Distressed M&A
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LEXOLOGY
Getting The Deal Through

United States

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MARKET CLIMATE AND LEGAL FRAMEWORK

Market climate

1 | How would you describe the general market climate for distressed M&A transactions in your jurisdiction?

In general, US M&A activity faced a significant contraction in the first nine months of 2020, falling approximately 38 per cent by deal value as compared to the first half of 2019, according to Mergermarket. The drop was primarily driven by the 65 per cent drop in deal value during the first half of the year, although there was a significant rebound in the third quarter of 2020 relative to Q2 activity. The decline in US M&A activity is primarily attributable to the effects of covid-19, which has created significant economic uncertainty and weakened business confidence. However, contrary to expectations, there has not been a significant uptick in distressed US M&A in 2020 as of yet, and data indicate that the volume and value of deals in 2020 involving a bankruptcy, liquidation or wind-down is similar to figures seen in previous years. This is, in part, attributable to the debt and rent payment deferrals many companies have obtained; debt and equity financings that companies have done to shore up balance sheets; and unprecedented government stimulus to support consumers and businesses through the pandemic. We may see an increase in distressed M&A towards the end of 2020 and in early 2021 if the business climate does not improve.

Legal framework

2 | What legal and regulatory regimes are applicable to distressed M&A transactions in your jurisdiction?

In the United States, distressed M&A transactions are regulated by the corporate law of the US state in which the buying and selling companies are organised. State corporation laws regulate the corporate requirements for effecting transactions (including the required support of shareholders) and the fiduciary obligations of directors. In the corporate context, the legislation and jurisprudence of the State of Delaware and its courts have been particularly influential given the number of US corporations that are organised in Delaware. Transactions involving public companies are also subject to the federal securities laws and the oversight of the US Securities and Exchange Commission.

If a distressed seller has filed for bankruptcy protection (such bankrupt entity, a 'debtor'), any sale process it conducts will be subject to the supervision of the bankruptcy court where it has filed and must comply with the applicable requirements of Title 11 of the United States Code (the Bankruptcy Code). Certain provisions of the Bankruptcy Code override provisions of state corporate law, such as requirements that a sale of substantially all of a debtor's assets be approved by its shareholders.

Main risk in distressed M&A transactions

3 | Summarise the main risks to all parties involved.

Often the most significant risk to the buyer in a distressed M&A transaction is that the seller is in distress for a reason. Whether this is due to a poor industry environment, an outdated business model or significant liability exposure, the buyer faces the risk that these problems will travel with the assets or entity being purchased. This risk can be amplified by the fact that the seller may have an immediate need for cash, leading to a compressed sale timeline and due diligence process, which in turn can make it more difficult to uncover all material risks to the buyer. Additionally, if a distressed asset sale is conducted out of court, there is a risk to the buyer that the seller will become insolvent following the sale, potentially making any post-closing obligations of the seller practically or legally unenforceable and opening up the buyer to fraudulent conveyance or successor liability claims. However, these risks are often offset by the ability to purchase distressed assets at more attractive prices.

Typically, the most significant risk to a seller in a distressed M&A transaction is execution risk. If a seller is in acute distress and a proposed sale falls through, it may need to file for bankruptcy. If the seller is already in bankruptcy, an asset sale may be the best way to maximise recoveries for its creditors. Failure to consummate an asset sale could prevent a debtor from successfully emerging from bankruptcy.

Director and officer liability and duties

4 | What are the primary liabilities, legal duties and responsibilities of directors and officers in the context of distressed M&A transactions in your jurisdiction?

Generally speaking, state corporate law imposes upon directors certain fiduciary duties to a corporation and its stockholders. The contours of these duties vary across jurisdictions, but in the M&A context these duties require directors to seek to maximise value for the company's stockholders and, once the company becomes insolvent, for the company's creditors as well. Once insolvent, creditors become the residual claimants of the company's value and are thus recognised as an additional constituency to which fiduciary duties are owed.

Differences from non-distressed M&A

5 | In general terms, what are the key legal and practical differences between distressed and non-distressed M&A transactions in your jurisdiction?

Unlike non-distressed M&A, which is usually conducted bilaterally between buyer and seller, distressed M&A can be a multiparty transaction involving lenders, other creditors, customers and other stakeholders (and, for in-court transactions, the bankruptcy court itself). In such a setting, the competing interests of the various parties add additional challenges to navigate. For instance, when considering how to structure a sale process involving several potential buyers, stockholders or out-of-the money creditors may prefer a longer process in the hope that it will result in greater interest and greater value, whereas secured creditors might prefer a faster transaction that guarantees repayment of their debts regardless of whether a different process has the potential to generate value for the benefit of unsecured creditors.

Timing of transactions

6 What key considerations should be borne in mind when deciding when to acquire distressed companies or their assets?

Distressed companies may seek to avoid filing for bankruptcy because of the significant procedural and financial burden involved. An out-of-court transaction is typically faster and simpler than an in-court transaction, with the timing to closing depending upon any required stockholder approval and regulatory review. Out-of-court transactions may also avoid potential reputational damage of bankruptcy on relationships with other constituents, such as customers and employees. However, pre-bankruptcy transactions may leave the buyer subject to successor liability or fraudulent conveyance claims by the seller's creditors.

TRANSACTION STRUCTURES AND SALE PROCESS

Common structures

7 What sale structures are commonly used for distressed M&A transactions in your jurisdiction? What are the pros and cons of each, and what procedures and legal requirements apply?

The sale of a distressed company or its assets can be effected in court or outside of formal bankruptcy proceedings. An out-of-court sale offers the seller and buyer the greatest freedom to contract and options for transaction structuring, and avoids the complexity of multiparty negotiations. However, unlike a sale in bankruptcy, an out-of-court transaction in a distressed situation offers a less clear path for bidders to acquire the target or its assets free and clear of all liens and encumbrances. As a result, out-of-court buyers in a distressed situation are likely to prefer an asset purchase over a merger or stock purchase because the buyer can, in principle, acquire those assets and liabilities of the seller that it wishes and leave everything else behind.

In-court M&A transactions are typically implemented as sales conducted pursuant to section 363 of the Bankruptcy Code or through a Chapter 11 plan of reorganisation.

Most in-court asset sales are conducted as 363 sales, as they are simpler and faster to complete than transactions implemented through a plan of reorganisation. For a debtor to sell its assets outside the ordinary course of business under section 363, it must provide notice to interested parties and obtain court approval of the sale. To obtain court approval, the debtor typically must show that the proposed sale constitutes the 'highest and best' offer for the assets, which it is able to do by running an auction process in accordance with bidding procedures that it has approved by the court.

In-court transactions are typically implemented through a plan of reorganisation when there is some transaction-specific reason why it would be preferable to acquire the equity of a debtor instead of its assets (for example, to preserve the seller's tax attributes or retain any non-transferable IP or permits held by the seller). By acquiring through a plan, an acquiror can use the Chapter 11 process to shape the business and liabilities of the target whose equity it is acquiring by, among other things, rejecting unfavourable executory contracts and discharging liabilities.

Transactions implemented through a plan of reorganisation typically take the form of a debt-for-equity exchange by existing creditors or the injection of new capital by a 'plan sponsor' that wishes to acquire equity of the reorganised debtor. The main drawback of a plan transaction is that it is a significantly more involved process than a 363 sale and will result in the plan sponsor being involved in aspects of the case that a purchaser in a 363 sale would not, such as the treatment of creditors under the plan and plan confirmation issues. Accordingly, most acquisitions out of bankruptcy are effected by 363 sales rather than through plans of reorganisation.

Packaging and transferring assets

8 How are assets commonly packaged and transferred in a distressed M&A transaction in your jurisdiction? What procedural, documentary and other requirements apply?

In a 363 sale, the asset purchase agreement between buyer and seller typically sets forth the terms of the transaction and identifies assets, contracts and other liabilities the buyer will assume, as well as the treatment of employees. At the closing, assets and contracts are usually transferred via a bill of sale and an assignment and assumption agreement.

In order to reorganise through Chapter 11, a debtor must draft and negotiate a plan of reorganisation specifying how different classes of creditors will be treated and describing the restructuring transactions (including any change in equity ownership) that will be implemented through the plan. Additionally, prior to soliciting creditor votes on the plan, the debtor must obtain court approval of a disclosure statement containing 'adequate information' about the plan. If the necessary votes are received and other legal requirements are met, the court will confirm the plan and it will go effective once its conditions precedent have been met. 'Pre-packaged' plans can allow the debtor to shorten its stay in bankruptcy by conducting plan negotiations and vote solicitation prior to filing.

Transfer of liabilities

9 What legal requirements and practical considerations should be borne in mind regarding the acceptance and transfer of any liabilities attached to the distressed company or assets?

Buyers in distressed M&A transactions are likely to prefer to structure a transaction as an asset purchase rather than a share purchase, because the buyer can acquire only the assets that it chooses and, unlike in a share purchase or merger, an acquiror is in principle able to leave behind liabilities not expressly assumed. In the purchase agreement itself, it is important to clearly specify what liabilities are to be assumed and to state that all other liabilities are excluded.

Under certain circumstances, a buyer may be held liable for non-assumed liabilities under the state law doctrine of successor liability. The doctrine varies across jurisdictions, but generally provides that where the buyer is a 'mere continuation' of the seller, or where a transaction constitutes a 'de facto merger' or is intended to defraud creditors, liabilities otherwise excluded from the transaction can be passed on to a buyer. By acquiring through an in-court sales process, a buyer can obtain incremental protection from successor liability, as the court order approving the sale will typically state the buyer is not a 'successor' as a result of the transaction.

Consent and involvement of third parties

10 What third-party consents are required before completion of a distressed M&A transaction? What are the potential consequences of failure to obtain these consents? In what other ways are third parties commonly involved in the transaction?

If a transaction is conducted out of court, the required third-party consents will not differ substantially from those in a traditional M&A transaction. Generally, the sale of a company or transfer of substantially all its assets requires the approval of the company's stockholders. A buyer must also obtain third-party consents to the assignment of certain contracts, and contracts that the buyer plans to acquire may contain consent or termination rights upon a change of control. Third-party consents may also be required for the transfer of any licences or permits associated with the acquired company or assets. An acquisition may also be subject to regulatory review for antitrust, national security or other industry-specific areas.

In bankruptcy, a debtor must obtain court approval under section 363 of the Bankruptcy Code to be able to sell its assets outside of the ordinary course of business. Additionally, in certain jurisdictions and under certain circumstances, for a debtor to sell an asset free and clear of a security interest in a 363 sale, it may be necessary to obtain the consent of the lienholder if the sale proceeds will not be sufficient to repay the underlying debt in full.

To implement a transaction through a plan of reorganisation, it is necessary for the court to find that the plan has met the requisite conditions in the Bankruptcy Code to be confirmed, including that at least one impaired class of creditors accepts.

Time frame

11 How do the time frames and timelines for the various transaction structures differ? Can these be expedited in any way?

Regardless of deal structure, a distressed M&A transaction may be subject to review by antitrust authorities and the Committee on Foreign Investment in the United States for risks to national security. The timetables for these reviews go to the substantive regulatory analysis and do not change simply because a company is in distress. Prospective out-of-court buyers should also be aware of the need to obtain any industry specific regulatory approvals, third-party consents or shareholder approvals.

For in-court transactions, the timing by which a transaction can close is also driven by the requirements of bankruptcy law and practice. It typically takes 60 to 90 days from the time a stalking horse bidder (ie, the bidder who submits an offer that acts as a floor in the subsequent sale process) is selected (or, if there is no stalking horse, from the start of the sale process) to complete a 363 sale, subject to any closing conditions that might extend this timing. This timing is driven by the need to receive court approval of the bidding procedures pursuant to which the sale process will be run, to offer bidders the time to conduct diligence, hold a live auction and then receive court approval of the sale. However, in exigent circumstances, the bankruptcy court may allow the process to be completed in a shorter time frame.

To implement an M&A transaction through a Chapter 11 plan of reorganisation, it is necessary to confirm a bankruptcy plan. The process of drafting and negotiating a plan, soliciting creditor votes and then receiving approval of it from the court typically takes several months. This process can be expedited by conducting plan negotiations and vote solicitation prior to filing and filing a 'pre-packaged' plan of reorganisation with the court.

Tax treatment

12 What tax liabilities and related considerations arise in relation to the various structures for distressed M&A transactions in your jurisdiction?

Most distressed M&A transactions implicate many tax considerations. Although most tax rules apply in the same way regardless of whether the transaction occurs in or out of bankruptcy, special relief is sometimes available for companies in bankruptcy.

In particular, distressed companies may incur tax or impair their net operating losses and other tax attributes in connection with a distressed M&A transaction, including as a result of the discharge, equitisation or other restructuring of their outstanding debt. If the company is not otherwise insolvent or if there is a substantial issuance of stock to creditors, the company may prefer to undertake these transactions in bankruptcy to take advantage of special relief. In addition, distressed companies undertaking substantial reorganisations may wish to take advantage of special provisions applicable only to corporations in bankruptcy.

Auction versus single-buyer sale process

13 What are the respective pros and cons of auction sales and single-buyer sales? What rules and common practices apply to each?

As in any M&A transaction, there are pros and cons to both approaches. An auction provides the best opportunity for broad price discovery and the benefits of competition to maximise value. However, an auction may take longer, require more bandwidth from the target to manage multiple bidders and be more expensive. From a legal perspective, a robust and competitive sale process can help defend the parties against fraudulent conveyance claims, because an auction results in a market price that reflects 'reasonably equivalent value'. An auction may also provide more protection to the target's board of directors to the extent their conduct in effecting a sale is subject to challenge. It is very difficult to effect the sale of a distressed business in an in-court transaction without conducting an auction of some sort.

DUE DILIGENCE

Key areas

14 What are the most critical areas of due diligence in a distressed M&A transaction?

Diligence is key to understanding how the target's distress may have impacted its business and assets. For example, the company may have deferred maintenance on its physical assets or key customers, suppliers or employees may have decided to abandon what they view as a sinking ship.

The diligence process should also focus on identifying liabilities to either exclude from the transaction or reflect in the purchase price and understanding the extent of any liabilities that may travel with the target. Although acquirors who purchase assets through a 363 sale are able to buy them free and clear of all encumbrances, an acquiror should be aware that the assets may not be cleansed of all liabilities in the sale (such as certain environmental, tax, labour and product liabilities).

It is also important for an acquiror to review the key contracts to be assigned to the acquiror in the transaction. An acquiror should review all contracts for change of control and anti-assignment provisions and should be aware of any provisions in a target's contracts that may interfere with the acquiror's use of the acquired assets or business. However, with some exceptions, anti-assignment provisions are not enforceable against entities in bankruptcy seeking to assume and assign executory contracts.

Searches

15 | What searches of public records should be conducted as part of a due diligence exercise in distressed M&A transactions in your jurisdiction?

A potential acquiror in a distressed M&A transaction should search federal, state and local public records and litigation dockets for judgment liens, tax liens, lawsuits, financing statements and other encumbrances that might be attached to the assets to be acquired. An acquiror should also perform confirmatory diligence on the seller's IP assets. Although acquirors in in-court transactions can purchase assets free and clear of encumbrances, it is important to ensure that the seller is providing adequate notice of the free and clear sale to all holders of publicly filed interests in the assets so that the 'free and clear' provision of the sale order is effective against these interest holders.

If the seller is in bankruptcy, a potential acquiror should review the bankruptcy docket to understand relevant background information about the target and its bankruptcy case.

Contractual protections and risk mitigation

16 | What contractual protections and other strategies are commonly used to mitigate diligence gaps in a distressed M&A transaction?

In private out-of-court M&A transactions, purchase agreements frequently include indemnification provisions for breaches of representations and warranties (and buyers are typically able to negotiate for broad representations and warranties covering many aspects of the target's business). However, the US M&A market has seen the increasing prevalence of representation and warranty insurance in lieu of (or as a supplement to) typical indemnification obligations from sellers. In 363 sales the number and scope of representations and warranties will tend to be more limited than in a non-bankruptcy context. Additionally, a distressed target may be unwilling to agree to an indemnity and, even if it is willing, the buyer may have difficulty recovering any amount owed if the seller's distress continues unless the indemnity is secured by a holdback or escrow arrangement to support the indemnity obligation.

VALUATION AND FINANCING

Pricing mechanisms and adjustments

17 | What pricing methods, adjustments and protections are commonly used in the valuation of distressed M&A transactions in your jurisdiction and what are the pros and cons of each? How are they used to balance the interests of the parties?

Like in non-distressed M&A transactions, purchase agreements in distressed US M&A transactions typically calculate the purchase price on a cash-free, debt-free basis and may include a net working capital adjustment mechanism. However, unless the seller agrees to an escrow or holdback, the buyer is taking a risk that the seller will not be able to pay any adjustment to the buyer. Other typical mechanisms for calculating purchase price are less common in the United States (including locked box structures), although not unheard of. Although earn-out provisions ordinarily can help to align parties with differing valuations of a business, attempting to negotiate an earn-out with a seller with immediate liquidity needs may disadvantage a potential acquiror's offer.

Fraudulent conveyance

18 | What rules govern fraudulent conveyance of distressed assets sold undervalue in your jurisdiction? How can clawback risks be mitigated when negotiating the deal price?

In the United States, fraudulent conveyance or transfer laws are a feature of both state law and the Bankruptcy Code. Generally, creditors of an insolvent company may be able to 'claw back' a sale of the company's assets or seek recourse against the buyer if a court finds that the transfer of the assets constituted a fraudulent transfer. Generally, a buyer of assets may be liable for either 'constructive' or 'actual' fraudulent conveyance. A transfer is an actual fraudulent conveyance if it was made 'with actual intent to hinder, delay, or defraud' creditors. A transfer is constructively fraudulent if the seller:

- did not receive 'reasonably equivalent value' as consideration for the assets sold; and
- was insolvent at the time of the sale or became insolvent as a result of the transfer; was engaged in, or about to engage in, a business or transaction for which any property remaining with the company was 'unreasonably small capital'; or intended to incur, or believed that it would incur, debt that would be beyond its ability to pay as such debt matured.

A bankrupt company or its creditors may seek to avoid purported fraudulent conveyances made within the two years preceding the bankruptcy filing under section 548 of the Bankruptcy Code, or may seek to avoid them under applicable state laws with longer lookback periods (which vary by state, but are typically the later of four years after the transfer was made and one year after the transfer was discovered).

Financing

19 | What forms of financing are available and commonly used in distressed M&A transactions? How can financing be secured?

Buyers in distressed M&A transactions use the same types of acquisition financing available to buyers in traditional M&A transactions. The type of financing used is likely to be driven by the size of the deal and the timeline on which it needs to be executed.

Pre-closing funding

20 | What provisions are typically agreed to secure pre-closing funding of distressed businesses and assets?

Businesses that have filed for Chapter 11 protection typically finance their bankruptcy case through a debtor-in-possession loan (a 'DIP loan'). DIP loans, which must be approved by the bankruptcy court, are often secured by a priming lien that is senior even to existing pre-petition secured debt. As it relates to an M&A transaction, it is not uncommon for DIP loan agreements to impose sale- or plan-related milestones on the debtor.

DOCUMENTATION

Closing conditions

21 | What closing conditions are commonly agreed in distressed M&A transactions? How do these differ from non-distressed transactions?

Compared to non-distressed M&A, potential buyers may try to negotiate closing conditions specific to the continuity of the target business, such as the retention of key customers and the receipt of third-party consents. Buyers may also seek a lower bring-down standard for representations and warranties at closing than is typical in non-distressed situations, making it easier to terminate the agreement in the event of a breach. Distressed sellers are likely to resist these conditions because they reduce certainty of closing and increase the risk of driving the seller further into distress, noting that buyers in distressed situations may have more leverage to prevail on these topics.

Material adverse effect (MAE) clauses are common in purchase agreements, but may not provide the buyer with the protection that it would like if the buyer wants to back out of a transaction. Material adverse effect is a very high standard in the US, and courts are generally reluctant to find that an MAE has occurred and may view the buyer as having assumed any risks associated with buying the distressed company. MAE clauses also typically exclude effects that adversely affect the economy or the seller's industry as a whole, and an increasing number include specific carveouts (such as changes in law, the effects of pandemics and other *force majeure* events). Additionally, the definition of MAE in an in-court transaction will typically include an exclusion for events leading to the bankruptcy itself.

Representations, warranties and indemnities

22 What representations, warranties and indemnities are commonly given in distressed M&A transactions?

In out-of-court transactions, sellers will be expected to make customary representations and warranties about, among other things, the company's title to assets, corporate authority and good standing and the nature of the third party and governmental consents and approvals necessary to complete the transaction. Sellers also provide extensive (but negotiated) representations and warranties about the business or its assets being acquired.

In a 363 sale, the number and scope of representations and warranties will tend to be more limited than in a non-bankruptcy context.

Indemnity provisions are included much less frequently in bankruptcy M&A than in non-distressed transactions. Sellers in bankruptcy M&A transactions place a high value on deal certainty and in receiving a known amount of sale proceeds that will be available to distribute to creditors shortly after closing. However, when an acquiror in a 363 sale is able to negotiate to receive an indemnity for breaches of any representations or warranties that survive closing, it should also seek some form of security, such as a holdback of part of the purchase price, to ensure that it will actually be able to collect any indemnity claim it has while leaving the debtor clear to distribute the rest of the funds to its creditors.

Remedies for breach

23 What remedies are available and commonly sought for breaches of closing conditions, representations, warranties and indemnities in distressed M&A transactions?

Even outside a bankruptcy setting, post-closing recourse is likely to be more limited for distressed companies than non-distressed companies. Negotiating an indemnity may not be an option, and illiquid sellers that do agree to an indemnity may be unable to indemnify a buyer in the event of a breach. Buyers of distressed assets out of court will commonly balance these risks upfront by negotiating a reduced purchase price and acquiring representation and warranty insurance policies and, if they do negotiate an indemnity, by putting a portion of the purchase price in escrow.

Insurance

24 Is warranty and indemnity (W&I) insurance available for distressed M&A transactions in your jurisdiction? If so, what provisions and exclusions are commonly included in W&I policies?

Representation and warranty insurance (RWI) is available to acquirors in distressed M&A transactions. A potential buyer of a distressed company or assets is incentivised to acquire RWI to mitigate the seller's potential inability to satisfy indemnity obligations, because the seller may be unwilling to provide an indemnity and to eliminate credit risk post-closing.

RWI policies will typically exclude coverage for known breaches of representations and warranties and breaches that occur between signing and closing. Policies also tend to exclude coverage of subject areas that have not been subject to thorough due diligence, meaning acquirors must balance compressed diligence time frames with the need to meet insurer requirements for RWI coverage in these areas. In 2020, many insurers have proposed broad exclusions for the effects of covid-19 or insisted upon thorough diligence of the effects of covid-19 on target companies.

REGULATORY AND JUDICIAL APPROVALS

Merger control

25 What merger control rules and filing requirements govern the acquisition of distressed businesses and assets in your jurisdiction? Is the 'failing firm' defence recognised in your jurisdiction?

In the United States, the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the HSR Act) requires that transactions that meet specified transaction value thresholds be filed with the Department of Justice (DOJ) and Federal Trade Commission (FTC) before they are permitted to close. For most M&A transactions, HSR filings are subject to a 30-day waiting period, which is subject to extension if the DOJ or FTC issues a 'second request' to investigate the transaction further. However, HSR filings for 363 sales (but not necessarily other types of transactions conducted in court) are subject to only a 15-day waiting period. The DOJ or FTC may impose conditions to transactions (including divestitures or other behavioural remedies) before allowing the transaction to close. Out-of-court transactions involving distressed companies are not eligible for any expedited antitrust review simply because the target company is in distress.

In theory, antitrust regulators may permit an otherwise anticompetitive transaction if the parties can establish the 'failing firm defence'. To do so, the parties must demonstrate that the allegedly failing firm will be unable to meet its financial obligations in the near future, cannot reorganise successfully through bankruptcy and has made unsuccessful, good faith efforts to find alternative acquirors. Companies claiming the failing firm defence, which is rarely successful, are rigorously scrutinised by the antitrust regulators, and in May 2020 the FTC announced that it would not relax its standard of review in response to the covid-19 pandemic.

Foreign investment review

26 Are distressed M&A transactions subject to foreign investment review in your jurisdiction? What rules, procedures and common practices apply?

In the United States, a transaction in which a foreign person invests in a US infrastructure, energy or technology asset or certain other assets that impact national security may be subject to review by the Committee on Foreign Investment in the United States (CFIUS). Since February 2020, new regulations enacted by the US Department of the Treasury have further expanded CFIUS' power of review over foreign investments, and during the covid-19 pandemic commentators have noted that regulatory scrutiny from CFIUS has increased significantly. Distressed M&A transactions may be subject to CFIUS review, and unlike for HSR filings, there is no procedure for expedited review of 363 sales.

Bankruptcy court

27 What rules and procedures govern the bankruptcy court's approval of distressed M&A transactions in your jurisdiction?

For a debtor to sell its assets outside the ordinary course of business under section 363, it must provide notice to interested parties and obtain court approval of the sale. To obtain court approval, the debtor typically must show that the proposed sale constitutes the 'highest and best' offer for the assets, which it is able to do by running an auction process in accordance with bidding procedures that it has approved by the court.

In order for a plan of reorganisation to be confirmed, it will need to meet the requirements of section 1129 of the Bankruptcy Code, which requires, among other things, that:

- at least one impaired class of creditors accepts the plan (excluding the votes of insiders);
- the plan is in the 'best interests' of any impaired creditor who votes against it (meaning that the creditor would receive no more in a Chapter 7 liquidation than it would receive under the plan);
- the plan is feasible (meaning that the debtor is unlikely to need to file for bankruptcy again after implementation of the plan); and
- the plan is 'fair and equitable' and does not 'unfairly discriminate' against any class of creditors that rejects the plan.

DISPUTE RESOLUTION

Common disputes and settlement

28 What issues commonly give rise to disputes in the course of distressed M&A transactions and what practical considerations should be borne in mind when seeking to settle such disputes out of court?

For in-court transactions, disputes often arise relating to the bidding procedures pursuant to which an auction will be conducted. For example, a stalking horse bidder in a 363 sale may seek to set a tight deadline for other potential bidders to submit a qualifying bid, arguing that the assets could lose value if a sale does not close quickly. However, other potential bidders or out-of-the money creditors may object to this on the basis that it will prevent the estate from receiving the highest value possible for its assets.

Additionally, disputes may arise as to the extent to which a secured creditor should be able to 'credit bid' its claim in exchange for its collateral, particularly when that claim was acquired by the secured creditor substantially below par and the ability to credit bid the face value of the claim would chill bidding and deter other potential acquirors from putting in a cash bid.

When a transaction is implemented through a plan of reorganisation, it is common for there to be intercreditor disputes as to how the deal consideration should be allocated between classes of creditors. The possibility (or reality) of an objection from a creditor to the plan on this basis may require the plan sponsor to have significant involvement in resolving these disputes, even if it has no interest in any creditor getting more or less consideration.

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Litigation and alternative dispute resolution

29 What litigation forums are used to resolve disputes arising from distressed M&A transactions in your jurisdiction and what procedures apply? Is alternative dispute resolution (ADR) commonly used?

In the event that a distressed seller eventually files for bankruptcy, parties will submit to the bankruptcy court's jurisdiction for the resolution of their disputes. The bankruptcy court provides a forum whereby interested parties may seek discovery and pursue claims, directly or derivatively, against or on behalf of the debtors.

Outside of bankruptcy, parties may agree in advance to settle their disputes through ADR methods, such as arbitration and mediation. However, most US M&A transactions still resort to the courts to resolve transaction-related disputes other than purchase price adjustments referred to an accounting arbiter.

UPDATE AND TRENDS

Recent developments and outlook

30 What have been the most significant recent developments and trends affecting distressed M&A in your jurisdiction, including any notable court decisions, regulatory actions and deals? What is the general outlook for future transactions?

In 2020, the covid-19 pandemic has had an uneven impact on the economy. For instance, technology companies have proved more resilient to the effects of the pandemic than retail or hospitality companies, according to research by Refinitiv and PwC. In harder-hit sectors, this has translated into declines in deal volume that will likely continue into 2021 and may lead to an increase in distressed M&A in such sectors.

* *Cravath associates Bethany A. Pfalzgraf, Alexander Gerten and Jerome C. Newton also greatly contributed to this chapter.*

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