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Guidelines for Successful Puerto Rico Asset Purchases in Bankruptcy

Section 363 of the Bankruptcy Code provides for the sale of property of a Chapter 11 debtor in bankruptcy. Through this process, parts of a business or an entire enterprise may be sold. Innovative practices have made such sales more valuable to the reorganization of business enterprises because bankruptcy courts have, in recent years, become much more receptive to traditional acquisition techniques. These techniques, including auctions, customary acquisition agreements, use of financial advisers and payment of break-up fees, have made investing through the bankruptcy sale process more efficient.

In addition, bankruptcy courts can assure purchasers, under the proper circumstances, that assets may be purchased free and clear of encumbrances and that successor liability may be minimized, thereby adding value to the assets being sold by the debtor. Thus, these sales create significant strategic and financial opportunities for investors.

This article is intended to familiarize readers generally with the landscape of an otherwise fairly complicated process involving the sale of assets of a debtor in bankruptcy. It also highlights some of the more important and easily misunderstood issues faced by potential purchasers of such assets.

Bidding Procedures

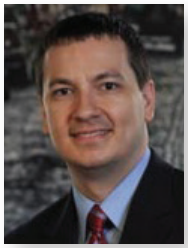
There is no set formula that must be adhered to in connection with the sale of a debtor's major assets. In general, however, bankruptcy courts will require some sort of open bidding procedure, often in the form of an auction, before approving the sale of significant assets of a debtor. The purpose of this process is to ensure that the debtor's estate, and thus its creditors, realize the greatest return from the sale of the assets.

Bidding procedures may involve a number of items, including setting the auction date, specifying the assets to be sold, establishing a break-up fee and the initial overbid and bidding increments (that is, the amounts by which subsequent bids must exceed prior bids). Any proposed bidding procedures must ultimately be approved by the court, after notice to interested parties and an opportunity for parties with a pecuniary interest (i.e., creditors) to be heard.

The Stalking Horse Bidder

Investors may first learn of an opportunity to purchase assets in a bankruptcy sale process from a third party exploring the marketplace in an attempt to gauge interest. Generally, the first to bid is known as the stalking horse bidder, and while there may be an initial reticence in bidding against yourself, there are some distinct advantages to being the stalking horse bidder.

If you, as the prospective stalking horse bidder, make an acceptable offer for the debtor's assets, you and the debtor will likely enter into a letter of intent, or possibly go directly to definitive documentation by way of an asset purchase agreement. It is important to remember that it is generally not possible to lock up the purchase prior to obtaining approval of the sale from the bankruptcy court. Usually, third parties will have the opportunity to come to court on the day the sale is scheduled for approval and offer a higher purchase price. This is more likely to succeed if the new offer is on the same terms as the initial offer. This notwithstanding, after the parties have agreed to the terms of the deal, but



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before a firm offer is made, the purchaser has the most leverage in imposing its terms on the debtor. For example, the stalking horse bidder can condition its bid on court approval of certain bidding procedures. If the proposed procedures are not approved, the purchaser will generally reserve the right to withdraw the bid without penalty.

The Bidding Process

In negotiating the initial offer, the goal of the prospective purchaser obviously is to acquire the desired assets at the best price. Generally, you can expect that the debtor will establish a "data room" for interested bidders to conduct due diligence. If you are going to enter the bidding process and conduct due diligence, expect to be asked to sign a confidentiality agreement. Any offer to purchase the debtor's assets will require court approval, will be subject to higher and better offers and will immediately become public knowledge. In part, these requirements are designed to ensure that only sales that are negotiated at arm's length, in good faith and without collusion are approved by the bankruptcy court.

The Sale Date

From the perspective of the stalking horse bidder, the earlier the auction the better. An earlier auction provides less time for other prospective bidders to formulate their bids and may make it more likely that additional bidders will fail to satisfy the requirements set forth in the bid procedures. There may, however, be a less subjective reason for holding the sale as soon as possible. If the debtor's assets are declining in value, the sooner the sale the more value the assets will bring. In many instances, however, local rules of practice will impose parameters with regard to how much and to whom notice must be given. In contrast to the stalking horse bidder, who wants to move the process along as quickly as possible to frustrate potential competitors, creditors will want to stimulate the bidding in the hope of receiving one or more higher bids. From the creditors' perspectives, the longer the process, the greater the likelihood of obtaining the best possible price for the assets. This is particularly true if the assets are not declining in value.

A word here about the provisions of the asset purchase agreement pertaining to representations and warranties: the purchaser will want some recourse if something should go wrong after the sale closes. The purchaser will generally understand that the debtor may not be able to respond to a breach of contract claim. However, if the estate will have substantial assets after the sale, the purchaser would not want to limit his or her claim for potential breaches of representations and warranties. The principal concern of the purchaser should be to obtain full disclosure of all information about the assets he or she is buying through representations and warranties, and some assurance that the debtor's operational controls are maintained so that the assets do not lose value through the bidding and pre-closing period. Thus, the purchaser will want, at the very least, to ensure that the accuracy of the representations and warranties be a condition precedent to closing and may want a hold back of a portion of its purchase price to cover post-closing adjustments and breaches of representations and warranties.

The debtor and the creditors will want to avoid making any representations, warranties or indemnities that could create a risk of additional claims that will dilute the sale proceeds available for distribution to creditors. The argument most often used by the debtor and the creditors to avoid making such representations and warranties is that the purchaser can rely on the sale order issued by the bankruptcy court for comfort. If drafted properly, the sale order will offer greater protection than any representation or warranty – for example, a sale order will vest title in the purchaser free and clear of all liens and encumbrances, and can cut off successor liability. Generally, the only way to obtain representations and warranties in the asset purchase agreement is to create an economic incentive by offering to pay for the representations and warranties.

The Auction

The auction process may take many forms. Usually, there will be a deadline set by the court for interested parties to announce their intention to submit bids that exceed the initial bidder's offer by the requisite overbid amount. If no such notice of a competing bid is received by the bid deadline, no auction will be held and the parties will go forward with the proposed sale agreement. If one or more such notices are received by the deadline, however, some type of formal auction will generally be held, usually at the office of the debtor's attorney or in open court.

The debtor and the creditors will generally look for the most cash, with a minimum of risk; however, the creditors' may advocate a more risky deal if they are "out of the money," that is, if there is no value in the assets being sold over and above that which is owed to secured, administrative and priority claimants. A higher, riskier bid may provide the creditors a chance at some recovery from the case which would not be available with the less risky deal.

As highlighted above, purchases of distressed assets in bankruptcy can be advantageous and viable to investors that are versed in the applicable Bankruptcy Code provisions.