

DISTRESSED M&A – Stalking Horse Bids in Insolvency



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Stalking Horse Bids in Insolvency

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- Court-supervised sale “as a going concern” of the assets and business of a distressed company
- Pursuant to a “pre-plan” CCAA proceeding
- “Stalking horse” process
- No creditor approval
- No shareholder approval
- “Need for speed” – “melting ice cube” assets

Prominent recent examples

- Lehman sale to Barclays - \$43 billion
- Sale of General Motors to US Treasury - \$48 million
- Sale of Chrysler to Newco and Fiat - \$2 billion
- Chicago Cubs, Phoenix Coyotes
- Nortel divisions – \$4 billion - wireless, ethernet and networking business units, patent portfolio
- Canwest – not part of a joint Canada/US proceeding
- A&B Sound, Pope & Talbot, Grant Forest Products
- ***But see*** Cliffs Over Maple Bay and Forest & Marine Finance

- Historically, the large restructurings involved prolonged and complex negotiations among creditor classes
- Aimed at developing and implementing a comprehensive plan to rehabilitate an insolvent company
- Complicated process - compromises of creditor claims were approved in creditor meetings
- Expensive labour and time intensive business aimed at giving a company and its incumbent management the “breathing space” needed to develop a business plan and to effect operational changes

What are the drivers of the new reality?

1. New players dominate the debt market
2. Debt is now extensively securitized
3. Capital structures have become more complex
4. Drift towards laxer covenant patterns
5. Influence of U.S. practises in cross-border restructurings
6. Legislative changes in Canada

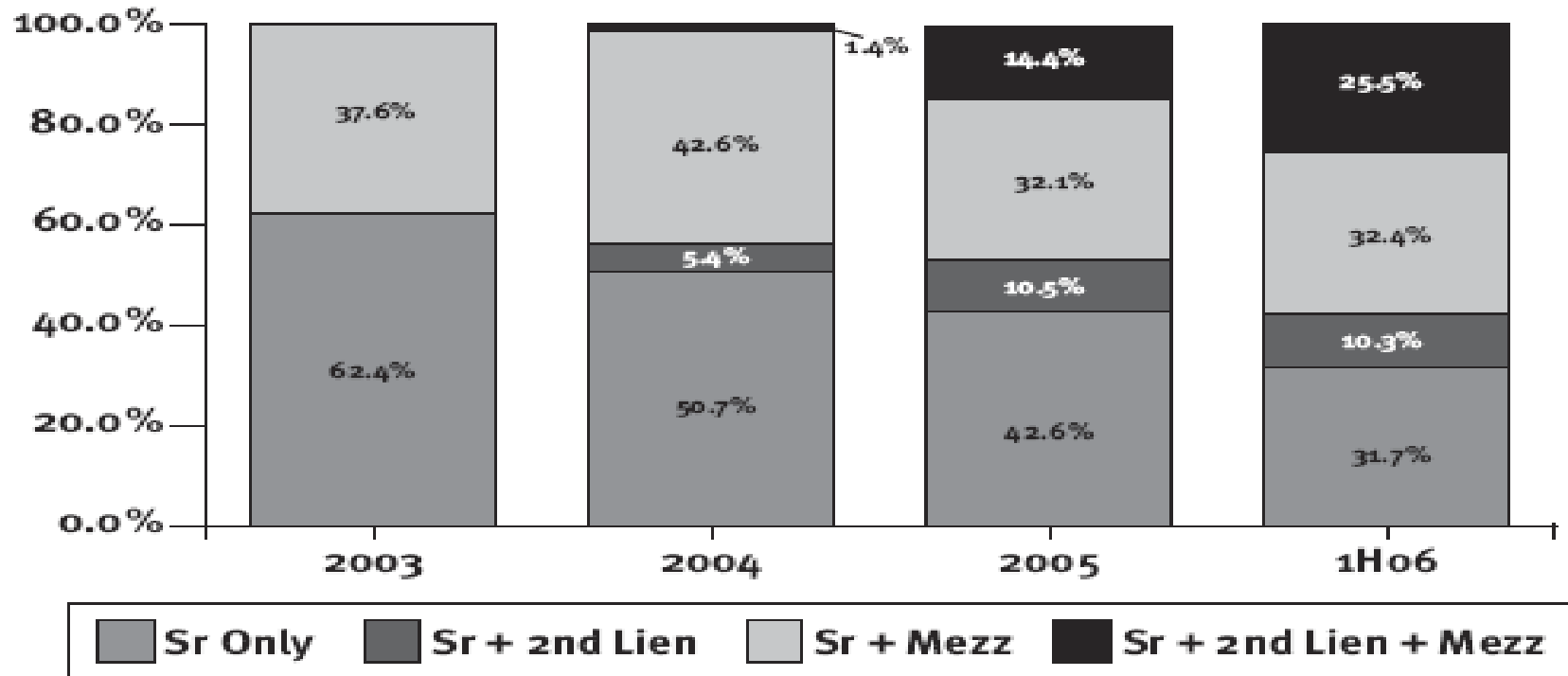
- Traditional lenders were “renters of money” - their objective was to be repaid – not really interested in converting into equity in a meltdown
- Bank lenders perform a thorough credit analysis and view borrowers in terms of long term customer relationship
- Negotiated credit agreements that gave them the ability to closely monitor and exercise control over their borrowers
- In a meltdown, the failing loan was sent to the “special loans” dept to orchestrate a restructuring of the debtor company

The World has Changed - Restructuring Dynamics Have Become More Complicated

- Large companies now have complex multi-level capital structures
- Extensive syndication at each level – securitization spreads credit risk broadly - original underwriting syndicate likely to have sold down
- Parties are continually trading in and out of positions - by the time a default occurs, the original creditor is no longer much of a factor - may be simply acting as a servicer of the loan
- Parties with CDOs may prefer a bankruptcy liquidation to trigger a swap

- Traditionally, the senior lender controlled the bankruptcy process
 - First ranking security interest giving control of asset sales and DIP financings
 - Entitled to standstill and payment blockage on junior debt in event of default
- Now – second lien and mezzanine tranches, PIK/toggle, etc.
- Debt gravitates to holders with a “trading” mentality as the debtor gets closer to insolvency
- Credit arbitrage – plays hold debt across capital structure for tactical purposes

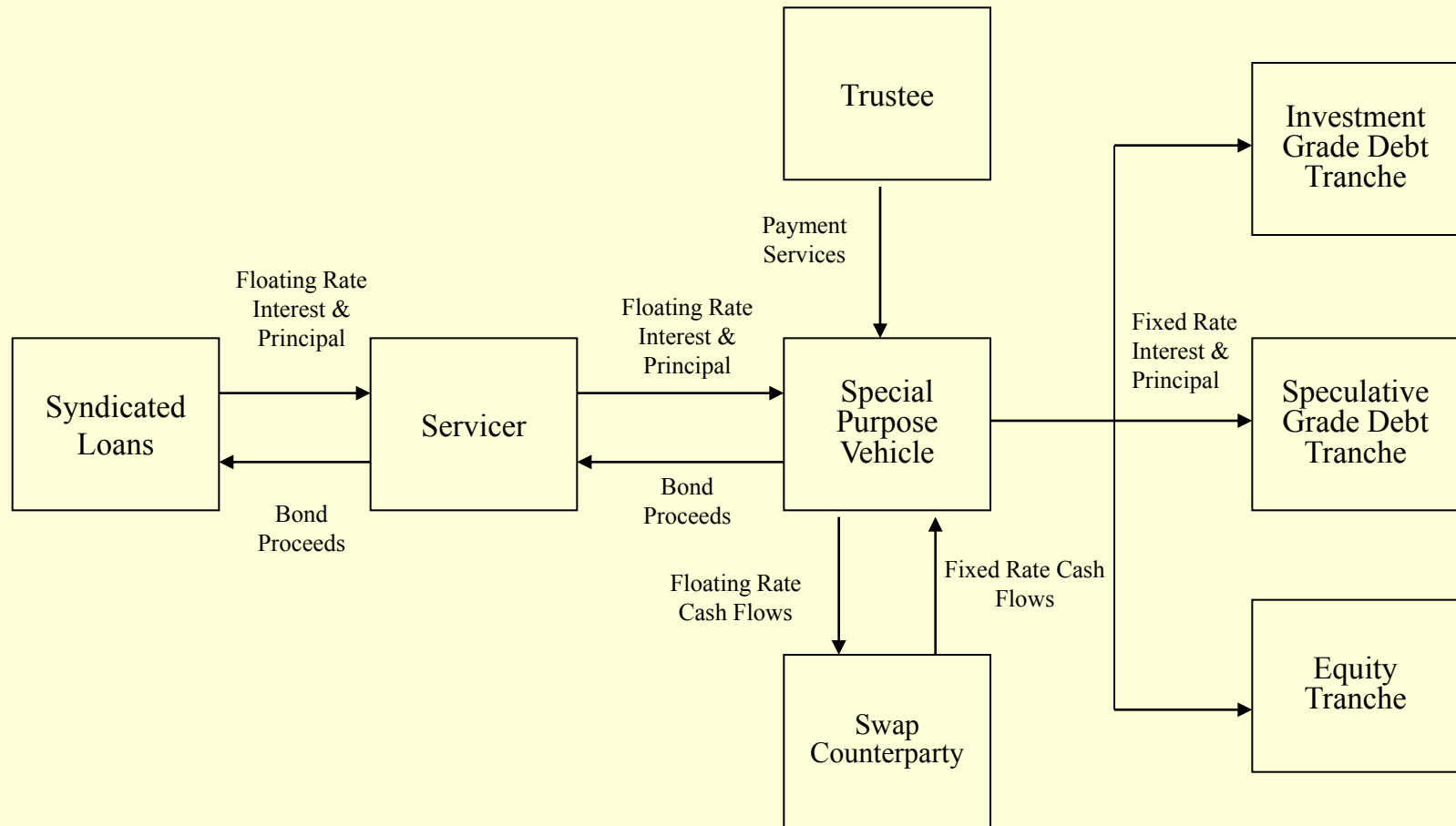
The Move to Multi-Layer Capital Structures prior to the economic meltdown



Source: Standard & Poor's
LCD

- Convergence of lending and bond markets – even bank debt now a “tradable” commodity - extensively securitized and held by new players with a trading mentality
- Private equity funds
- Hedge funds
- Other non-bank lenders
- Structured investment vehicles or conduits
 - Collateralized debt obligations – CDO’s
 - Collateralized loan obligations – CLO’s
 - Credit derivative swaps – CDS’s

Securitization - CLO Fund



- Risk spreading now goes far beyond traditional bank syndications – even traditional lenders do not hold the loan on their balance sheets long term
- Credit analysis now secondary to the ability to “sell down” the loan
- Credit is now “sliced and diced” and sold down to unregulated entities – no capital requirements or investment restrictions (e.g., industry concentration or size of loan participation)
- Buying a security rather than a negotiated document, with the expectation that a fluid market will provide an exit

- *Maintenance covenants* – require the borrower to maintain a defined level of financial performance in order to avoid default – e.g. minimum net worth or minimum debt service ratio
- *Incurrence covenants* – applied only on an “episodic” basis – e.g. when the debtor proposes to incur additional debt or make a restricted payment – prohibited unless net worth exceeds \$X or debt service ratio exceeds X/X
- Implications of lax covenants – no early warning protections - the first default may be a payment default

- In the current downturn, Distressed M&A has emerged as the preferred “work out alternative” in a variety of situations
- Distressed M&A is the pre-plan sale of a financially distressed company as a going concern pursuant to a Section 363-like Court supervised sale process
- Bears a greater similarity to conventional M&A than the traditional receivership-sale process

- Stalking horse bids are commonly used for business sales under §363 of the U.S. Bankruptcy Code
- In the early 2000s, Canadian Courts began approving their use in cross-border insolvencies
- However, their use in domestic insolvencies is not yet well established
- The traditional two-stage private sale process is still most common

- In the U.S., liquidation of assets follows a codified approach requiring a transparent auction
- Once the stalking horse bid is in, there is a formal process for submission and consideration of subsequent bids on the same terms & conditions – i.e. *a two-stage process*
- An approval date is set, with the understanding that is the date to submit overbids on the same or substantially similar terms, which will be open to inspection

1. The debtor engages in a marketing process to find potential purchasers
2. A “stalking horse” bidder is selected and, jointly with the debtor, presents a fully negotiated asset purchase agreement to the Court
3. The parties propose and the Court approves a post-signing competitive bid procedure
4. Before any sale is approved, a court-supervised auction is conducted

- Good faith deposit
- limited reps & warranties and indemnities – “as is, where is”
- limited conditions to closing – deal certainty
- break fee, reimbursement of costs or topping fee
- limited no-shop clause
- overbid increment protections
- RoFR / Matching right

- Minimum bidding increments
- Approved form of purchase and sale agreement
- Standard bidder qualifications
- Approval of break fee
- Expense reimbursement to stalking horse if outbid
- Proof of ability to close promptly
- Proof of financing

- Short time periods are established between the signing of the agreement with the stalking horse and the Court-supervised auction
- Due diligence by the second round bidders is limited
- Offers must be based wholly or, at least substantially, on the initial agreement and bidders must post a refundable deposit
- Bidders must “overbid” the initial stalking horse bid by some defined increment at a sale hearing
- In the event of a “topping” bid, the stalking horse receives a break fee (typically 1-3%) and expense reimbursement

■ Pros

- a “floor” price can increase value
- provides certainty of a transaction and short-term stability
- reduces due diligence resource demands
- alleviates concerns over management self-interest or bid shopping

■ Cons

- the top bidder may have been prepared to pay more
- the break fee may reduce recovery to the estate
- other bidders may not accept the stalking horse's terms & conditions (or would pay more with different ones)
- other bidders may not have confidence in the stalking horse's due diligence

- Strictly speaking, it is not necessary to have a stalking horse
- Nevertheless, a stalking horse is always part of the process
- Having a stalking horse bid establishes a price floor, kicks off the bidding process and ensures that a sale will be consummated
- It is a way of ensuring that the time and cost of setting up a Court-supervised auction process will be justified

- Opportunity to tailor the due diligence process and the terms of the sale agreement to its particular issues or concerns
- Opportunity to be involved in designing the sale process and bidding procedures
- Advantages of time to thoroughly analyze and thoroughly understand the target's assets before the bidding process starts
- Opportunity to develop relationships and understandings with creditors, suppliers and other key participants in the process

- Other potential buyers get a late start and are forced to scramble with their due diligence
- For the most part, restricted to the form of purchase agreement entered into by the stalking horse
- Subject to minimum overbid requirements and to the stalking horse's right to match
- Must respond in a very attenuated time period

Legal Considerations for the Stalking Horse Bidder

- Is there expense reimbursement if overbid?
- Will the break fee be approved?
- Do the bid terms of procedures advantage the bid or will they risk disapproval?
- Is there a RoFR?
- Will approval require a plan of arrangement?
- Is there sufficient stakeholder support?

- Does the process meet the *Soundair* principles?
- Has there been enough marketing?
- Will the Court see the terms as fair? (e.g. management incentives)

- Are the purchase terms fair?
- Are the bid qualifications fair?
- Is there an opportunity to challenge or reopen the process?
- Is the break fee excessive?

- The U.S. stalking horse approach crept into Canada in the context of Canada/U.S. cross-border workouts
- The cross-border joint CCAA/Chapter 11 cases follow a co-operation protocol, which may make the Canadian Court more likely to endorse a stalking horse procedure
- Examples:
 - PSI.net Ltd.
 - Agribiotech Canada Inc.
 - Mosaic Group Inc.
 - Archibald Candy Corp.
 - Nortel Networks
 - Pope & Talbot

- Business or units may be sold in receivership, or more commonly in last 25 years in proceedings under the *Companies' Creditors Arrangement Act (CCAA)*
- In either case, there is much less statutory prescription of process than in U.S. Bankruptcy Code
- More is left to Court discretion, allowing for process to be tailored to the individual situation and to evolve over time

- Court approval is governed by *Soundair* principles. Court considers whether the receiver or debtor:
 - made a sufficient effort to get the best price and has not acted improvidently
 - considered the interests of all parties
 - considered the efficacy and integrity of the process by which offers were obtained
 - considered whether there has been unfairness in the working out of the process

- Data room prepared for due diligence
- Advertising for prospective bidders
- Information package and CA distributed
- Deadline for completion of due diligence and site visits
- Deadline for letters of intent or indicative bids
- Selection of preferred bidder(s)
- Deadline for definitive agreement
- Court approval and closing

- Bids are kept confidential to avoid bid shopping, and thereby promote confidence and maximize final bids
- As a result, at the approval hearing the Court will not entertain overbids absent extraordinary circumstances
- Disclosure prior to approval of bid price or terms in such a process would likely be seen to violate the *Soundair* principles

- Because overbids are not entertained, sellers can generally avoid bid protections, cost indemnities and break fees
- At the approval hearing, the Court will usually review competing bids to consider the fairness of the process, but on a sealed basis (i.e. no transparency to other bidders)

- Thus far stalking horse bids have been considered in only a few purely Canadian cases
- Mr. Justice Farley has applied the *Soundair* principles in the context of a CCAA proceeding - A Canadian bankruptcy court (relying on its inherent jurisdiction) will sanction the pre-plan sale of a debtor's business as a going concern where proper and sufficient efforts are made to get the best price through a reasonable and effective process which is fair to all parties interested in bidding for the asset
- Results are mixed, with no general acceptance or rejection of the practice

- Stelco
- Tiger Brand Knitting Co.
- A&B Sound Ltd.
- Sky Power Corp.
- Canadian Red Cross Society
- Forest & Marine Financial Corp.
- Canwest Publishing Inc.

Asked 4 questions in approving a “pre-plan” sale

- Is the sale warranted?
- Will the sale benefit the whole economic community?
- Does any creditor have a *bona fide* objection?
- Is there a better alternative?

1. Nortel has been working diligently on a plan to reorganize
2. Nortel has concluded that it cannot continue to operate successfully within the CCAA framework
3. Unless a sale is undertaken the long-term viability of the business will be in jeopardy
4. The Sale Agreement continues the business as a going concern, will save at least 2,500 jobs and constitutes the best and most valuable proposal
5. The auction process will serve to ensure Nortel receives the highest possible value for the business
6. The sale of the business is in the best interests of Nortel and its stakeholders
7. The value of the business is likely to decline over time

- Lionel used Section 363 to sell its most valuable asset, an 82% interest in a non-bankrupt affiliate
- Lionel moved to sell it quickly at the insistence of its creditors' committee, which wanted to turn the stock into a "pot of cash" to repay creditors under a subsequent plan of reorganization
- A bankruptcy judge approved the sale, though the asset was not declining in value and there was no imminent emergency

- A group of Lionel equity holders appealed, arguing the sale deprived them of their right to participate in a Chapter 11 plan
- The 2nd Circuit overturned the sale, ruling a debtor has to have a sufficient business reason to sell assets expeditiously outside a plan and that the demand of creditors to do so is insufficient

1. The proportionate value of the asset to the estate as a whole
2. The time elapsed since the bankruptcy filing
3. The likelihood that a plan can be confirmed "in the near future"
4. The effect of the sale on a future plan
5. The value of the sale proceeds compared with appraisals of the asset
6. Alternatives to the sale
7. Whether the asset is increasing or decreasing in value (most important factor)

- Bankruptcy law reform (Bill C-12) was passed in late 2007 and has recently been proclaimed into force
- The amendments are a codification of the principal elements of Canadian court-made restructuring law as developed by Justice Farley
- Codification may impose a consistency across the various provincial jurisdictions which previously varied considerably in their interpretation of the permitted limits of the CCAA

- S.36(1) – Permits a court to authorize the sale of assets “outside the ordinary course” and without obtaining shareholder approval
- S.36(6) – The court may authorize the sale “free and clear of any security, charge or other restriction”
- Because of concern regarding constitutional limitations of the federal government to override provincial bulk sales laws the original proposals to give the Courts power to override bulk sales legislation have not been enacted

1. Whether the process leading to the proposed sale was reasonable in the circumstances
2. Whether the monitor approved the sale process
3. Opinion of monitor that sale or disposition would be beneficial to creditors than a bankruptcy
4. Extent to which creditors were consulted (notice to secured creditors is required)
5. Effects of the sale on creditors and other interested parties
6. Whether consideration to be received “reasonable and fair”, taking into account market value

- If the proposed sale is to an officer, director or controlling shareholder, the court must be satisfied that
 - good faith efforts were made to sell the assets to persons who are not related to the company
 - the consideration to be received is superior to the consideration that would be received under any other offer made in accordance with the process leading to the proposed sale or disposition

- The court may authorize the sale or disposition even if shareholder approval was not obtained
- The court may grant the authorization only if the court is satisfied that the company can and will make the priority payments to employees that would have been made if the court had sanctioned the compromise or arrangement

The sale process for a troubled company is a continuum

- The sales process typically commences prior to a bankruptcy filing
- Depending upon the “staying power” of the debtor company, a working capital deficiency, loss of critical customers, loss of suppliers, or other factors will drive the company into insolvency and necessitate a bankruptcy filing
- There are significant advantages to filing – it makes available the “full box of restructuring tools”

- Allows the incumbent management to continue in possession and operation of the business
- Automatic stay provisions provide breathing room from credit or onslaught
- Permits the “disclaimer” of contracts
- Permits assignment of contracts
- Protects buyer from fraudulent conveyance allegations
- Permits assets to be conveyed “free and clear”

- Solves the problem of non-assignable agreements and agreements which may have terminated because of the insolvency
- A Court may order the assignment of a contract *notwithstanding anti-assignment or early termination provisions*
- Excludes collective agreements, eligible financial contracts and contracts not assignable by nature

Rejection of contracts - “Take the Best and Leave the Rest”

- The Court can authorize a debtor to disclaim contracts (other than collective agreements, real property leases and eligible financial contracts)
- Right to reject contracts provides planning opportunities:
 - Either the debtor can assign all contracts, with the buyer assuming the obligations, with the attendant costs of curing payment defaults; or
 - The debtor can reject contracts, which results in additional unsecured claims against the estate for rejection damages
- Counterparty may apply to set aside the notice of disclaimer

- What is it? - Lender provides new cash in exchange for a super priority security
- Court has the authority to make an order granting a super-priority security charge on the debtors property in favor of a person who agrees to lend funds required by the company
- May also grant security to protect directors indemnification

- A Court may authorize a sale “free and clear of any security, charge or other restriction”
- Any creditor whose security is affected by such an order is entitled to a charge on the proceeds of the ultimate sale or on other assets retained by the debtor company
- What does a vesting order extinguish? - Does it, for example, extend to environmental liabilities?
- In Chrysler, extinguished personal injury and asbestos related liabilities
- In GM, extinguished environmental liabilities

- Automatic stay – no person may terminate or amend or claim accelerated payment or forfeiture of any agreement by reason only that the company is insolvent or has commenced proceedings
- Protects against challenges of transfers as fraudulent preferences
- Order requiring a “critical supplier” to supply goods or services on terms consistent with the supplier relationship or as the Court considers appropriate
- Order granting security in support of director or officer indemnities (except for gross negligence or willful misconduct)
- Leases and public utility services cannot be terminated simply for failure to pay in period prior to filing

- A financial advisor runs the process
- Confidentiality agreements and information package
- Electronic data room
- Bidders submit LOIs; finalization of due diligence
- Definitive agreement
- Market testing through an auction process
- Deal protection such as break fees and matching rights
- Court approval and closing

- The “stalking horse” auction process has the “touch and feel” of the public company sale process where directors have a fiduciary duty to endeavor to maximize the return to shareholders
- The initial bid is always subject to higher and better offers
- Bidding procedures are important
- Break-up fees – Will they be assessed on the basis of reasonableness under the “business judgment rule” (are “auction inhibiting”?) or under the principles applied to administrative claims (“necessary to preserve the value of the estate”)?

- Very public process because of court supervision and monitoring by various creditor classes
- Time pressures deriving from the urgency of the situation, ability of debtor to finance continued operations during the sale process
- Not for the faint of heart – Prospective purchasers must adjust to shorter time period than usual for completing due diligence and submitting final offer and live with an absence of any representations, warranties or indemnities
- Various added complexities inherent in the purchase of distressed assets

- Many of the potential bidders that would otherwise compete to purchase a company may be discouraged by the dire straights of the business, the complexity of the court ordered sale process and their unfamiliarity with it
- There is a limited timeframe for due diligence, and no surviving representations and warranties, and the bidder must deal with the concerns of various creditors and other stakeholders who may challenge either the process or the terms of the proposed sale
- Knowledgeable and sophisticated representation is required to successfully navigate the process

Comparison of Sale Processes

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	Traditional M&A	Distressed M&A
Opportunity for bargains		√
Potential for competitive bidders	√	√
Opportunity to conduct due diligence	√	√
Ability to obtain assignment of contracts		√
Ability to reject contracts		√
Acquisition of assets “free and clear”		√
Involvement of third parties	√	
Flexibility on type of consideration	√	
Ability to extract indemnifications	√	
Flexibility re earnouts	√	

- Knowledgeable and experienced at running sale processes
- Experienced and familiar with auction processes and deal protection features
- We have developed a sensitivity to the multiple issues involved – eliminating “tire-kickers”, protecting sensitive company information such as intellectual property, key customers, pricing margins, price models until later in the process

- Prepare teasers, offering memoranda, management presentations, data rooms, data summaries
- Manage a due diligence process
- Provide a sophisticated and nuanced approach – sensitive to the importance of running a thorough and transparent process free of conflicts of interest and in which directors can exercise their business judgment and satisfy their fiduciary obligations

Comments and Questions

