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Be vigilant when acquiring assets from a company in distress

When a company is in trouble, it may seem like the ideal time for a competitor to swoop in and make an offer. After all, aren't outside investment groups always looking for companies with growth potential? And who wouldn't like to snatch up certain intellectual property or products from a distressed rival?

But there are many pitfalls to watch out for.

Purchase outside the bankruptcy process

If a company with a number of competitors is in trouble, the first potential buyer to the table likely does not want this news to become public. Thus, for the buyer, acquiring the assets in a bankruptcy sale is not the desired course of action. But buying the assets of a distressed company outside of the bankruptcy process can be equally hazardous.

When a sale of a company results in a tidy profit for its shareholders and all of its creditors are paid in full, a buyer typically does not have to worry about legal challenges from these parties. However, in a situation where all creditors are not fully paid, or shareholders don't feel the company was sold at its maximum value, it is more typical that the buyer (and company) becomes the target of lawsuits.

Dissatisfied creditors are entitled in some circumstances to challenge a sale of assets as a fraudulent transfer under federal law. The law allows creditors to void a transfer that's in violation, to the extent necessary to satisfy the creditors' claims.

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The statute of limitations on such claims is usually four years after the transfer is made. Essentially, the buyer has to prove that he paid fair value for the assets of the company, which is usually not an easy task.

Unwanted liabilities

Even if you can fend off these types of claims, another pitfall of buying assets outside of a formal bankruptcy proceeding is a higher risk of assuming unwanted liabilities.

Every potential buyer should be aware that there are legal doctrines of successor (buyer) liability that are often applied to a deal which result in those liabilities being assumed.

For example, under the "de facto merger" theory, successor liability can arise when the parties to an asset purchase achieve essentially all of the results of a merger without actually merging. In determining whether a transaction amounts to a "de facto merger," most courts ask:

- Is there a continuation of the seller's enterprise (management, location, assets, etc.)?
- Is there a continuity of shareholders, with stock transferring from buyer to shareholders of the seller?
- Did the seller cease its business operations, liquidate and dissolve soon after the transaction closing?
- Did the buyer assume the obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations?

If the answer to these questions is yes, then the buyer has just inherited all of the seller's liabilities. In some cases, even when the answer to all four questions is no, liabilities may be assumed. In other words, consult closely with counsel.

The bankruptcy alternative

When buying the assets of a company out of bankruptcy, many parties assume they are buying those assets free and clear of all liabilities. This is not always true. While a formal bankruptcy proceeding (under Chapter 11 of the U.S. Bankruptcy Code) does protect a distressed company from creditor demands, it does not necessarily rid the buyer of all liabilities.

A bankruptcy sale also has its own set of issues that don't necessarily favor a buyer trying to acquire distressed company assets at a bargain price.

In many cases environmental liabilities, patent or trademark infringement claims and products liability claims have followed buyers who bought real estate, intellectual property and products in bankruptcy sales. The extent to which these liabilities follow assets depends on a number of factors that have not yet been fully decided by the courts.

There are certain things a buyer can do, however, to minimize its exposure in these areas.

A lot of risk can be minimized by ensuring comprehensive notice is provided to potential claimants and by careful drafting of the sale approval order that will ultimately be submitted to the bankruptcy court. Buyers can also, in certain instances, require a holdback on a portion of the purchase price for a period of time to deal with potential claims.

In addition to concerns about potential assumed liabilities, buyers buying assets in a Section 363 sale under Chapter 11 of the Bankruptcy Code face competition they many not otherwise face in a pre-bankruptcy sale (because of a court-mandated auction process). However, there are definitely ways the original bidder can avoid competing with other buyers through a court-mandated auction in a Section 363 sale.

Ultimately, it is important to consult with advisers familiar with the process before making the leap into a distressed company acquisition.

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