Diligence Opportunities in Bankruptcy

With the worst downturn since the Great Depression upon us, it is not surprising that we are seeing record numbers of companies filing for bankruptcy. In the past, companies frequently filed petitions for reorganization under chapter 11, obtained debtor-in-possession (DIP) financing to fund ongoing operations and then go through a lengthy process of developing a plan of reorganization. The plan would identify the debtor's creditors and their claims in a disclosure statement, and then describe the framework of how those claims will be satisfied according to the priorities in the bankrupcy code.

Secured creditors generally have the highest priority followed by unsecured claims. Certain costs known as "administrative claims" may come ahead of the unsecured creditors. In some instances, environmental cleanup costs associated with facilities owned or operated by the debtor may be considered adminstrative costs. In contrast, liabilities associated with non-owned disposal sites will be considered unsecured claims. For those sites, government agencies and PRPs will have to share the funds in the unsecured creditor pot.

Once the plan is approved by the court, the claims are paid in accordance with the plan, the claims are discharged and the debtor emerges from bankruptcy. When the debtor emerges from bankruptcy, it is considered a new entity and the court will issue an injunction precluding creditors from pursuing claims against the new company.

It is important for creditors who may have contribution claims against a debtor for cleanup costs to file proofs of claims. It is important to estimate the value of the claims as the court may conduct what is known as an estimation procedure to attach a value to that claim.

If the creditors fail to file a proof of claim , they will not likely be able to recover their costs against the new company as bankruptcy judges do not like creditors messing with their injunctions. As a result, EPA and many states have bankruptcy groups that will file claims during a bankruptcy case and frequently settle for pennies on the dollar of the potential liability.

However, this is not your normal recession. Because of the credit crisis, many debtors cannot obtain DIP financing. So, many debtors are trying to restructure and raise cash by selling assets under section 363 of the bankruptcy code which enables the debtor to sell assets quickly.

Section 363 allows debtors to sell assets "free and clear" of liens and interests. The bankruptcy courts are divided on whether section 363 applies to environmental liabilities. Often times, the purchasers try to have the bankruptcy court order provide that they are acquiring assets free of environmental liability or that the purchaser will not be considered a "successor" for purposes of environmental liability. More frequently, though, and especially when the purchaser will be acquiring real estate, the environmental liability may follow the purchaser. Thus, bankruptcy sales may be an opportunity for consultants to provide due diligence services to purchasers of debtor's assets.

Without going into too much detail, the normal process for a 363 sale is that the debtor will retain an investment banker or broker to market the assets.
After marketing the assets, a preliminary winner will be selected who is known as the "stalking horse" because that bidder's terms become the baseline for other bids. It is the stalking horse who will usually do the brunt of the diligence.Sometimes, purchasers will want to purchase substantially all of the business while others may only be interested in acquiring certain pieces of a business. the bidder may be a new entity comprised of management who has attracted new capital. On other occasions, the bidder may be a secured creditor who is willing to exchange its debt for new debt in the purchaser that is on more favorable terms or perhaps equity in the purchaser.

Once a stalking horse is identified, the debtor will file a motion with the court to approve procedures for selling the assets. The motion will identify the stalking horse, the terms of the agreement between the stalking horse and the debtor as well as other material terms. The order will also identify the other information that prospective bidders may be required to submit. If no stalking horse is identified, the assets will likely be sold pursant to an auction.
Disclosure is of paramount importance in a 363 sale as courts need to be shown that the sale is providing fair value and has been done in good faith. Material information needs to be developed and disclosed. Likewise, full disclosure of environmental liabilities is important in a traditional plan of reorganization.
The interplay between environmental law and bankruptcy is complex. The laws have different purposes. The bankruptcy code is designed to give companies a "fresh start" while environmental laws often look backwards under their "polluter must pay" approach. Thus, if environmental issues are not adequately addressed in bankruptcy so that environmental claims are not discharged, a purchaser of corporate assets or the new company that has emerged from bankruptcy might be considered a successor to the debtor and find itself saddled with unexpected environmental liabilities.