SELECTED TOPIC

A Value Play: Chapter 11 Mergers and Acquisitions

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Chapter 11 is known as a forum for reorganizing or selling a financially distressed business. Chapter 11 allows companies to reject burdensome contractual obligations, shed non-core assets and "clean up" the balance sheet by writing off unsecured debt.

However, Chapter 11 is also a forum for investment opportunities, whether a purchase of assets, a merger or the acquisition of a controlling equity position in an ongoing business venture. Strategic buyers, investment banks and private equity often take advantage of the "distress" normally associated with Chapter 11 companies to acquire assets at a discount, exemplifying Warren Buffet's "value" buying. Very often buyers interested in purchasing distressed companies or assets prefer to do so in the Chapter 11 context, since Chapter 11 transactions can bind dissatisfied creditors who do not expressly consent to the transaction. Chapter 11 is also a forum where ownership and control of companies change, effecting a takeover, whether consensual or hostile. As a fundamental principle of corporate law, the parties or entities with a controlling equity position control the selection of the board of directors, who in turn select the officers who run the company on a day-to-day basis. There are three fundamental methods by which a company can be bought or sold in Chapter 11: Asset Purchase, Merger or Debt for Equity Conversion.

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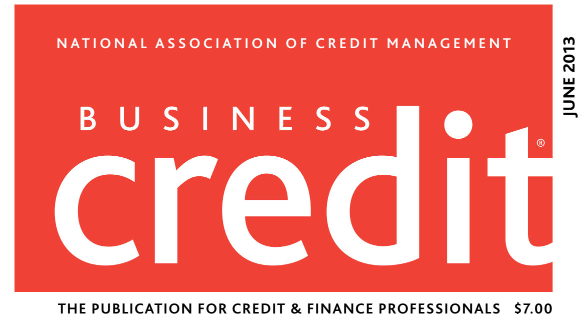
Asset Purchase or Section 363 Sale

Section 363 of the Bankruptcy Code allows the debtor to sell substantially all of its assets free and clear of liens, with liens attaching to proceeds of sale, for a later allocation among competing creditors. The purpose of Section 363 is to allow a debtor to realize maximum value for assets quickly, to avoid erosion of asset values due to continued operating losses. In these liquidating 11s, the Section 363 sales involve an initial



asset purchase contract often referred to as the "stalking horse bid," which is subsequently "shopped" in the market, hopefully to elicit better and higher bids, to achieve maximum value for the assets being sold. Management of insolvent companies owes a fiduciary duty to creditors as well as shareholders and is obligated to achieve the best value possible under the circumstances. This bankruptcy auction process requires notice to all constituents and court approval before a sale can be finalized. Although there is no time period prescribed for Section 363 sales, most occur within six months of the company's Chapter 11 filing.

In perhaps the most heralded Section 363 sale in Chapter 11 history, in September, 2008, Lehman Brothers Holdings, Inc. and Lehman Brothers Inc. sold their coveted brokerage business to Barclays Capital, Inc. for about $45 billion just five days after Lehman's Chapter 11 filing. In that case, the bankruptcy court had to balance the actual or perceived need to allow a quick sale to stabilize the global financial markets with the "due process" to be afforded various creditors and stakeholders involved. Almost five years later, most observers would say that Barclays made a very good strategic acquisition, with the 2012 earnings of the former Lehman unit reaching $750 million.

Merger or Stock Purchase

A leading example of an acquisition of an operating business is the recent acquisition of Chapter 11 debtor American Airlines by U.S. Airways. The acquisition will be accomplished by a merger, valued at $11 billion, which was approved by the New York Bankruptcy Court presiding over the American Airlines Chapter 11 proceeding on March 27, 2013. The merger agreement

provides for the creation of a new entity which will own and operate the combined operations, with American Airlines' creditors receiving about 72% of the diluted equity of the combined entities (it has been reported that existing American shareholders will receive about 3.5% of the equity), and current U.S. Airways shareholders getting about 28% of surviving entity.

The agreement and plan of merger recently approved by the bankruptcy court specifically provides that a condition of closing is confirmation of an American Airlines plan of reorganization by the Bankruptcy Court, which will occur later this year. America Airline's plan of reorganization will in essence approve and consummate the merger transaction and provide for payment of certain creditors and also allocate equity among the various stakeholders of the pre-merger airlines.

Debt for Equity Conversion

Another acquisition vehicle is a Chapter 11 debt for equity plan of reorganization. A Chapter 11 plan of reorganization is at its essence a contract between the debtor and its stakeholders, primarily creditors, that provides for the "treatment" of creditors' claims by class. As a condition of confirmation, the Bankruptcy Code requires that a plan of reorganization adhere to the payment priority scheme set forth in the Bankruptcy Code, which provides for payment, in order, of secured claims, administrative claims, certain priority claims, general unsecured claims and equity interests. The Bankruptcy Code's "absolute priority rule" further provides that the debtor is not permitted to provide any value to a particular class of creditors unless all classes senior to such class are satisfied in full. This means that pre-petition equity owners cannot retain their equity ownership (absent a de facto re-purchase of the equity at current market value) unless the unsecured creditors who have priority are paid in full. Often the pre-petition debt structure includes material bond or trade debt, originally provided to fund operations or provide liquidity. In most cases, it is impossible for Chapter 11 debtors to satisfy the claims of bondholders or unsecured creditors. Since these claimants are not paid in full, the existing equity is normally extinguished. Moreover, in lieu of payment, the unsecured creditors may receive, under the terms of a plan of reorganization, replacement debt instruments, or may receive controlling interest of the equity of the reorganized debtor. It is common for debtors to propose a debt for equity Chapter 11 plan of reorganization, which extinguishes existing equity interests and distributes the equity of the reorganized debtor to the debtor's pre-petition creditors.

In addition, the Bankruptcy Code permits the largely unregulated buying and selling of debt claims during the Chapter 11 case. In fact, sophisticated markets for the purchase of bankruptcy claims have developed. An investor, for example, can aggregate a control position by acquiring debt claims, anticipating that such claims will be converted to a controlling interest of the equity of the reorganized debtor entity. In addition, investors who purchase sufficient debt claims can influence the Chapter 11 case, particularly with respect to negotiating the terms of a debtor's plan of reorganization.

In 2003, Wilbur Ross acquired Burlington Industries, Inc. in a bankruptcy auction after having purchased a significant portion of the company's unsecured bonds and bank debt. Ross acquired Burlington for $614 million in 2003, outbidding Berkshire Hathaway in the process. Also in 2003, Eddie Lampert's ESL Investments acquired Kmart through the purchase of bonds and bank debt during the pendency of Kmart's Chapter 11 case. Lampert helped steer Kmart through the bankruptcy reorganization and became chairman when Kmart emerged from Chapter 11. Within less than two years after Kmart's exit from Chapter 11, the stock price soared from $15 per share to $109 per share. Clearly, acquiring bankruptcy debt and converting it to equity was a profitable acquisition for Lampert.

Conclusion

Some of the most significant mergers and acquisitions have occurred in Chapter 11 cases. Investors such as Barclays Capital, U.S. Airways, Wilbur Ross and Eddie Lampert have found good deals in Chapter 11. Rather than shy away from the "distress" associated with Chapter 11, these investors embraced the unique provisions of Chapter 11 to effect strategic mergers or acquisitions.

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