How An M&A Tool Can Benefit Bankruptcy Sales

By **Bryan O'Keefe, Gena Usenheimer and James Sowka** (May 7, 2020, 3:14 PM EDT)

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It sounds like a bankruptcy lawyer's dream: the introduction of a product that will both raise the value of a distressed or insolvent asset and give potential bidders expanded protections with a solvent entity to back up the promises in the purchase agreement.

Luckily, such a product does, in fact, exist in the form of representations and warranties insurance. While used sparingly in U.S. Bankruptcy Code Section 363 or distressed asset sales, players in the bankruptcy realm are about to discover what their M&A counterparts learned during recent boom times: Representations and warranties insurance can be a win-win for all parties involved.

Of course, representations and warranties insurance has been theoretically available for 363 sales for some time. But given the relative paucity of such sales in recent years during the bull market, the number of bankruptcy transactions that have actually utilized the product are negligible, according to recent conversations we have had with both insurers and prominent brokers as well as our personal experience.

Like everything else, COVID-19 will likely be the game-changer. Bankruptcies are a lagging indicator of the pandemic-related economic turmoil we are seeing each day. Laying off 30 million people was the first step businesses took to rescue themselves — but hardly the last.

There will likely be other measures, including: new rounds of layoffs; lease terminations; office closures; the seeking of exotic capital or novel high interest-rate financing; and the slashing of any other marginal cost. But even after all of that, it is highly likely that a substantial number of businesses are going to fail in the coming months and years. We are only in the second or third inning of the game.

The 363 Process Explained

As the economic turmoil continues to manifest, a common way for businesses to reorganize themselves will be to sell assets through Section 363. To initiate the process, the debtor files a motion with the bankruptcy court seeking to sell substantially all of its assets free and clear of all liens, claims and encumbrances held by third parties. As a part of this process, the debtor markets its assets in hopes of finding a stalking horse bidder, whose initial bid sets the floor price at the ensuing bankruptcy auction.

Being first on the scene, the stalking horse enjoys certain benefits. The stalking horse bidder has more time than other bidders for due diligence. The stalking horse also has a say in creating the rules of the game by negotiating the terms of the asset purchase agreement with the debtor — which then usually serves as the standard template for other bidders.

A public marketing process and auction ensue with other potential bidders competing against the stalking horse. After the auction closes and the successful bidder is selected by the bankruptcy estate, the bankruptcy court must approve the sale.

Right now, most 363 sales are as is, where is — meaning that the asset purchase agreement has no indemnities and as a result the debtor has no skin in the game. Debtors will likely be reluctant to move from the customary as-is, where-is model because of the temporary and insolvent nature of bankruptcy estates. After all, the bankruptcy estate already lacks sufficient assets to pay all claims and only exists until the case is closed.

While the free-and-clear order wipes out third-party claims against the assets, it does nothing for first-party claims — that is, the representations and warranties made between the debtor and buyer around the financial state of the assets.

Given the typical as-is, where-is structure, these risks fall entirely onto the buyer. This puts a premium on the buyer's due diligence, which is usually conducted on a truncated timeline. Peril abounds and many buyers do not have appetite for this risk.

With some tweaks, the representations and warranties product can be a valuable tool in solving these problems.

The Benefit to Debtors: A More Lucrative Asset

For debtors, the introduction of a no-indemnity representations and warranties product to back up the representations and warranties in the purchase agreement will increase the value of the assets. It's a no-brainer that a distressed asset with an A+ insurance company standing behind the representations and warranties is going to be vastly more attractive to buyers than a similar asset in the pure as-is, where-is form.

Debtors can provide these representations and warranties and still avoid potential claims by expressly excluding any indemnity in the purchase agreement.

Moreover, debtors can further allay any concerns about the introduction of representations and warranties by including specific language in the 363 sale order providing that the transaction is a no-indemnity deal and that the buyer has no financial recourse against the debtor.

The Benefit to Buyers: The Representations and Warranties in a 363 Asset Purchase Agreement Actually Mean Something

And for buyers? Generally speaking, representations and warranties insurance should provide insured bidders with a competitive advantage at the auction.

One way the product can benefit buyers in the unique bankruptcy context is for stalking horse bidders to include representations and warranties insurance in the initial negotiated asset purchase agreement, which serves as the baseline agreement for other bidders. The ability to have a stable, solvent entity backing up the representations and warranties in the purchase agreement should be an obvious benefit to the stalking horse and any other potential bidders that obtain coverage.

Another way representations and warranties insurance can benefit buyers is the potential introduction of so-called synthetic representations and warranties. In the traditional representations and warranties product, insurers can use synthetic representations to cover areas in a policy that were omitted from the purchase agreement. For instance, a synthetic representation covering all preclosing taxes can be added to a representations and warranties insurance policy if the underlying agreement is missing a preclosing tax indemnity.

In that same way, buyers and insurers could potentially add synthetic representations around areas that buyers may want to see covered in a 363 sale, but were not part of the asset purchase agreement. The ultimate ability to do so however will largely depend on whether insurers can get comfortable with the amount of buyer due diligence in the area that will be covered by the synthetic representation.

The Benefit to Insurers: New Business Opportunities and Better Diligence

Transactional risk insurers themselves should be open to underwriting these policies. Beyond the obvious economic incentives that come along with a downturn in M&A and search for new business opportunities, the 363 sales process itself may give insurers more diligence than they receive in the typical private M&A deal.

Bankruptcy court petitions and related filings are a treasure trove of information about a potential target, all signed under penalty of perjury. In addition, the court-ordered claims bar date incentivizes parties with any inkling of potential claims, including contingent and unliquidated claims, to file those claims prior to the deadline thereby resulting in another source of disclosures.

Moreover, most Chapter 11 bankruptcy cases have creditor committees appointed that investigate the debtor's operations and seek to identify potential litigation targets. In comparison, insurers in recent years have grown legitimately concerned about a rise in claims due to incomplete diligence from buyer's counsel.

The Stalking Horse Bidder Break-Up Fee and Interaction With Insurance Premiums

The insurers and brokers who are able to take advantage of the opportunities that bankruptcy presents will be those that can adapt the logistics of the product to this new market. One area of particular interest will be consideration of how the insurance premium is typically paid and the break-up fee that stalking horse bidders can obtain.

Stalking horse bidders usually negotiate a break-up fee equal to approximately 2% to 2.5% of the bid amount in the event that the stalking horse bidder is not the successful bidder. On the insurance side, insurers usually charge insureds a one-time upfront due diligence fee, ranging from $25,000 to $50,000, and then charge another 10% of the premium at binding, with the remainder due at closing.

In a win-win for everyone, the due diligence fee and a 10% customary insurance premium may be rolled into the stalking horse break-up fee, such that there is little downside for either the buyer or the insurer in binding the policy early in the process.

Insurers may forgo charging the due diligence fee upfront entirely for stalking horses since the break-up fee can serve as a source of payment if the stalking horse bidder does not win the auction. The successful bidder can then bind its own separate policy on an expedited basis, either with the original insurer or a new insurer, which may have charged its own preexclusivity fee during the auction process.

The Importance of Education

Insurers should use this time while there is a lull in the M&A markets and no uptick in bankruptcies to educate the masses about the benefit of this product for bankruptcies. The vast acceptance of representations and warranties insurance in the M&A context was the result of a concerted effort by brokers and insurers to explain the benefits of the product.

While there is some overlap in the bankruptcy and M&A spheres, the vast majority of bankruptcy attorneys grew up in the as-is, where-is mindset, and are not intimately familiar with how representations and warranties insurance works and how it could both benefit buyers and sellers.

In particular, insurers should assuage debtors' counsel that the insurance company will pay claims related to the policy, and not seek payment as administrative claims against the estate, which could otherwise jeopardize the payment of the debtor's professional fees.

Getting bankruptcy attorneys comfortable with the product and its nuances is critically important for expansion and growth. Call some of your contacts. Dial up Zoom. Now is the time for insurers, brokers and their underwriting counsel with bankruptcy experience to school the bankruptcy bar.

Conclusion

To be sure, COVID-19 is a history-altering pathogen that has resulted in economic pain, which remains difficult to fully appreciate. M&A markets have come to a standstill since the middle of March and may be stuck there for the foreseeable future. But out of every economic calamity comes an opportunity.

In that way, the representations and warranties industry has a valuable role to play in the broader economic recovery by repurposing its product to the exigency of today. In doing so, the industry can help debtors get a better price for the insolvent or distressed asset, and buyers gain more certainty in what they are purchasing — which should, in turn, lead to more buyers, fresh infusions of capital into moribund companies, and, hopefully, new starts for many businesses and their workers.

The opportunity is there; let's make it happen.

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