

Bargain Shoppers Beware: Considerations in Buying a Distressed Business

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A financially distressed business may appear at first glance to be an attractive acquisition target. The opportunity to pay a "bargain price" to acquire assets or stock of a competitor, another business in the buyer's supply or distribution chain, or any other business with a strategic fit to the buyer, often seems like too good a deal to pass up. However, there are a variety of potential issues and pitfalls to be aware of – avoiding them can help ensure that the deal really is as good as it initially appears. A buyer acquiring a troubled business should not only be focused on minimizing the purchase price. Taking title to the seller's assets free and clear of liens, and avoiding potential claims against the buyer by the seller's creditors and third parties are also critical to the success of the transaction. This *Update* highlights some of the potential issues in acquiring a distressed business.

Structure of Transaction

The five basic options in structuring the purchase of a business in financial trouble are to purchase through:

1. an ordinary stock or asset sale,
2. an assignment for the benefit of creditors,
3. an Article 9 (UCC) sale,
4. a receivership (in such states where receiverships are authorized by statute), or
5. a bankruptcy.

There are pros and cons to each of these structures, and the right one depends on a variety of factors, including:

- what type of assets the buyer seeks to purchase
- whether the buyer wants to buy some or all of the assets of the seller
- where the assets are located
- whether the buyer needs any of the protections that only the Bankruptcy Code can deliver
- whether there are creditors with liens on the assets that the buyer wants to purchase
- whether the business or its value can tolerate a shut-down, or whether the buyer needs the business to operate without interruption during the sale process
- whether the business itself can survive the obligations and strains that can accompany a bankruptcy

Potential Avenues of Liability for Buyer

In addition to the factors set forth above, the choice of transaction structure may reduce the risk that creditors of the seller may pursue recovery of unpaid claims from the buyer under fraudulent conveyance, successor liability or statutory liability theories.

Fraudulent Transfer

A purchase transaction may be "unwound" and the value returned to the transferor if it involves actual or constructive fraud in violation of state or federal law. One of the most common measures of determining fraud is whether the seller received a reasonably equivalent value in exchange for the transfer and the seller either (i) was engaged in a business for which the remaining assets (after the transfer) were unreasonably small in relation to the business, or (ii) intended to incur, or believed or reasonably should have believed that it would incur debts beyond its ability to pay as they became due.

To avoid having to return the assets or pay back to the seller the value of the assets, the buyer must be able to prove that it acquired the assets in good faith and for reasonably equivalent value. The structure of the transaction will impact the risk to the buyer of a fraudulent transfer claim.

Successor Liability

Under most state's laws, the buyer does not automatically assume the liabilities of the seller. There are certain factual scenarios, however, under which a court may impose liability on the buyer for obligations owed by the seller. Some of these scenarios and legal theories include:

- *Buyer's intentional assumption of liabilities.* There may not be an express assumption of liabilities, but one may be implied by the buyer's actions under certain conditions.
- *Mere Continuation.* This doctrine applies successor liability where the buyer has the same officers, directors and shareholders as the seller, with the existence of only one corporation at the end of the transaction.
- *Substantial Continuation.* This doctrine examines the continuity of the business itself (as opposed to the ownership and management). A court may look at (among other things) whether the employees are the same, whether the production facilities are continued in the same location, whether the product is the same, whether the name of the new entity is the same, or whether the successor holds itself out as the continuation of the previous business.
- *De Facto Merger.* In determining whether the purchase should be treated as a de facto merger (in a merger, the surviving entity *does* become liable for the non-surviving entity's liabilities), a court may look at four criteria: (i) whether there is a continuity of management, employees, location, general business operations and assets; (ii) whether there is a continuity of shareholders; (iii) whether the seller ceases operations and dissolves as soon as legally and practically possible after the transaction; or (iv) whether the buyer assumes the obligations of the seller which are ordinarily necessary for uninterrupted continuation of normal business operations.

Statutory Liability

A variety of statutes may impose seller liabilities on a buyer even when the buyer and seller do not intend that such liabilities be transferred to the buyer. Certain environmental, labor and tax liabilities of the seller may attach to the buyer notwithstanding the parties' intent.

Minimizing Risk and Avoiding Liability

To avoid or minimize the risks identified above, the buyer should consider purchasing the assets through a competitive process (like an auction sale), conducted through an Article 9 process, a bankruptcy or receivership, or an assignment for the benefit of creditors. While this may result in an increased purchase price, it does expose the assets of the business to competitive bidding, which is a good indicator of the value of the business. This would help in defeating potential fraudulent transfer claims.

In addition, the buyer should try to structure the transaction so as to avoid too much similarity between the buyer (post-closing) and the seller (ownership, management, trade name, website, etc.). These efforts would help in minimizing potential successor liability.

The structure of the transaction itself is also a major factor in minimizing risk. The riskiest structure is a stock purchase, as the buyer literally becomes the owner of the seller entity – and takes ownership of that entity subject to all liabilities of the seller, known and unknown. The least risky structure is to purchase the assets through a federal bankruptcy sale. This results in an order of the federal bankruptcy judge approving the sale, free and clear of all liens, claims and encumbrances of the seller. Between these two ends of the risk scale, are:

- An asset purchase with no competitive bidding process, but with representations and warranties of the seller (if possible) and with indemnification and other provisions as typically found in an asset purchase agreement
- An asset purchase following some reasonable effort by the seller or its broker to market and sell the assets
- A purchase from a secured lender through a legally proper Article 9 process, or from an assignee for the benefit of creditors or state or federal court-appointed receiver

Due Diligence

Regardless of how the transaction is structured, one key to the success of any acquisition is comprehensive due diligence about the target company. Without a clear understanding of the financial, legal, and industry position of the target, the buyer may be assuming unknown risks or stepping into unidentified legal, financial or political situations. This is true in any potential acquisition, but is especially important when the target is in financial trouble. However, depending on the source of the pressures the financially troubled target is facing, extensive due diligence is often not possible, as the pressures the seller is facing may compel the seller to complete the transaction very quickly. Buyers should be especially careful when allowed to only conduct a superficial due diligence review.

In any event, the risk of potential successor liability should cause the buyer to investigate the financial condition of the seller. Ideally, the buyer should look beyond any standard data room materials provided by the seller. If possible, the buyer should try to interview the company's management, customers and suppliers, and should work to obtain information from any outside consultants the company uses to discover possible latent liabilities. Finally, some buyers may consider retaining their own valuation experts or investment banking advisors to help understand the real value of the assets or business they are contemplating buying.

Final Thoughts

Once the buyer learns through the due diligence process what the issues are, the buyer is going to have to fix them if it is the successful purchaser of the stock or assets. A prudent buyer will understand before purchasing what skills are necessary to fix the problems. Does the buyer have specific turnaround skills? Superior management skills? The ability to inject capital? If not, maybe that particular financially distressed business just isn't the right acquisition target for the buyer.

Finally, while this *Update* highlights certain considerations and risks, each situation is unique and there are a variety of ways to structure a transaction to minimize risk. Ultimately, the decision as to how to proceed will involve analysis of the unique characteristics of the troubled business and the potential purchaser's goals and objectives.

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