WINTER 2009

Full Disclosure

NEWS AND INFORMATION FROM BENESCH'S BUSINESS REORGANIZATION PRACTICE GROUP

Purchase Price Adjustments in Bankruptcy Asset Sales: Keeping an Eye on the Bottom Line

Asset sales of the free-and-clear-of-claims variety that have become the go-to mechanism for liquidating debtor companies in chapter 11 bankruptcy should, in theory, be pretty simple. In its most basic form, a Bankruptcy Code section 363 asset sale should be a clean transfer of everything on the left hand side of the balance sheet for cash on the barrelhead, with everything on the right hand side of the balance sheet being left behind.

But the typical 363 buyer in today's distressed market is rarely of a simplistic mindset, and buyer sophistication becomes most apparent as a closing approaches and the finer points of the purchase agreement become all the more important. While bidders will attempt to exploit to their advantage a number of purchase agreement terms, the one that debtor-sellers tend to overlook most frequently amidst the starry-eyed fervor of the early bid solicitation process is the price "adjustment" clause in the purchase agreement. Of course, not every asset sale contains such a mechanism. But as transaction size and complexity increase, so too do the odds of a price adjustment being a critical component of overall transaction value.

The typical purchase price adjustment is a formula that mandates an increase or decrease in the final purchase price based upon a corresponding increase or decrease in the value of some acquired asset or combination of assets between the date of signing of the purchase agreement and closing—a lag that can be weeks or even months with intervening auction and bankruptcy court hearing requirements. Accounts receivable and/or inventory are typically the

continued on page 2

IN THIS ISSUE:

News About Us

- Will Kohn is presenting "Breaches in the Supply Chain" at the Plastics News Executive Forum 2009, March 1-4, in Las Vegas, Nevada.
- Will Kohn is presenting "Dealing with a Distressed/Bankrupt Chinese Company and Understanding the Recent Changes to China's Bankruptcy Laws" to the Cleveland Foreign Credit Group on February 12th at The Union Club in Cleveland.
- Brad Sandler was appointed to the Board of the Philadelphia Art Alliance.
- Benesch's Business Reorganization Practice was recognized as a "Leading Firm" by Chambers USA 2008.
- Brad Sandler was appointed Adjunct Professor of Law at Temple University School of Law.
- Brad Sandler was appointed Co-Chair of the Special Projects Task Force of the Asset Sales Committee of the American Bankruptcy Institute.
- Bill Schonberg was listed in "Best Lawyers in America" 2009.
- Stuart Laven is presenting "Negotiating Commercial Leases—When Your Tenant Files for Bankruptcy" June 16, 2009 in Cleveland (location TBA—Sterling CLE Education Services).

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Purchase Price Adjustments in Bankruptcy Asset Sales: Keeping an Eye on the Bottom Line

continued from page 1

assets used in the formula because they are inherently subject to material fluctuation over time and, as a result, are a source of potentially significant pricing exposure. Most adjustment clauses call for the "true-up" calculation to occur after the closing, although some may also have pre-closing features.

So how, exactly, should a purchase price adjustment clause be crafted to achieve maximum strategic advantage? And what stands to be gained (or lost) from a shrewdly (or poorly) written adjustment? Of course, the answers to these and other, corollary questions will be measurably different for buyers and sellers. But a few, broad observations are worth making. Consider the following:

Given the disconcerting possibility (probability) of a dramatic plunge in purchase price at closing in the absence of a cap, an open-ended, carte blanche adjustment right is a recipe for disaster for the seller.

Carefully Defining Assets and Valuation Methodologies

The greatest potential for exposure under a purchase price adjustment lies in the manner in which the component assets are defined. A smart buyer will attempt to define the assets in a way that gives it the greatest wiggle room in calculating a desired downswing in asset value (and purchase price) at closing. This is sometimes achieved via a deliberately vague definition of assets to be *excluded* from the adjustment formula.

Consider the following post-closing adjustment formula from a recent 363 sale of a Tier 1 automotive supplier, in which inventory was the only asset counted:

> If, on the Closing Date, the actual book value of the Purchased Inventory (*excluding from such value all Inventory that is obsolete, defective, non-merchantable, or not of the type currently used by Seller* ("Excluded Inventory")) is more or less than the Base Inventory Amount, the Purchase Price and the Cash at Closing shall be increased or decreased dollar for dollar.

In this instance, the ambiguous descriptors used in the definition of "Excluded Inventory"—especially "obsolete" and "non-merchantable"—gave the buyer the ability, at least arguably, to subtract just about any type or quantity of inventory from the closing-date count it wanted. Is inventory "non-merchantable" if the customer doesn't want to buy it in a previously specified quantity or at full price? Is it "obsolete" if the customer reduces order volume or defers delivery dates? The difficulty in answering these questions gives the buyer the upper hand in demanding a potentially large discount to the purchase price at closing.

Care should also be given to defining the valuation methodologies used in the adjustment formula. Like asset definitions, these too can be a source of closing-table consternation and gamesmanship: if the valuation methodology is unclear, or undefined altogether, the party controlling the true-up—usually the buyer—can take advantage.

A good way to assure clarity is via reference to the debtor-seller's past practices. In the deal above, the parties used the seller's prior year-end inventory as a guidepost for the closing-date inventory count and described the accounting method to be used in painstaking detail. Additionally, the parties agreed to rely on a physical count of the closing-date inventory, rather than an inherently less credible estimation (*i.e.*, a formulaic extrapolation from a sampling).

Capping the Adjustment; Escrows and Holdbacks

Should a purchase price adjustment be capped? The answer, especially for sellers, is always a resounding "yes." Given the disconcerting possibility (probability) of a dramatic plunge in purchase price at closing in the absence of a cap, an open-ended, carte blanche adjustment right is a recipe for disaster for the seller.

Questions sometimes arise as to what the dollar amount of the cap should be, and how funds should be earmarked for payoff on a negative adjustment. On the question of the cap amount, there is no simple rule of thumb, as the determination of the cap amount typically mandates the involvement of each side's financial advisors and, at some level, the seller's senior lenders. The financial advisor's task will be to assess the risk of material variation in the formula assets and balance that projected risk against each party's pricing expectations.

As for how funds should be set aside for payment of a downward adjustment, an escrow is commonplace and generally a wise move. Once purchase money is paid into a chapter 11 estate, the likelihood of a pull back is remote, especially if proceeds are paid over to secured lenders at closing. Experienced buyers know this and will always demand the right to withhold some of the purchase price pending the true-up.

But if the buyer simply retains the adjustment money, the debtor-seller may be forced to chase the buyer around in collection litigation if the buyer fails to pay off on a post-closing true-up that yields an increase to the base (pre-adjustment) purchase price. Thus, the seller should require that any holdback be funded into a true escrow account, with the escrow agent's release of the funds conditioned upon final resolution of the purchase price adjustment per the terms of the purchase agreement.

Going Forward

A stress-free 363 closing requires the parties and their advisors to achieve as much pricing certainty as possible during the myriad negotiations and Bankruptcy Code-induced complications that preoccupy the parties in the days or weeks that precede the closing. Of course, an agreed right to materially swing the purchase price under a formulaic price adjustment undermines any notion of pricing certainty, especially when multiple formula variables exist. But well counseled buyers and sellers can take maximum advantage of their relative positions in sale negotiations if they have done their homework and understand the ways in which a price adjustment right can encourage competitive bidding and ultimately drive value—something *everyone* will want to do in an increasingly bullish distressed market.

For more information on this topic, please contact Stuart A. Laven, Jr. at slaven@beneschlaw.com or (216) 363-4493.

Basics of Distressed Debt Investing: Claims Trading Strategy, Part Deux

In the last edition of Full Disclosure, we discussed the basics of claims trading. In this edition, we will look at the topic of insider trading of bankruptcy claims and how that issue is addressed by the Bankruptcy Court. We also will look at the implications of bankruptcy claims trading and how distressed investors can protect themselves so that they do not run afoul of applicable laws.

The positive tax consequence of NOLs can be lost or restricted (i) if there is a change in ownership through a transfer of a debtor's stock by its holders, and (ii) if there is a change in ownership through the conversion of debt to equity pursuant to a confirmed plan of reorganization.

Insider trading of bankruptcy claims occurs when the purchaser of a claim has acted on material, non-public (i.e., confidential) information. While trading securities on insider information is prohibited under federal securities laws, the prevailing view is that the securities laws do not apply to claims trading. Nevertheless, bankruptcy courts have imposed harsh sanctions (including, but not necessarily limited to, disallowance, subordination, and/or other adverse treatment) when trading claims on insider information has been established.

Members of official committees of unsecured creditors in a chapter 11 bankruptcy need to be cognizant of the prohibition of insider bankruptcy claim trading. Committee members should, and likely will, receive commercially sensitive or proprietary information from the debtor and others. Given that a committee member is a fiduciary who owes both the duties of care and loyalty to its constituency body, he or she is required to hold sensitive or proprietary information in confidence. Failure to hold such non-public information confidential would likely not only negatively impact communications between the debtor and committees, but also likely cause harm to the debtor. However, there have been some courts willing to allow committee members to participate in claims trading if appropriate screening walls have been established.

Trading Restriction Orders

In large chapter 11 cases, often the debtor has generated large net operating losses (NOL) in the months and years preceding the initiation of the chapter 11 proceedings. Subject to certain limitations, the Internal Revenue Code (IRC) provides that NOLs can be used as either carrybacks (i.e., a corporation can use the NOLs to offset taxable income for up to two (2) previous taxable years) or carryforwards (i.e., a corporation can use the NOLs to offset taxable income for up to twenty (20) taxable years into the future).

The positive tax consequence of NOLs can be lost or restricted (i) if there is a change in ownership through a transfer of a debtor's stock by its holders, and (ii) if there is a change in ownership through the conversion of debt to equity pursuant to a confirmed plan of reorganization. Essentially, if pre-emergence trading in claims and equity results in persons who are not Qualified Creditors or historic stockholders receiving more than 50% of the equity in the reorganized debtor, the IRC's more stringent restrictions, which are listed in Section 382, on prospective NOL treatment may apply.

Because of the potential positive tax consequences to the debtor, NOLs are property of the estate that must be protected and preserved. However, since the value of NOLs may be quickly and adversely affected by equity and claims trading, bankruptcy courts in recent years have been willing to enter orders that restrict the trading of a debtor's debt and other securities during the pendency of the debtor's bankruptcy proceedings so that the debtor's NOLs are protected and preserved.

The Bond Market Association and the Loan Syndications and Trading Association have developed a Model NOL Order that attempts to protect a debtor's NOL by permitting trading of claims, as long as it does not substantially change the ownership structure of the debtor. The Model NOL Order restricts the trading of equity, but permits the trading of claims until (i) the debtor files a plan of reorganization that relies on the Section 382(l)(5) exemption, which is the NOL is preserved as long as debtor's existing shareholders and/or qualified creditors (held claim for 18 months or claim arose in ordinary course of debtor's business) own at least 50% of the value and voting power of stock after plan confirmation, and (ii) a "sell down" order is entered by the bankruptcy court. Assuming a 382(l)(5) Plan is confirmed, and a party required to comply with the "sell down" order fails to do so, such claim holder forfeits his or her right to any distribution on the portion of his or her claim subject to sell down.

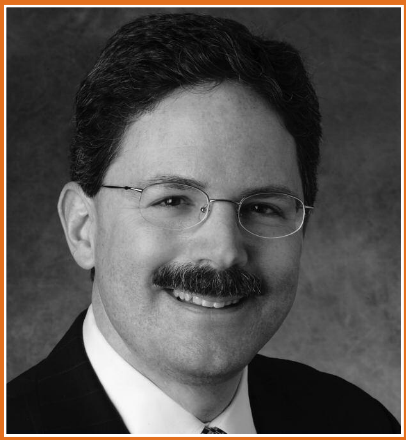
Implications

Restrictions on claims trading, while beneficial to the debtor (e.g., to preserve NOLs), is not beneficial to the distressed debt investor (e.g., hedge funds and private equity firms). Many prognosticators have speculated that the next tide of chapter 11 cases will see a substantial increase in activity by and from hedge funds. Whether this is true or not no one now knows for sure; however, between some recent rulings on claim trading restrictions and hedge fund disclosures, hedge funds may very well be less inclined to be active players in bankruptcy proceedings. In fact, these recent trends may persuade hedge funds to assist debtors in reorganizing outside of bankruptcy.

Corporate defaults are at a 2002 level, and likely will rise as the US economy is headed into the most severe recession in perhaps more than 80 years, which likely will cause a substantial increase in the filing of chapter 11 cases. Although the rate of Chapter 11 filings has increased in 2008 from 2007 levels, as the liquidity crisis eases allowing for the next tide of chapter 11 cases, it is of the utmost importance for distressed debt investors to retain sophisticated bankruptcy counsel who understands fully these recent trends in claims trading (and disclosure requirements) so that these investors are in a position to make informed investment and planning decisions.

For more information on this topic, please contact Bradford J. Sandler at bsandler@beneschlaw.com or (302) 442-7007.

Get to Know **Bill Schonberg...**



Who: Bill Schonberg is the Vice-Chair of the firm's Business Reorganization Practice Group. He focuses his practice primarily on the representation of debtors and creditors in such matters as asset-based loan agreements, workouts, reorganizations, secured transactions, and loan origination, negotiation and restructurings. He also has extensive experience with general corporate transactional strategic analysis and has handled matters in such industries as wholesale distribution, retail, light manufacturing and service.

What Bill wants you to know about the current Business Reorganization industry: The challenges imposed by the current economic climate and state of the credit markets dictate use of creative methods to effectively and timely reorganize a growing concern to preserve and maximize its value. Counsel experienced in all facets of the restructuring practice can focus on the techniques and resources available to effectively advise corporate clients and their Boards in the use of traditional, and importantly, alternative approaches to achieving their goals to serve the best interests of all their constituencies.

When Bill is not practicing law: He is involved in serving on several local community organization and charitable Boards as a fulfilling means of helping these organizations navigate through their changing environments and unique constituent needs. And, in the winter months, he attempts to find the time to ski with family and friends. Bill resides in Pepper Pike with his wife, Lisa. He has two children, Adam and Julia.

Emergency Economic Stabilization Act of 2008: A Summary of the Act As Amended by Recent Developments

Introduction

In response to the critical state of the United States' economy, on October 3, 2008, Congress passed and the President signed into law the Emergency Economic Stabilization Act of 2008 (the "Act"). Although mainstream media colloquially referred to the Act as the Bailout Bill and focused on the Act's creation of a program for the purchase and guaranty of up to $700 billion in troubled assets from financial institutions, the Act itself contains numerous provisions aimed at its ultimate goal of restoring liquidity and stability in the United States' financial system and the Act affords the Secretary of the Treasury (the "Secretary"), Henry M. Paulson, Jr., certain powers to carry out the Act's purposes. The following is a summary of the important provisions of the Act, including important events since its passage:

The Troubled Asset Relief Program

Much of the attention surrounding the Act focused on the creation of the Troubled Asset Relief Program ("TARP"), which was created to enable the Secretary to use up to $700 billion to purchase from financial institutions both residential and commercial mortgages and any other related instruments originated or issued on or before March 14, 2008 through the newly created Office of Financial Stability. The Act provided for the $700 billion to be released in three stages: (i) immediate access to $250 billion; (ii) an additional $100 billion available upon the request of the President; and (iii) the remaining $350 billion upon request of the President, provided Congress does not act to deny the funds. To date, $350 billion has been released to the Treasury.

Shortly after passage of the Act, and later confirmed by the Secretary, the purchase of "toxic assets" was rejected in favor of capital infusions into various financial institutions.

Shortly after passage of the Act, and later confirmed by the Secretary, the purchase of "toxic assets" was rejected in favor of capital infusions into various financial institutions. As of November 19, 2008, over $200 billion of the first $350 billion has been committed to a variety of financial institutions including Citigroup, Wells Fargo, JPMorgan Chase, Bank of America, and Morgan Stanley. Of the $200 billion, $40 billion went directly to insurer American Insurance Group ("AIG") in exchange for preferred stock in the company. According to the Secretary, the remaining balance may be used for further capital infusions, or other programs aimed directly at aiding consumers, such as programs directed at providing consumers with greater access to credit cards, automobile loans, and student loans. However, the Secretary has also stated the remaining $350 billion, which has yet to be made available will be left untouched until President-Elect Obama takes office.

FDIC Insurance

As previously stated, the Act did more than just "bail out" troubled banks. The Act includes many provisions directed toward individual Americans, which aim to promote the overall stability of the United States' economy. For example, in an apparent effort to promote stability in the economy through additional security, the Act contains a provision that temporarily increases the amount of FDIC deposit insurance from $100,000 to $250,000. The deposit insurance limit for credit union deposits insured by the Credit Union Administration Board is similarly increased. This insurance, which is provided per depositor, per bank, is available to reimburse parties for amounts that are on deposit and lost when a bank or savings association fails. This additional insurance should act to prevent parties from creating a run on the banks.

Mark-to-Market Accounting

Mark-to-Market accounting, which is the accounting practice of recording an asset at a price to reflect its current un-matured market value rather than its book value, is said to be partly to blame for the current economic crisis facing the United States. The Act provides that the Securities and Exchange Commission (the "SEC") may suspend the use of this practice. In determining whether to suspend its use, the SEC is required to conduct a study and report to Congress on the effect this accounting practice has on balance sheets and, specifically, what impact its use had on recent bank failures. As of the date of this newsletter, this practice is still in effect.

Amendments to the HOPE for Homeowners Act

In a previous attempt to aid the United States' failing economy, on July 30, 2008, Congress passed and the President enacted the HOPE for Homeowners Act ("HOPE"). HOPE created a voluntary program to help consumers struggling with home mortgages refinance into fixed-rate government-insured mortgages. Mortgage lenders that voluntarily participate in the program are required to write down the principal amount of mortgages so that the mortgage does not exceed 90% of the current value of the property. As enacted, HOPE was available to borrowers whose mortgage debt-to-income ratio was greater than 31%. The Act amended HOPE to provide eligibility to those borrowers whose debt-to-income ration is *likely* to exceed 31% due to an adjustable rate being reset. Additionally, the Act provides that HOPE may reduce the write-down requirements.

Congress also has spoken out in strong support of further programs to prevent foreclosures and the FDIC has developed a model, with the help of IndyMac Bank, to modify loans for individuals facing foreclosure. These modifications have reduced monthly payments by an average of 23% thereby reducing the numbers of individuals who are unable to meet their mortgage obligations.

Tax Provisions

Another heavily reported aspect of the Act is the magnitude of tax provisions and extensions that accompanied the Act. Below is a summary of the key tax provisions:

- Gains or losses arising from the sale or exchange of preferred stock of Fannie Mae or Freddie Mac are treated as ordinary gain or loss and not capital gain or loss;
- Financial institutions selling more than $300 million in assets through TARP may only deduct up to $500,000 for executive compensation. These same institutions will also incur a 20% tax on any golden parachute payments made pursuant to an agreement in place before the Secretary purchased or guaranteed assets;
- A current deduction excluding forgiveness of mortgage indebtedness, up $2 million is extended through 2012;
- Various existing tax credits for solar energy property, qualified fuel cell property, and microturbines are extended through 2016;
- Brokers are required to report customers' tax basis to the Internal Revenue Service for all transactions involving securities;
- The Alternative Minimum Tax ("AMT") exemption is increased from $33,750 to $46,200 for individuals and from $45,000 to $69,950 for married couples filing jointly;
- The itemized deduction for state and local income taxes is extended through 2009;
- Group health plans are required to offer mental health benefits and medical and surgical benefits on the same terms; and
- Various tax relief provisions are aimed at disaster relief, specifically benefiting victims of flooding and hurricane damage.

Conclusion

The Act's provisions were implemented to restore confidence with the United States' financial system. Since its passage, the funds allocated under the Act have been used in manners not originally anticipated, and more and more industries have stepped up seeking government aid. Time will tell whether the Act, and other actions by the US government, will prove successful in stabilizing the US economy.

For more information on this topic, please contact Kari Coniglio, at kconiglio@beneschlaw.com or (216) 363-4690.

Benesch Teams up with Legal Aid to Provide Financial Relief to Local Elderly and Disabled

Under the leadership of William Kohn ("Will"), Benesch Friedlander Coplan & Aronoff LLP ("Benesch") has teamed up with the Legal Aid Society of Cleveland ("Legal Aid") to introduce the Bankruptcy-By Pass Initiative (the "Initiative") to Northern Ohio. The Initiative, first developed and implemented by Will in Chicago, is a bankruptcy alternative for low-income individuals, particularly the elderly and disabled, with no assets to be seized or wages to be garnished. The Initiative provides relief from creditors' collection efforts without filing for bankruptcy relief.

Through the joint effort of Benesch and Legal Aid, potential clients will be identified by Legal Aid and then directed to a semi-monthly meeting hosted by Benesch where local attorneys will review assets and liabilities to determine whether the client is in fact "judgment proof." Volunteer attorneys will then draft letters to creditors advising that continued collection efforts will be fruitless. As was demonstrated through Will's Initiative in Chicago, these letters will drastically reduce collection efforts, effectively relieving creditor debt enforcement of the local elderly and disabled populations. These beneficial results are easily achieved with only a minimal commitment of 3-4 hours every month by local volunteer lawyers.

This program which has been highly acclaimed by the bench and the bar, having been awarded the "Excellence in Public Service Award" by the Chicago Chapter of the Federal Bar Association and the District Court for the Northern District of Illinois and the Volunteer of the Year Award from the Center for Disability and Elder Law of Chicago, promises to provide a much needed benefit to the needy in Northern Ohio.

For more information on this topic, please contact Will Kohn at wkohn@beneschlaw.com or (216) 363-4182, or Kari Coniglio at kconiglio@beneschlaw.com or (216) 363-4690.

Representative Transactions

Some of our recent client engagements include:

- Retained as Committee Counsel in National Dry Cleaners, Inc. et al Chapter 11 proceedings.
- Retained as Committee Counsel in Kardex Solutions, Inc. in Chapter 11 proceedings.
- Retained as co-counsel to the Committee in Delfasco, Inc. in Chapter 11 proceedings.
- Retained as co-counsel to Committee in Rehrig International, Inc. et al in Chapter 11 proceedings.
- Represented residential and commercial home builder in successful out-of-court workout, which included negotiation of capital infusion from home builder's lender.

Pass this copy of *Full Disclosure* on to a colleague, or email jgurney@beneschlaw.com to add someone to the mailing list.

For more information about our Business Reorganization Practice Group, please contact any of the following:

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