in lieu); *Bank of Commerce v. Woods*, 585 S.W.2d 577 (Tenn.1979) (successor liability for deed in lieu, and potentially for foreclosure).

[10] For a recent example, see *Bridgeport Holdings Inc. Liquidating Trust v. Boyer (In re Bridgeport Holdings, Inc.)*, 388 B.R. 548 (Bankr. D. Del. 2008). The acts of management are often closely scrutinized after the fact in the insolvency arena.

[11] See, *e.g.*, 28 U.S.C. Section 2001 (applicable to federal receiverships).

[12] For a full discussion of loan-to-own strategies, see Bobby Guy, "How Pro's Play the Loan-to-Own Game: Pricing and Buying Distressed Debt," *The Distressed Debt Report*, July 13, 2010 (Dealflow Media).

[13] See 11 U.S.C. Section 363(f), which provides for sales free and clear of liens, claims, and encumbrances. See also I*n re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003)(finding that Section 363 sales can be free and clear of "successor liability").

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