

BANKRUPTCY M&A

Buying a business in bankruptcy

BY CLAIRE SPENCER



The recession has resulted in a surge of bankruptcies across Europe. One trend in the current wave is that an increasing number of cases are being resolved through an auction sale of the debtor's assets. This may allow savvy buyers to acquire viable distressed assets at a fraction of the replacement cost. But acquisitions pursued through this route are not without risks. Indeed, sometimes assets acquired at bargain prices require a great deal of restructuring, despite their external appearance. As with any acquisition, even more so when the owners are bankrupt, buyers should conduct thorough due diligence and take on external advice from bankruptcy specialists. But performing such comprehensive due diligence is not easy given the short timeframe of a bankruptcy scenario. Rushed deals that are overpriced and poorly planned can involve additional costs and even result in litigation.

Insolvency sales across Europe

Trends regarding bankruptcy sales tend to differ slightly on a country-by-country basis – for both legislative and economic reasons – although there are commonalities. In the UK, for example, the volume of pre-packaged administrations is quite telling, notes Christian Pilkington, counsel in the Corporate Restructuring department at Skadden, Arps, Slate, Meagher & Flom. “Following the re-

forms of the Enterprise Act, pre-packs have become more prevalent in administrations. On the one hand, pre-packaged deals can enable distressed companies to reorganise their capital structure or dispose of assets quickly and efficiently, preserving value in their businesses and maximising returns for creditors. On the other, the process may lack transparency, sidestep certain procedural safeguards, be controlled by self-interested management, office holders or senior lenders, and offer no guarantees that the interests of all creditors will be properly taken into account,” he warns. This notwithstanding, their use is unlikely to decrease while the number of bankruptcies remains high, and while efficiency and preservation of jobs remain a priority for the UK economy. Further, as liquidity increases, it is more likely that buyers will step up to acquire distressed or insolvent companies.

This is also true elsewhere in Europe, at least to some extent. In Spain, there has been significant growth in the number of distressed acquisitions, although the vast majority take place as part of an out-of-court restructuring process. This is partly due to the fact that Spanish companies are still reluctant to face the stigma associated with formal insolvency proceedings, and also because such proceedings are considered slow, tortuous and expensive, explains José María Gil-Robles, a partner at Garrigues. “However, we are see-

ing an increasing number of sales taking place in insolvency proceedings – probably due to a change in the mindset of receivers and courts regarding disposals of businesses and assets, than to changes in the Insolvency Law that were approved in order to address some of these problems. Rules preventing the sale of the debtor's assets during the first stage of the court proceedings are nowadays viewed in a more flexible way, allowing debtors to dispose of assets that are not needed in their daily activities, including non-core lines of businesses,” he explains. This change in attitude is very important – in countries where bankruptcy has a powerful stigma, the true extent of distress is often obscured until it is too late.

Germany has also seen an increase in the number of insolvencies – but even the most attractive of these have often struggled to find strategic or financial buyers. “Strategic investors are often also affected by the worldwide crisis, might be afraid of the uncertain economic developments, or are not able to generate enough funds to provide the purchase price and working capital for the next few years,” explains Dr Annerose Tashiro, a partner at Schultze & Braun. “Banks are often reluctant to agree on a loan. Private equity investors have their own issues – they do not have a good standing in Germany, although they often bring the right people and level of professionalism to rescue the business.” Consequently, she recommends that any financial investors looking to acquire distressed assets or businesses in Germany are careful to demonstrate their approach in details, show their ability to understand the industry or company culture and problems and be transparent with their structure and costs and fees.

The UK, Spain and Germany have all been hit by the economic downturn – and while Poland has too, so far it has proved more resistant to negative forces. “Nevertheless, Polish enterprises also suffered as a result of the crisis, which is reflected by the 50 percent plus increase in the number of declared bankruptcies, compared to 2008. However, it should be noted that in recent years the number of such bankruptcies was decreasing steadily, and in 2005 was higher than at present, whereas this

number was several times lower at the beginning of the decade,” notes Dominik Gałkowski, a partner at Kubas, Kos, Gaertner – Adwokaci sp.p. He also explains that the time elapsed between a declaration of bankruptcy and a sale – with the exception of stocks and goods – is at least several months, so an increase in the supply of distressed businesses and assets is yet to occur, although it probably will further down the line.

Auction variance

Distressed sales often take the form of an auction, which is typically thought to be the clearest way of accurately defining what an asset is worth, and getting the best price for that asset. “This view is probably still shared by most sellers, although they should acknowledge that the current downturn means that now may not be the best time to sell assets. Sellers may be able to get a better price if they can wait – although this is not certain as things may still get worse before they get better,” says Partha Kar, a partner in the European Restructuring Group at Kirkland & Ellis International LLP. “Auctions have generally been the default way of selling assets and their use may have increased in the current downturn as sellers try to maximise returns, but other methods may be more appropriate, particularly in certain sectors where there may be large strategic buyers and market consolidation is taking place, such as a stalking horse sales process.” He adds that, ultimately, the seller will generally choose the method that they feel will secure the best price.

Indeed, auction sales are not uniformly prevalent in distressed situations. “Most of the distressed sales that we have seen recently have taken place in bilateral deals rather than through auctions, which are still a rarity in Spain when it comes to distressed sales,” explains Mr Gil-Robles. “Confidentiality concerns remain the main obstacle for auction-based sales in the case of refinancing processes. This should be less of a problem where the debtor has reached a standstill agreement with its main creditors, preventing them from rushing off to court to petition for an insolvency order or enforce any security that they may have. However, being viewed as insolvent by customers and suppliers is a concern, even in these cases,” he says. Bilateral agreements are also more common with regards to court proceedings, partly because courts and receivers do not want to face the costs associated with auctions. However, Mr Gil-Robles adds that involved parties are normally (but not always) informed about the sale before it is approved by the court, giving them the chance to put together a better offer.

Furthermore, in Germany, auctions have never been a popular sale option among administrators, explains Dr Tashiro. “Conducting an auction requires the administrator to firstly decide the scope of the asset deal and to issue a concrete offer to which the interested parties can make their bid. This – to some extent and from the perspective of an administrator – would limit the chances of obtaining the best offer. Another issue is that administrators like to receive complete concepts, especially in circumstances when large parts of the business are for sale. It is not always the case that the highest bid wins the sales process; sometimes it comes down to the best concept – the concept that has the best chances for a sustainable turnaround and restart, that gives the most people a new job, or that has the financial background for working capital,” she explains. As such, a pure auction process would limit these possibilities and perspectives for the insolvency administrator. Nonetheless, there are advantages to using the auction process in Germany – firstly, a seller can prepare the deal, and easily compare the bids without having to compile ‘concepts’. Importantly (at least to them), it also allows them to pick the highest bidder.

In Spain, auctions compare unfavourably to bilateral deals on the grounds that the amount, and indeed the accuracy, of information on the assets is generally more limited. As such, potential purchasers will generally factor that in when making a bid. “In theory, auctions lead to higher prices, but only when there are enough investors willing to acquire the same assets,” adds Mr Gil-Robles. “As demand for certain assets has evaporated, and financing acquisitions becomes increasingly difficult, it is not unusual nowadays to see unsuccessful auctions. The timing and costs of auctions can also explain the prevalence of bilateral sales. Internet-based auctions are an attempt to address these concerns, as they are speedy and most auction websites have success-fee policies,” he notes. As mentioned earlier, the prices achievable through auctions should normally be higher than those obtained in bilateral sales, but this requires a certain degree of interest in the assets to be sold that is absent in most cases.

Ultimately, sellers should be drawn to the auction process on the grounds that it reflects the true market value of the assets being sold at the time of the sale – after all, an asset is only truly worth what someone is willing to pay for it, asserts Mr Kar. “Of course, other issues come into pricing, such as the type and level of information available to prospective buyers, the risks that the seller would like to be taken

on by prospective buyers, and so on. The type of sale process used itself may not be determinative of the price ultimately achieved. Other critical factors include the quality of the assets, but also the quality of the sales process and ensuring the right group of prospective buyers participate,” he adds. Of course, it is partly due to these other considerations that pre-pack bankruptcy sales are becoming so popular in the UK, although these are not technically considered to be an auction sale. To supporters of the process, it offers the prospect of a successful turnaround with minimum disruption and reduced risk of a decline in the reputation, employees, assets, customers and suppliers of the business. Furthermore, associated costs tend to be far lower than is the case in similar processes.

Risks and realities

The clarity, ease and reliability of most auctions have made them a popular choice in the sales process, particularly in the current climate, where uncertainty still prevails to some extent. However, it is important that sellers come to terms with reality – a fair price in the current market may be some distance away from what they consider a fair price to be. “In Germany, auctions are only really an option in cases where the business is not too complex, and where there are not many options and alternatives to restructure,” explains Dr Tashiro. “In these circumstances, the auction can reach a better price and the outcome will be easier to handle and simpler to compare. In the current economic climate, however, it is not too easy to find interested buyers, so a streamlined auction process might limit the administrator’s choices, as well as the buyer’s concepts, and ultimately have no positive effect,” she warns.

Nonetheless, sellers do have options, although they are somewhat limited. Buyers are better-placed, but should ensure that they take the time to make wise choices. “Transactions performed in the course of bankruptcy proceedings require a similar level of attention and preparation from the purchaser as in case of other transactions,” says Mr Gałkowski. “However they might require putting more effort into preparing the business analysis, as the enterprise being sold has already lost its market position. Despite the fact that the legal situation of a purchaser is fairly secure, by no means should he resign from comprehensive legal support of the transaction, since despite general regulations leading to the purchase of the bankrupt’s estate without encumbrances and third parties’ claims, there are exceptions which should be thoroughly analysed in each case,” he cautions. Similar concerns exist for

the UK's pre-pack structure, adds Mr Pilkington. "Critics argue that where the business of the insolvent company is sold in a pre-packaged transaction, the market may not have been properly tested, resulting in the business being undersold and a smaller return for junior or trade creditors. Concerns about the objectivity of the process are increased if the pre-pack involves a sale of assets to existing management or shareholders, which is common in the UK," he says, explaining that the process can sidestep procedural safeguards, and as such, does not protect the interests of all creditors who may have limited opportunity to object to or participate in the process.

The need for due diligence is more acute outside of a firesale. However, in certain countries, this is often complicated by a general lack of information surrounding the assets to be sold. Buyers must do what they can, but ultimately, sometimes the only way to manage the risk is to pay the lowest price possible, or indeed walk away. It can help to set a pre-determined price, and stick to it – rather than get caught up in the

competitive nature of the bidding process. Furthermore, there may be no need to offer the best price if a buyer can offer the best overall deal – which will go a long way in countries like Germany, where employee rights are particularly strong. Realistically, all a buyer can do is ensure that they fully understand the assets or business they are looking to buy, and its associated risks, and that they forecast the prospects for the business to the best of their abilities, bearing in mind the difficulty of doing so in the current economic situation.

In general then, the purchase of an enterprise or its elements in the course of bankruptcy proceedings is a favourable solution for the purchaser. As Mr Gałkowski points out, this is largely on the grounds that it generally leads to the purchase of the assets with an unencumbered status and free of third parties' rights and the purchase is not liable for the tax obligations of the bankrupt entity. "In the case of the purchase of an enterprise, the purchaser also acquires all concessions, permits, allowances and licenses. The purchaser of the estate from the

receiver in bankruptcy is also able to evade the claims of third parties which could arise in a situation in which the enterprise is bought directly from the entrepreneur, particularly if the entrepreneur is in a difficult financial situation and the purchaser must take the possibility of charges being made by the seller's creditors, which will maintain that the transaction was performed in order to cause damage to them, into account," he notes.

Based on the current environment, it is likely that the number of bankruptcy sales will rise throughout 2009 and into 2010 across Europe, roughly aligned with the number of bankruptcies as a whole. This should be good news for both strategic and financial buyers in a position to acquire, but they will still need to act with caution – due diligence is a must, even if bankruptcy seems to have stripped the target of its liabilities. As for sellers, they must be prepared to sell at the price the market dictates – assets are only ever worth what a buyer is willing to pay for them, and many sellers may have few options in the short to medium term. ■



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