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Why You Should Learn the Playbook: Know the Game Plan for Distressed Acquisitions and Divestitures, Part Three—Sale Terms and Market Considerations

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This Briefing is part three of a three-part series on distressed health care sales. Part one provided a market snapshot and an overview of distressed sales.[1] Part two reported on a sampling of market terms and timelines in court-approved asset sales.[2] Part three discusses seller and purchaser considerations in negotiating the following sale terms for a court-approved stalking horse auction process: earnest money deposit, break-up fee, the minimum initial overbid amount, bid increments, the scheduling of a closing date, and certain closing conditions. It will also discuss how the court approval process may impact the seller and purchaser's perception of the reasonableness of these sale terms.

Negotiating these terms requires a balance of competing interests. The seller seeks terms that ensure the sale of the purchased assets will be to a contractually and financially committed bidder at a price that the seller believes is fair, while preserving the ability of the seller to potentially obtain higher and better offers at an auction for the benefit of the seller and its creditors. Purchasers often seek terms that give them greater exclusivity or protections (a higher break-up fee and a higher initial overbid amount) and reduce their risk (lower deposits, increased closing conditions, and a most favorable closing date). In court-approved sale processes the court is the final arbitrator of the reasonableness of the balance struck by the seller and purchaser, and other parties in interest in the case are given the opportunity to weigh-in.

The Earnest Money Deposit

The earnest money deposit has multiple purposes, each of which influences the acceptable amount of an earnest money deposit for a purchaser or seller. Each purpose also suggests whether the purchaser or seller seeks to set the deposit amount lower or higher.

There are several purposes that suggest that the deposit should be higher. The deposit is one way to demonstrate the purchaser's financial wherewithal to consummate the transaction. The higher the deposit, the better it demonstrates the purchaser's financial wherewithal. This may be more important when the purchaser is unknown in the industry. A higher deposit provides the seller with greater security in the event the purchaser breaches its obligations. The seller will want the earnest money deposit to at least cover the seller's cost of negotiating, documenting, and seeking court approval of a sale. A higher deposit can also incentivize the purchaser to "push" the transaction along so that the earnest money deposit does not languish unused in an escrow account. A higher deposit is also a way for the purchaser to demonstrate the seriousness of its commitment to the proposed transaction. In addition, a higher deposit may provide the purchaser with greater exclusivity by making the purchaser's offer more attractive or by effectively eliminating other potential bidders who are unable to tie up a similar amount of capital.

There are several purposes that suggest that the deposit should be lower. Earnest money deposits can be tied up for a long period of time while waiting on conditions to close. In addition to closing conditions present in typical healthy transactions, such as required regulatory approvals, in a distressed sale, the auction and court approval processes add to the timeline during which the deposit is held. Potential bidders may be reluctant to tie up a large amount of capital for an extended period of time and for transactions that are subject to court-approval and the scrutiny of third parties. If there are objections to a proposed sale or sale procedures, the purchaser's deposit may be tied up for an extended time period until such objections are resolved. For these reasons, a seller will not want to set the deposit so high that it quashes the market or excludes potential bidders. A seller should also protect against the possibility that a very high deposit chills the bidding at an auction. A lower deposit favors the possibility of more bidders qualifying for an auction. The seller and purchaser also need to consider that if the bidder is chosen as a back-up bidder (i.e., the second highest bidder), the back-up bidder's deposit may also be held for an extended time period until the successful bidder closes the transaction.

As is the case in healthy transactions, parties to distressed transactions also negotiate the timing of when the purchaser will pay its earnest money deposit and under what circumstances the deposit is refundable to the purchaser. While many of the same considerations are at play in a distressed versus healthy transaction, in a distressed transaction there is the backdrop of a court approval process and the potential for a back-up bidder to be standing ready to close if the successful bidder does not. This may lead a purchaser, for example, to include timing conditions whereby the deposit will be refundable and the purchase agreement terminable if the sale is not approved within a certain period of time. On the seller side, it is common to also see a so-called "drop dead date" after which the seller may terminate the agreement and retain the deposit if the sale has been approved but the purchaser has failed to close. On the other hand, diligence outs in distressed transactions are typically much more limited.

Break-up Fees

The Break-up Fee is specifically designed and calculated to: (1) reimburse a stalking horse purchaser for its reasonable out of pocket expenses incurred in connection with, among other things, reviewing, assessing, and conducting diligence on the potential transaction and retaining third-party consultants and advisors to perform financial, operational, legal, and regulatory analyses, and (2) incentivize the stalking horse to make its bid public and subject it to higher or better offers.[3] The break-up fee must be reasonable in light of the size and type of the transaction. The break-up fee must be set high enough to incentivize a stalking horse, but low enough that it will not require a minimum initial overbid amount that chills bidding (recall that the next highest bid should include an amount sufficient to repay the break-up fee).

Break-up fees are often determined as a percentage of the purchase price. The range of break-up fees approved by courts is varied, but in the authors' experiences a 3-5% break-up fee is most typical.[4] However, there are exceptions. For example, a health care asset that requires significant due diligence may support a break-up fee that is relatively high in percentage terms because it still needs to incentivize and cover costs. Alternatively, even a 3-5% break-up fee may chill bidding if the purchase price is already high.

Parties may also negotiate for both a break-up fee and a separate expense reimbursement. In such cases, parties must consider the expense reimbursement in connection with the break-up fee to determine whether the two, combined, are reasonable. In addition, the expense reimbursement, break-up fee, and minimum initial overbid must be considered in the aggregate to determine whether the terms may chill bidding. Another consideration in requesting an expense reimbursement is that the bidder may have to prove up their expenses, and the reasonableness of such expenses, while a fixed break-up fee alone requires no such proof.

Minimum Initial Overbid Amount

The minimum initial overbid amount is the dollar amount by which a topping bid must exceed the stalking horse purchaser's initial bid. There are several arguments for adopting a higher initial overbid amount. A higher initial overbid amount protects the stalking horse by encouraging only serious additional and higher bids. A seller also needs the initial overbid amount to be high enough to incentivize the stalking horse to make its bid public and subject it to potential topping bids. A seller should protect itself by ensuring that any initial overbid amount covers the cost of the break-up fee and results in additional proceeds material enough to justify the risk of switching horses, so to speak, to a new purchaser. Finally, the seller should seek to set the initial overbid amount high enough to cover additional transaction costs and any additional carrying costs that will need to be paid in order to close with a new purchaser, and still result in a material increase in net proceeds received.

There are a few factors that suggest the initial overbid amount should be lower. A seller wants to set an initial overbid amount low enough that it will not drive the topping bid price above the estimated market value. A seller also wants the initial overbid amount set low enough that potential bidders who may have done initial due diligence but were not selected as the stalking horse will decide to bid at the auction.

Bidding Increments

In negotiating bidding increments, which are the amounts by which subsequent bids must top prior bids made after the initial overbid, parties may consider three points. First, the increment should be in a material amount. If the increment is too small, it may fail to eliminate bidders and cause the pace of the auction to move too slowly. Second, the increment should be small enough to encourage bidding. A large increment may defeat the energy created by an auction if it is so large that it moves the price immediately out of range of reasonableness for other potential bidders. Third, even a stalking horse candidate should seek to negotiate a reasonable bid increment. A stalking horse may believe that a high bid increment favors the stalking horse bidder. However, if a topping bid is made, the stalking horse may find itself immediately on the sidelines if the bid increments are so large as to put the bid price quickly outside of the stalking horse's range of reasonableness.

Closing Date

The seller often considers the proposed closing date in selecting a stalking horse bidder or another offer as highest or best. The closing date is often tied to one of several events in a health care transaction: (1) entry of a court order approving the sale, (2) the expiration of the time to appeal a court order approving the sale, and (3) the purchaser's receipt of licensing and regulatory approvals necessary to operate the health care asset. If the purchaser is financing the purchase, its lender may require that the court order be final and non-appealable before it will provide financing. A fiduciary, like a receiver, may also want to consider whether it wants to convey assets to an entity that is not yet licensed or be exposed to having a transaction unwound if the purchaser does not obtain regulatory approval.

Closing Conditions

As described herein, because of needed court and regulatory approvals, distressed health care sales may take a significant period of time. Purchasers need to build in protections so that facility operations are maintained in substantially the same manner that they are at the time the price is set. Purchasers need to consider the type of health care entity and the inputs that drive the health care entity's value. Purchasers will want a contract that provides an "out" or price adjustment if those inputs materially change, which can be more likely in an already distressed transaction.

Conclusion

Sellers and purchasers need to consider how the sale terms incentivize one another when negotiating the following sale terms for a court-approved stalking horse auction process: earnest money deposit, break-up fee, the minimum initial overbid amount, bid increments, the scheduling of a closing date, and certain closing conditions.

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[1] https://www.americanhealthlaw.org/content-library/publications/briefings/a4094e97-3c39-485e-b559-fcae40926315/Why-You-Should-Learn-the-Playbook-Know-the-Game-Pl.

[2] https://www.americanhealthlaw.org/content-library/publications/briefings/196b4fda-a874-42f0-b98b-be9d267d3e47/why-you-should-learn-the-playbook-know-the-gam-1.

[3] *See, e.g., In re 995 Fifth Ave. Assocs. L.P.*, 96 B.R. 24, 28 (Bankr. S.D.N.Y.) (bidding incentives "may be legitimately necessary to convince a white knight to enter the bidding by providing some form of compensation for the risks it is undertaking").

[4] *See e.g., Calpine Corp. v. O'Brien Envtl. Energy, Inc. (In re O'Brien Envtl. Energy, Inc.)*, 181 F.3d 527, 536 (3d Cir. 1999) (break-up fee of approximately 4% is reasonable in relation to the purchase price); *Gey Assocs. Gen. P'ship v. 310 Assocs., L.P.*, No. 02 Civ. 0710 (SHS), 2002 U.S. Dist. LEXIS 20759 (S.D.N.Y. Oct. 29, 2002) (3.23% break-up fee of $100,000 for a $3.1 million purchase price is reasonable); *In re Kaiser Aluminum Corp.*, Case No. 02-10429 (JFK) (Bankr. D. Del. June 21, 2004) (court approved break-up fee of 4.6% ($1.05 million) in connection with a $23 million sale transaction); *In re Chi-Chi's, Inc.*, Case No. 03-13063 (CGC) (Bankr. D. Del. Nov. 4, 2003) (court approved break-up fee of 5% ($200,000) in connection with a $4 million sale transaction); *In re America Classic Voyages Co.*, Case No. 01-10954 (EIK) (Bankr. D. Del. March 20, 2002) (court approved break-up fee of 6.6% ($250,000) in connection with a $3.75 million sale transaction).

