AMERICAN COLLEGE OF BANKRUPTCY SEVENTH CIRCUIT 2021

BUSINESS PANEL

September 24, 2021

1. ***Third party releases***
2. ***363 issues***
3. ***Valuation***
4. ***Whether you can have rights offerings going to creditors as only consideration***

Moderator: **Felicia Perlman**
Global Co-Head of Restructuring & Insolvency
McDermott Will & Emery

Panelists: **Jim Sweet,** Partner, Steinhilber Swanson LLP

Jay Jaffe, Partner, Faegre Drinker

John Castellano, Managing Director, AlixPartners, LLP

---

2. Sec. 363 ISSUES IN A VOLATILE ECONOMIC ENVIRONMENT.

I. Introduction.[1]

Distressed M&A in normal times is hard work, and COVID-19 has only made these transactions more challenging. First, speed matters in distressed sales processes. Thus, due diligence must be completed by prospective buyers, and to a certain extent the debtor, in a compressed timeframe. COVID-19 and its aftereffects have increased the difficulty of undertaking due diligence because parties may not in most instances meet face-to-face, and sensitive data must be shared with individuals continuing to work from home, potentially on unsecured networks.

[1] The author expresses his deep gratitude to the efforts of Atty. Lisa Eddy of Steinhilber Swanson for providing most of the source material and text of this outline. I could not have completed this without her valuable assistance.

Additionally, and with further presentation by my fellow presenters, valuations of assets remain very challenging. Traditional tools used to bridge value gaps in many insolvency deals, such as earn-outs or some form of equity participation or consideration, may be non-starters for a company's creditors that expect to be satisfied on closing the acquisition to be paid.

Finally, closing certainty is of paramount importance in 363 sales. Corporate buyers with significant market overlaps and foreign buyers pursuing assets perceived to implicate national security interests may be at significant disadvantage in distressed sale/363 processes. First, a debtor cannot afford the risk of a failed regulatory approval (or the threat of a non-notified transaction) and the sale process and estate may not be able to accommodate a drawn-out review process.

Here, difficult to attain risk allocation measures, such as reverse break-up fees, may be an essential tool for a debtor who wishes to propose an attractive but conditional sale transaction and who must argue that such a sale, with conditioned on regulatory approval, is truly in the best interest of the estate.

This outline explores such tools and situations.

II. Regulatory Approval as a Condition Precedent to Sale Closing – CFIUS as a new concern.

One example of regulatory approval that can create a very real threat to 363 sale transactions is a requirement that a transaction undergo "CFIUS review." Pre-COVID-19 changes to certain national security regulations significantly expanded the jurisdiction of the Committee on Foreign Investment in the United States ("**CFIUS**") to review potential transactions involving the acquisition of control – and in some cases, even a minority stake – in critical U.S. technology, critical U.S. infrastructure and sensitive personal data.

A. *What is CFIUS?*

CFIUS is a U.S. government interagency committee that examines foreign investments in U.S. businesses scrutinizing such transactions for national security risks. The Committee has become more prominent in recent years, particularly as the U.S. has placed greater scrutiny on foreign investments in strategically important industries.

The Foreign Investment Risk Review Modernization Act of 2018 ("**FIRRMA**"), signed into law August 13, 2018, was the first Congressional

update to the laws governing CFIUS in over a decade. Final Rules implementing FIRRMA became effective October 15, 2020.

B. *Impact of 2018 FIRRMA and 2020 regulations/rules.*

Since the enactment of FIRRMA, CFIUS has been given additional jurisdiction to review certain non-controlling investments and real estate transactions. Some deals trigger mandatory filings, and, backed by additional resources, CFIUS has grown increasingly aggressive in identifying and reviewing non-notified transactions of interest. 50 U.S.C. § 4565(b)(1)(H).

The U.S. Department of the Treasury has built a new team[2] whose only mission is to scour commercial databases, press releases, bankruptcy filings, and other sources, searching for transactions that were not filed with CFIUS. If Treasury's team identifies a non-notified transaction that may present a risk to U.S. national security, CFIUS has the authority to request a filing and perform a national security review of the transaction. As Treasury's team grows in size and capabilities, parties involved in business deals with national security implications will no longer be able to hide from the Committee by simply refusing to file a transaction with CFIUS.

C. *How long does the new review process take?*

Unlike the expedited Hart-Scott-Rodino clearance process available to transactions under sec. 363(b), there is not [yet] an equivalent provision for expedited CFIUS review of transactions occurring under the Bankruptcy Code.

Prior to FIRRMA the CFIUS review period was 30 days. Now, after CFIUS receives a filing, it has 45 days to review. CFIUS may request information from the parties during the review period. Most reviews are completed after the 45-day review period. If CFIUS is unable to resolve a national security concern during the 45-day review period, it can then initiate a 45-day investigation period, which can be extended by a 15-day period in extraordinary circumstances.

CFIUS has the power to block proposed transactions if such transactions "impair national security." There is no effective judicial review

[2] 50 U.S.C. § 4565(q)(2)

of this process (because of "national security"), and any resolution is allowed to be confidential.

Not surprisingly, and now particularly given the proactive role assigned to the intelligence community in CFIUS deliberations, "the CFIUS review process ... is generally protected from public disclosure, subject only to certain exceptions." *In re Global Crossing*, 295 B.R. 720, 722 Bankr. S.D.N.Y. 2003) (ordering *in camera* review of CFIUS materials, and not permitting public disclosure, "by reason of the national security nature of the information in question").

III. Break-up Fees.

When regulatory clearance is listed as a pre-condition to closing, it presents some unique issues for a bankruptcy estate negotiating the transaction. Unlike a financing contingency, which almost always is cleared before the bidding 363 sale process begins, regulatory clearance, by its nature, cannot be undertaken by the buyer until there is a transaction to be examined by the relevant agency and then cleared.

The inclusion of regulatory clearance as a condition to close places the debtor and its advisors in a very tough spot if the offer that contains such a provision is clearly better than competing offers—at least on the price front. The question for debtor's advisors is whether the proposed offer is sufficiently better to support taking the risk that the offer will not close—the old "bird in the hand . . ." problem.

The use of break-up fees in the chapter 11 setting is commonplace. But such provisions usually favor the buyer who is positioned as the stalking horse bidder in the bidding process to underwrite the time, effort, creativity, and money spent by the stalking horse to create a market for the assets. The risk to the stalking horse is real because virtually all bankruptcy courts expect the debtor to shop the stalking horse offer, thereby maximizing the value of the assets to be the source of payment to creditors.

But what about the risk a debtor takes by accepting an offer at the end of a 363-sale process that contains certain conditions to the buyer closing on the approved transaction that the debtor cannot fully assess or influence? One answer may be using the same tool the stalking horse buyer uses—a "reverse" break-up fee.

Outside of bankruptcy, breakup fees are a regular part of mergers and acquisitions negotiations and are "designed in part to compensate for the risk of losing a signed deal." *In re S.N.A. Nut Co.*, 186 B.R. 98, 102 (Bankr. N.D. Ill. 1995).

In a private, non-bankruptcy sale, the parties make their own decisions and are then bound by them. In a bankruptcy sale, however, there are absent third parties—that is, the creditors and equity holders—whose interests must be protected by the process. One way their interests are protected is by the requirement that a bankruptcy sale outside the ordinary course of business be approved by the bankruptcy court. (See *In re SpecialtyChem Prod. Corp.*, 372 B.R. 434, 438–39 (E.D. Wis. 2007), *citing* 11 U.S.C. § 363(b)).

A. *General Break-up Fee Principles:*

> In *In re Hupp Industries, Inc.*, 140 B.R. 191 (Bankr.N.D.Ohio 1992), the court identified seven "[s]ignificant factors to be considered in determining the propriety of allowing break-up fee provisions" in the context of "a major preconfirmation transaction":
>
> > (1) Whether the fee requested correlates with a maximization of value to the debtor's estate;
> >
> > (2) Whether the underlying negotiated agreement is an arms-length transaction between the debtor's estate and the negotiating acquirer;
> >
> > (3) Whether the principal secured creditors and the official creditors committee are supportive of the concession;
> >
> > (4) Whether the subject break-up fee constitutes a fair and reasonable percentage of the proposed purchase price;
> >
> > (5) Whether the dollar amount of the break-up fee is so substantial that it provides a "chilling effect" on other potential bidders;
> >
> > (6) The existence of available safeguards beneficial to the debtor's estate;
> >
> > (7) Whether there exists a substantial adverse impact upon unsecured creditors, where such creditors are in opposition to the break-up fee.
>
> *Id*. at 193, 194.

The court further remarked, "In the context of a non-bankruptcy asset sale, . . . break-up fees are presumptively appropriate in view of the business judgment rule, and thusly, seldom require judicial attention. In the bankruptcy context, however, the Court must be necessarily wary of any potential detrimental effect that an allowance of such a fee would visit upon the debtor's estate." *Id*. (citation omitted). After "carefully scrutiniz[ing]" the bidding incentives, the court concluded that they "would only be an unwarranted expense upon the Debtor's estate" and refused to approve the agreement. *Id*. at 196. (Cited by *In re O'Brien Env't Energy, Inc.*, 181 F.3d 527, 534 (3d Cir. 1999)).

B. *Seventh Circuit cases:*

1. *In re S.N.A. Nut Co.*, 186 B.R. 98, 104 (N.D. Ill. 1995). A breakup fee is treated as an administrative expense and, as such, the benefit to the estate needs to be justified. The bankruptcy court will not approve provisions for break-up fees absent compelling circumstances clearly indicating that payment of fees would be in best interest of estate.

2. *Matter of Tiara Motorcoach Corp.*, 212 B.R. 133 (Bankr. N.D. Ind. 1997). (1) The bankruptcy court could not rely on the business judgment of debtor but had to examine the proposed breakup fee to ensure that the best interests of debtor's estate, creditors, and equity holders were furthered, and (2) the proposed $200,000 breakup fee could not be approved.

a. The proposed breakup fee must be reasonable compared to the purchase price: The court notes that the *Twenver* court stated, "the 10% [breakup fee] sought [in that case] greatly exceeds the 1% to 2% fees found to be reasonable in the majority of cases approving such fees." *Twenver*, 149 B.R. at 957; see also *Integrated Resources*, 147 B.R. at 662 (the court heard expert testimony that the industry standard on average is 3.3 percent. The court ultimately accepted a breakup fee that was 1.6 percent of the purchase price).

b. The proposed breakup fee must not chill bidding: if approval of a breakup fee thereby requires companies to offer at least $3.1 million to overcome Mark III's proposed purchase price and breakup fee/expenses would not encourage bidding. *Id.*, 212 B.R. at 138.

C. *The consequences of failure to include Reverse- or Break Up Fee in executed APA:*

1. Must move for such a fee as an administrative expense under 11 U.S.C. § 503(b), which authorizes payment of "the actual, necessary costs and expenses of preserving the estate." 11 U.S.C. § 503(b)(1)(A).

2. An administrative claim will be afforded priority under § 503(b) if the debt, "both (1) arises from a transaction with the debtor-in-possession and, (2) is beneficial to the debtor-in-possession in the operation of the business." *In re Jartran, Inc.*, 732 F.2d 584, 587 (7th Cir. 1984) (quotations omitted).

3. Despite the potentially broad reach of § 503(b), "administrative priority claims are to be strictly construed because the presumption in bankruptcy cases is that the debtor has limited resources that will be equally distributed to creditors." *In re Nat'l Steel Corp.*, 316 B.R. 287, 299 (Bankr.N.D.Ill.2004).

4. The moving party bears the burden of showing its claim is entitled to administrative expense priority, and the standard of proof is preponderance of the evidence. *Id.* (citations omitted). *See In re SpecialtyChem Prod. Corp.*, 372 B.R. 434, 439–40 (E.D. Wis. 2007).

IV. Reverse Breakup Fees

One way for a seller to protect itself from the downside of a buyer failing to clear a condition to closing involving clearance by a governmental agency is inserting a liquidated damages provision in the form of a "reverse break-up fee".[3]

In Chateaugay Corp. is a 1995 Southern District of New York case that nonetheless perfectly illustrates the topic of this "current events in the 7th circuit" presentation. *In re Chateaugay Corp.*, 186 B.R. 561, 594 (Bankr. S.D.N.Y. 1995), order aff'd, appeal dismissed, 198 B.R. 848 (S.D.N.Y. 1996), aff'd, 108 F.3d 1369 (2d Cir. 1997). A full description of the case is warranted to illustrate the issues here.

Chapter 11 debtor was a manufacturer of military and commercial aerospace and defense products. Approximately 98% of the to-be-sold business derived either directly or indirectly from contracts with the U.S. armed services. The eventual

[3] *In re Chateaugay Corp.*, 155 B.R. 636, 639n.2 (Bankr. S.D.N.Y. 1993), order aff'd, appeal dismissed, 198 B.R. 848 (S.D.N.Y. 1996), aff'd, 108 F.3d 1369 (2d Cir. 1997).

winning bidder, Thomson-CSF, is French incorporated, and 58% of its outstanding shares and 75% of voting shares are owned by a corporation wholly owned by the government of France.

Through a bidding process, debtor generated bids from a number of U.S. and foreign entities. Over the three days of hearings the parties were given numerous opportunities to increase their bids.

The bidding process yielded final offers of $450 million from Thomson-CSF and $385 million from Vought. The debtor nevertheless favored approval of Vought's offer due to its belief that Thomson would be unable to secure the necessary governmental approvals. In addition, Vought's position was that it would not return if the Court approved a competing offer.

Thomson, however, expressed full confidence that it would be successful in negotiating with the government. Thomson's counsel stated boldly in open court that "Thomson is experienced not just in France but has . . . significant government [contracts] in this country. It knows what it is about with respect to dealing with the United States government and with the Department of Defense." The debtor's creditor and equity constituencies agreed to support the Thomson bid, *provided* that Thomson agreed to **a reverse break-up fee** payable if it was unable to close the transaction due to its failure to obtain necessary governmental security approvals.

The reverse break-up fee was designed, among other things, to compensate debtor for incurring the risk that its "bird in hand" (the Vought bid, not subject to government approval) would no longer be available if the Thomson-CSV deal fell through.

Thomson ultimately agreed to a $20 million reverse break-up fee, and the Court, citing the financial disparity between the two offers and Thomson's willingness to post a reverse break-up fee as significant factors in its decision, approved the Thomson-CSV offer.

Thomson-CSV had ignored information that the DOD and CFIUS would not approve the transaction and, per the Bankruptcy Court, ". . . stubbornly believed, despite all of the signs to the contrary, that with its team of high powered and influential advisors, it could acquire the Missiles Division on its own terms." The buyer failed to obtain the requisite approvals, and thus was unable to close the transaction.

By virtue of its failure to close the transaction, the now-failed buyer was obligated to pay to the debtor a $20 million reverse breakup fee pursuant to the terms of their asset purchase agreement. The failed buyer refused, and, finding it

in violation of Court Order, the Bankruptcy Court ordered the failed buyer to pay the debtor the $20 million reverse breakup fee plus 9% per annum prejudgment interest.

As CFIUS and other administrative agencies grow in importance under the current administration, advisors to bankruptcy estates will need to be more diligent in negotiating reverse break-up fees and other provisions that protect the estate from a buyer who ultimately fails to procure administrative approval of its proposed acquisition.

V. Sample Clauses to Consider – Protection Against Conditions to Closing

A. In Bid Procedures Example:

> Governmental and Regulatory Approvals: A Proposal must include a statement or evidence: (i) that the Prospective Bidder has made or will make in a timely manner all necessary filings under the Hart Scott Rodino Antitrust Improvements Act of 1976, as amended or any and all other anticompetition laws, as applicable, and pay the fees associated with such filings, and (ii) of the Prospective Bidder's plan and ability to obtain all governmental, regulatory (including, as applicable, telecommunications licensing, national security, and export controls-related licenses or authorizations), or other third-party approvals to operate the Debtors' business from and after the closing of the Sale transaction and the proposed timing for the Prospective Bidder to undertake the actions required to obtain such approvals. A Prospective Bidder further agrees that its legal counsel will coordinate in good faith with Debtors' legal counsel to discuss and explain such Prospective Bidder's regulatory analysis, strategy, and timeline for securing all such approvals as soon as reasonably practicable, and in no event later than the time period contemplated in (a) with respect to any Assets subject to a Stalking Horse Agreement (as defined below), such Stalking Horse Agreement (including all exhibits and schedules thereto), and (b) with respect to any other Asset, the Form Purchase Agreement (as defined below).

See In re OneWeb Global Limited, et al., Bankr S.D. NY 20-22437-rrd, ECF No. 104 at p. 22.

B. APA Covenants Example:

Filing With CFIUS: If the transaction contemplated by this Agreement is a "covered transaction" that requires submission of a filing to the CFIUS pursuant to 31 C.F.R. § 800.401 ("mandatory declarations"), Purchaser and Seller shall, and shall cause their respective affiliates to use reasonable best efforts to obtain CFIUS approval. Such reasonable best efforts shall include: (a) engaging in pre-filing discussions with CFIUS or its member agencies, as appropriate: (b) promptly making any draft and final filings required in connection with the CFIUS approval in accordance with the Defense Production Act; (c) providing any information reasonably requested by CFIUS or its member agencies in connection with the CFIUS review or investigation of the transactions contemplated by this Agreement; (d) consulting with each other in advance of any planned communication with CFIUS or its member agencies and promptly informing each other of any material communication with CFIUS or its member agencies; and, (e) ensuring that both Purchaser and Seller or their counsel review and approve in advance any material written communication with CFIUS or its member agencies; provided, however, that nothing in this Section ____ shall be construed as requiring Purchaser or Seller to disclose to the other(s) any communication or materials that the disclosing party(ies) considers to be proprietary or confidential. If the transactions contemplated by this Agreement do not require the filing of a "mandatory declaration" for CFIUS purposes, but CFIUS requests or requires a filing with respect to the transactions contemplated by this Agreement, then Purchaser and Seller shall, and shall cause their Affiliates to, use reasonable best efforts to obtain the CFIUS approval. In the event that the transaction contemplated by this Agreement is a "covered transaction" or if CFIUS requests or requires a filing in respect thereof, then CFIUS approval shall automatically (and without amendment hereto) be deemed to be a condition to the Closing hereunder.

See In re Carbonlite Holdings*, LLC*, Bankr. D. Del. 21-10527, ECF No. 514 (May 26, 2021).

C. APA Remedies Example:

(a) If on ________, 20__, (A) either of the conditions in Section ________ hereof shall not have been satisfied, (B) the Buyer does not

have an independent right not to proceed with the Closing (whether as a result of the non-satisfaction of the conditions set forth in Section _______ or the right of Buyer to terminate this Agreement pursuant to Section ______, for reasons that are not related directly or indirectly to either of the conditions contained in Section ______, hereof, and (C) Buyer does not proceed with the Closing, then Buyer shall pay to the Sellers as a nonrefundable fee an aggregate of _____ million dollars ($________) in immediately available funds by wire transfer to accounts designated by the Sellers.

[In the cited case, under section 10.01, Buyer's obligation to close was subject to two conditions: 1) the negotiation and execution of an SSA with the DOD, a draft of which was attached to the Purchase Agreement; and, 2) the receipt of final CFIUS approval, including any action by the President pursuant to the Exon–Florio Amendment.]

In re Chateaugay Corp., 155 B.R. 636, 646 (Bankr. S.D.N.Y. 1993), order aff'd, appeal dismissed, 198 B.R. 848 (S.D.N.Y. 1996), aff'd, 108 F.3d 1369 (2d Cir. 1997)

VI. Closing. See also:

- J. Eric Crupi, Addressing Buyer's or Seller's Remorse: Pre-Bankruptcy Considerations Involving Post-Signing/pre-Closing Strategic Transactions in A Volatile Economic Environment, 18 Am. Bankr. Inst. L. Rev. 495 (2010).