



presents

Leveraging Section 363 in Mergers and Acquisitions

Analyzing the Evolving Risks and Benefits of Buying and Selling Distressed Assets

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Robert L. Eisenbach III, Partner, **Cooley Godward Kronish**, San Francisco
Jennifer Fonner DiNucci, Partner, **Cooley Godward Kronish**, Palo Alto, Calif.

Wednesday, December 2, 2009

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12 pm Central

11 am Mountain

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Leveraging Section 363 Sales In Mergers And Acquisitions

presented by

Robert Eisenbach and Jennifer Fonner DiNucci

Current Environment

- ▶ Still a difficult business climate
- ▶ Large amount of debt maturing over next few years
- ▶ Decreased access to private capital
- ▶ Limited access to public markets
- ▶ Credit markets remain tight
- ▶ Buyer's market in many industries



Distressed Companies: Buyers' Opportunity and Risk

- ▶ Potential Opportunities
 - ▶ purchase assets at reduced cost
 - ▶ cherry-pick assets
 - ▶ less competition among buyers for assets
 - ▶ leverage to renegotiate leases and other executory contracts
- ▶ Potential Risks
 - ▶ inability to leave all unwanted liabilities behind
 - ▶ deterioration of employee base and customer base
 - ▶ limited diligence opportunity
 - ▶ less post-closing protection against risk



Distressed Companies: Unwanted Liabilities

- ▶ Fraudulent transfer claims under Bankruptcy Code and state law
 - ▶ Actual fraud
 - ▶ Rarely an issue in corporate M&A
 - ▶ Constructive fraud
 - ▶ Lack of reasonably equivalent value paid
 - ▶ Seller is financially impaired or will be rendered so by transaction
 - ▶ Fair value of assets less than liabilities
 - ▶ Unable to pay debts as they become due
 - ▶ Unreasonably small capital remaining
- ▶ Successor liability
 - ▶ De facto merger
 - ▶ Statutory or tort law liability
- ▶ Limited recourse against seller for indemnification claims



Flying Trapeze Without A Net

- ▶ Traditional asset purchase
 - ▶ Benefits
 - ▶ Speed
 - ▶ No-shops and exclusivity
 - ▶ Downsides
 - ▶ Fraudulent transfer risk
 - ▶ Risk of other unwanted liabilities
 - ▶ Avenues to limit risk
 - ▶ Escrow holdbacks
 - ▶ Indemnification by stockholders
 - ▶ Consents/waivers from creditors and other key parties
 - ▶ Third party appraisals



- ▶ Bankruptcy
 - ▶ Chapter 11 Plan
 - ▶ “363 Sale”
- ▶ Assignment for benefit of creditors (“ABC”)
 - ▶ Creature of state law
 - ▶ Assignee similar to bankruptcy trustee
 - ▶ No court filing in California
- ▶ Friendly foreclosure
 - ▶ Target allows secured creditor to foreclose
 - ▶ Title transferred by secured creditor



Bankruptcy: Section 363 Sales

- ▶ Major benefits
 - ▶ Reduced risk of later challenges
 - ▶ Free and clear of encumbrances
 - ▶ Ability to force assignment of contracts
 - ▶ Finality of sale
- ▶ Downsides
 - ▶ Cost and delay
 - ▶ Bankruptcy is public
 - ▶ Overbids and credit bids
 - ▶ IP Issues
 - ▶ Impact on business



Before Bankruptcy: Due Diligence

- ▶ Due diligence issues
 - ▶ Non-disclosure agreements
 - ▶ Access to data rooms
 - ▶ Valuation and pricing issues
 - ▶ Focus on key assets to purchase
 - ▶ Separating shared assets can be an issue
 - ▶ If less than substantially all assets are purchased
 - ▶ Some assets may be used in multiple divisions
 - ▶ Need for transition services
 - ▶ Executory contracts and leases
 - ▶ IP issues



Before Bankruptcy: Section 363 Sale Process

- ▶ The “stalking horse” bid
 - ▶ Negotiating the “stalking horse” agreement
 - ▶ Key definitions of purchased and excluded assets
 - ▶ Purchase price adjustments
 - ▶ Cure costs for executory contracts
 - ▶ Generally few reps and warranties
 - ▶ Bankruptcy process provisions and walk rights
 - ▶ Release or purchase of adverse claims
 - ▶ Debtors generally want to retain avoidance actions
 - ▶ Purchaser may want to acquire these claims against vendors and customers
 - ▶ Negotiating with contract parties and IP licensors
 - ▶ Improving terms
 - ▶ Obtaining required consents



- ▶ Protections for stalking horse bidder
 - ▶ Bidding procedures
 - ▶ Financial and other requirements for qualified bidders
 - ▶ Deadlines for competing bids
 - ▶ Access to information on potential competing bids
 - ▶ Break-up fee and expense reimbursement
 - ▶ Different standards in various courts
 - ▶ Concerns about bid chilling
 - ▶ Deal size can have impact
 - ▶ Overbid requirements
 - ▶ Minimum overbid amount to cover break-up fee and expenses
 - ▶ Setting bidding increments for overbid and auction
 - ▶ Stalking horse's ability to credit break-up fee



Venue And Secured Creditor Issues

- ▶ Venue considerations
 - ▶ Delaware and Southern District of New York are frequent venue choices for larger cases
 - ▶ Courts around the country vary on how Section 363 sales are handled
 - ▶ Differences in type of sale orders that will be approved
- ▶ Role of secured creditors
 - ▶ Critical that sale be “free and clear” of all liens and encumbrances
 - ▶ Consent of secured creditors may be required for “short sale”
 - ▶ Secured creditors have right to credit bid debt
 - ▶ Payment of break-up fee and expense reimbursement may be an issue if credit bid prevails
 - ▶ May provide DIP financing to enable operations through closing

The Filing: Section 363 Sale Process

- ▶ Court approval process
 - ▶ Bidding procedures motion
 - ▶ Often initial motion seeks approval of procedures, break-up fee, and expense reimbursement provisions
 - ▶ May be a “first day” motion if sale is pre-arranged
 - ▶ Section 363 sale motion
 - ▶ Motion seeks court approval of the asset sale itself
 - ▶ Form of “free and clear” sale order often submitted with motion
 - ▶ Motion to assume and assign contracts
 - ▶ Often includes all possible executory contracts and leases
 - ▶ Purchaser generally reserves right to remove contracts
 - ▶ Adequate assurance of future performance issues

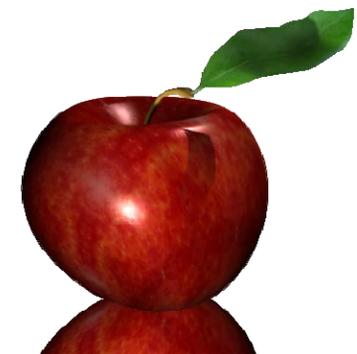
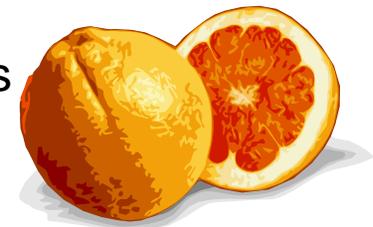
The Creditors' Committee

- ▶ Role of creditors' committee
 - ▶ Appointed after stalking horse agreement signed
 - ▶ Focus is on recovery for unsecured creditors
 - ▶ May have disputes with secured creditors
 - ▶ Could impact sale process
 - ▶ Entitled to be heard on all issues
 - ▶ May press for changes to stalking horse agreement
 - ▶ Longer sale period to attract overbids
 - ▶ Reductions in break-up fee and expense reimbursement
 - ▶ Substantive deal points



Overbids And Auction Process

- ▶ The bidding period and beyond
 - ▶ Shopping the deal
 - ▶ Debtor and creditors' committee want overbids
 - ▶ Fiduciary duty to maximize value to estate and creditors
 - ▶ Overbids
 - ▶ Questions whether qualified under bid procedures
 - ▶ Bid may be “orange” to stalking horse’s “apple”
 - ▶ Differences on terms other than price can be complicated
 - ▶ Auction
 - ▶ Stalking horse bidder’s advantages
 - ▶ Opportunity for overbidders
 - ▶ Auction strategies



Executory Contract Issues

- ▶ Executory contracts and leases
 - ▶ Review of key contracts
 - ▶ Identifying valuable agreements for assignment
 - ▶ Compiling list of contracts to leave behind
 - ▶ Assessing existing defaults and cure costs
 - ▶ Limited impact of anti-assignment provisions
- ▶ Special issues with intellectual property licenses
 - ▶ In-bound IP licenses may be non-assignable absent consent
 - ▶ Out-bound IP licensees may have rights to IP even if licenses are rejected



Executory Contracts Under The Bankruptcy Code

- ▶ **General rule:** Debtor or trustee can assume, assign, or reject executory contracts pursuant to section 365 of the Bankruptcy Code, subject to certain limitations.
- ▶ **Generally accepted definitions:**
 - ▶ A contract “that is not so fully performed that a breach by either side would constitute a material breach of the contract”
 - ▶ If there are unperformed obligations on both sides of the agreement, then the agreement is an executory contract.
- ▶ **IP licenses as executory contracts:** Courts generally hold that intellectual property licenses are executory contracts, often noting:
 - ▶ licensor’s obligations not to sue and to protect IP from infringement claims, and
 - ▶ licensee’s obligations to use IP within scope of license and to pay royalties when license is not fully paid-up.
- ▶ **Key limitation:** Section 365(c)(1) contains “applicable law” limitation on assignment and, according to some courts, on assumption.

Assumption and Assignment Under Section 365

- ▶ Section 365(b)(1) governs the assumption of executory contracts by a debtor if there has been a default under the contract, such as the failure of a debtor licensee to pay royalties to its licensor as required by the agreement.
- ▶ If a default exists, the executory contract may be assumed and assigned only if:
 - ▶ the debtor **cures** or provides adequate assurance that it will cure, all monetary defaults under the contract;
 - ▶ the debtor **compensates**, or provides adequate assurance that it will compensate, a party other than the debtor to such contract, for any actual pecuniary loss to such party resulting from the default; and
 - ▶ the assignee provides “**adequate assurance of future performance**” under the contract. See 11 U.S.C. § 365(b)(1)(A)-(C).
- ▶ Adequate assurance of future performance requires the assignee to demonstrate its ability to perform its obligations under the agreement after assumption and assignment, but it is not a guarantee of performance.
- ▶ Anti-assignment provisions are generally unenforceable, with certain exceptions.

Assumption and Assignment of Executory Contracts: Limitation of Section 365(c)(1)

Section 365(c)(1) of the United States Bankruptcy Code

(c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment;

IP Licenses: When The Licensee Is In Bankruptcy

- ▶ Most Courts of Appeals have ruled that “applicable law” includes patent and copyright law.
- ▶ Unpublished Ninth Circuit decision recently affirmed Nevada district court’s holding that trademark licenses are also personal and non-assignable without consent.
- ▶ Federal courts generally hold that *non-exclusive* patent and copyright licenses are personal to the licensee and not assignable without consent of the licensor.
- ▶ Ninth Circuit’s decision in *Gardner v. Nike*, 279 F.3d 774 (9th Cir. 2002), holds that *exclusive* copyright licenses are also not assignable without copyright holder’s consent.
- ▶ Rule is less clear for exclusive patent licenses, but no court has held they are assignable in bankruptcy over patentee’s objection.

Another Way To Assume Or Assign An IP License: Establish Licensor's Consent

- ▶ Applicable law and section 365(c)(1) prohibit assignment absent “consent” of licensor
- ▶ So what constitutes consent?
 - ▶ Many courts will enforce provisions in license agreement in which licensor gave advance, conditional consent to assignment of license.
 - ▶ License agreements sometimes contain provisions consenting to assignment “in connection with a sale of all or substantially all of the assets” of the licensee.
 - ▶ If consent conditions are met, may permit assumption and assignment in all circuits.
 - ▶ Minority view: Fourth Circuit’s *Sunterra* decision refused to treat prepetition consent language as sufficient consent under section 365(c)(1).

Section 365(n) Rights of Non-Debtor Licensees

- ▶ Under Section 365(n), if debtor licensor or its trustee rejects a contract, the non-debtor licensee has the right to make an election of remedies.
 - ▶ **Option One:** treat the license as terminated, cease using the IP, and file a claim under the Code for damages pursuant to section 365(g). Licensee will be treated as a general *unsecured* creditor absent a security interest.
 - ▶ **Option Two:** elect to retain the rights to the intellectual property under the license for the duration of the contract and any period for which the contract may be extended as of right, so long as the licensee makes all royalty payments. This includes rights of exclusivity. Licensee must waive any right to a setoff or for administrative claim based on the rejection.
- ▶ Upon request, trustee/DIP must (i) provide the licensee with the embodiment of the IP *to the extent provided for in the license*; and (ii) not interfere with the licensee's rights.
- ▶ For purchasers, out-bound IP licenses -- **even if rejected** -- may impact value and rights to IP purchased as part of Section 363 sale.

Sale Hearing And The Closing

- ▶ Sale Hearing
 - ▶ Confirm results of auction
 - ▶ Section 363(m) “good faith purchaser” finding
 - ▶ Address any objections by creditors or contract parties
 - ▶ Entry of sale order
 - ▶ Authorizes debtor to close
 - ▶ Approves assumption and assignment of executory contracts and leases
- ▶ Closing issues
 - ▶ Possible cure cost and executory contract issues
 - ▶ Satisfaction of closing conditions
 - ▶ Impact of appeal





Cooley
GODWARD KRONISH LLP

Presenters

Robert Eisenbach

- ▶ Partner in charge of the San Francisco office
- ▶ Focuses practice on bankruptcy and restructuring matters, including a wide variety of bankruptcy-related litigation
- ▶ Frequently assists purchasers of assets from financially troubled or bankrupt companies
- ▶ Represents unsecured creditors' committees in Chapter 11 cases
- ▶ Regularly guides companies and their boards of directors through Chapter 11 and out-of-court restructurings
- ▶ Recent representations include:
 - ▶ Levi Strauss & Co. in its acquisition of 73 outlet stores from Anchor Blue Retail Group, Inc. in its Chapter 11 bankruptcy, in the District of Delaware
 - ▶ The Official Committee of Unsecured Creditors in the Chapter 11 bankruptcy of Shoe Pavilion, Inc., in the Central District of California
 - ▶ Dot Hill Systems Corp. in its acquisition of key intellectual property from Ciprico, Inc. in its Chapter 11 bankruptcy, in the District of Minnesota
 - ▶ A private equity buyer of the European subsidiaries of MTI Technology Corporation in its Chapter 11 bankruptcy, in the Central District of California
- ▶ Listed in The Best Lawyers in America® for Bankruptcy and Creditor-Debtor Rights Law, and recognized as one of Northern California's Super Lawyers®
- ▶ Publishes In The (Red)®: The Business Bankruptcy Blog, to help CEOs, CFOs, boards of directors, credit professionals, in-house counsel and others to stay informed about business bankruptcy issues and developments



Partner In Charge

San Francisco
101 California Street
5th Floor
San Francisco, California 94111-5800

Phone: 415/693-2094
Fax: 415/693-2222
reisenbach@cooley.com

Jennifer Fonner DiNucci

- ▶ Focuses primarily on mergers and acquisitions, representing public and private companies from various industries as well as investment banks and venture capital firms
- ▶ Practice also includes securities and general corporate law matters
- ▶ Recognized by The Daily Journal as one of the Top 100 leading attorneys in California for 2006
- ▶ Frequently lectures on M&A related topics. Engagements include:
 - ▶ Distressed Company M&A and M&A and Antitrust, In-House Counsel MCLE Workshops, Cooley Godward Kronish
 - ▶ Board Considerations in M&A Transactions, Stanford Directors' Forum (Stanford Graduate School of Business and Stanford Law School)
 - ▶ Public Company Boards: The World Has Changed; Are You Prepared?, GCA Savvian/Cooley Godward Kronish presentation
- ▶ Ms. DiNucci has also authored, co-authored and consulted on several publications and articles including:
 - ▶ "Managing the Benefits and Risks of Transactions Involving Insolvent Companies." Inside the Minds: M&A Strategies for Bankruptcy and Distressed Companies. Aspatore Books (2009)
 - ▶ "Structuring Transactions Involving Intellectual Property." Intellectual Property in Business Transactions
 - ▶ Investment Banking: Valuation, Leveraged Buyouts, and Mergers and Acquisitions, J. Rosenbaum, J. Pearl. Wiley Finance (2009)



Partner

Palo Alto—Hanover Campus
3175 Hanover Street
Palo Alto, California 94304-1130

Phone: 650/843-5102
Fax: 650/849-7400
dinuccijf@cooley.com

Offices

California

Palo Alto—Five Palo Alto Square
Five Palo Alto Square
3000 El Camino Real
Palo Alto, CA 94306-2155
PHONE: 650/843-5000
FAX: 650/857-0663

Palo Alto—Hanover Campus
3175 Hanover Street
Palo Alto, CA 94304-1130
PHONE: 650/843-5000
Fax: 650/849-7400

San Diego
4401 Eastgate Mall
San Diego, CA 92121-1909
PHONE: 858/550-6000
FAX: 858/550-6420

San Francisco
101 California Street
5th Floor
San Francisco, CA 94111-5800
PHONE: 415/693-2000
FAX: : 415/693-2222

Colorado

Broomfield
380 Interlocken Crescent
Suite 900
Broomfield, CO 80021-8023
PHONE: 720/566-4000
FAX: 720/566-4099

DC

Washington, DC
777 6th Street, NW
Suite 1100
Washington, DC 20001
PHONE: 202/842-7800
FAX: 202/842-7899

Massachusetts

Boston
500 Boylston Street
Boston, MA 02116-3736
PHONE: 617/937-2300
FAX: 617/937-2400

New York

New York
The Grace Building
1114 Avenue of the Americas
New York, NY 10036-7798
PHONE: 212/479-6000
FAX: 212/479-6275

Virginia

Reston
One Freedom Square
Reston Town Center
11951 Freedom Drive
Reston, VA 20190-5656
PHONE: 703/456-8000
FAX: 703/456-8100

Washington

Seattle
719 Second Avenue
Suite 900
Seattle, WA 98104-1732
PHONE: 206/452-8700
FAX: 206/452-8800