Corporate Acquisition Through Bankruptcy Auctions

Ted Azarmi, (Email: tazarmi@csulb.edu), California State University Long Beach,
Christine Haecker, (christine.haecker@uni-tuebingen.de), Eberhard-Karls-Universität Tübingen, Germany

Abstract

The objective of this case is to teach and initiate a class discussion about how to find potential buyers for a bankrupt firm. The discussion is facilitated by a real world case example that focuses on strategies based on use of databases such as D&B or Sorkins, trade associations networks, trade magazines, information on recent industry acquisitions, and use of private equity groups. Issues relevant to optimal design of a bankruptcy auction and the required bidding process for achieving an optimal sale price are also addressed.

1. Case Description

On September 14, 2001, Ralph Jones regrets having taken on more responsibility than he can handle as the CEO of ITC (Illinois Tool and Casting). Under his watch, ITC sales have dropped rapidly for several years. Recently, a number of major customers are about to leave, key suppliers are increasing prices, and the bank is worried and refuses to extend credit. At 7:00 am on that day, Mr. Jones takes a phone call from his banker Mr. Smith. At one point in the conversation, Mr. Smith threatens to designate ITC's $9 million loan in default. This possibility is raised, since the continued losses of the company have led to a violation of a loan covenant calling for maintaining a required ratio of current liabilities over assets.

ITC, located in Peoria, IL is a metal stamping company with current revenues of approximately $24 million. Ever since its founders retired 6 years ago, revenues for this company have been falling from a $60 million peak to an all time low of $10 million. As a result, the firm has been operating in the red for the last two years of operations.

At 8 am, Ralph attends an emergency board meeting that was called the night before. Everyone is very tense. They have tried different strategies, but couldn't stop the decrease in revenues nor find ways to generate profits. The agenda for the day is to find a solution to their debt crisis.

Six months prior to this meeting, the board of directors considered selling the company. They hired an investment banking firm specialized in the sale of mid-sized private firms. Several potential buyers were found and submitted letters of intent. The board selected the best offer, which amounted to $24 million in cash and was almost $5 million more than the offer of the next highest suitor. By accepting the offer, the company had to accept an exclusivity rule, which prevented the seller from talking with other interested suitors. However, the Buyer, A&B Industries, had to also live up to its side of the agreement by depositing a required $500,000 non-refundable up-front fee (Ernest Money) proving his intent to complete the deal.

The investment bank, GP Associates, made several requests for the deposit of the Ernest money. However, after several empty assurances of "the check is in the mail" by A&B Industries, the investment banker concluded that this buyer lacked credibility. In light of this information, the board doubted that A&B Industries would complete the deal, and began to discuss further options. Meanwhile, the lending bank put intense pressure on the com

Readers with comments or questions are encouraged to contact the authors via email.

pany to complete the deal. With time, the lender was becoming increasingly impatient and worried that the company would be unable to service its loan.

The Board consists of four people in addition to Ralph, the CEO: the three former owners of the company and Ted, a consultant specialized in the manufacturing industry. At the emergency board meeting, everyone agrees that the best course of action is to sell the company, but not to A&B Industries. With decreasing sales and profits, lost customers, and impending layoffs, the Board has to find a quick solution.

Primarily to safeguard against the possibility of the bank freezing the firm's $500,000 cash reserves that happen to be deposited with this same lender, the board decides to file for bankruptcy protection. Under Chapter 11 of the bankruptcy law, the firm will gain protection from its creditors for a grace period that allows for a successful reorganization. The board is planning a bankruptcy sale under Chapter 11 through an auction process.

The date for the auction is set for December 20, 2001, and the company files all necessary paperwork with Judge J. Booth. The filings include the most recent financial and pro forma cash flow statements. The company also files a motion to employ GP Associates as their investment banker under the bankruptcy procedures. Judge Booth approves the investment bankers on the grounds that GP has already come up with several viable suitors for the business, and is in the optimal position to expand the number of suitors quickly in a three-month time period.

Additionally, the Board files a motion to employ a turnaround consultant (Christine Chang) during the reorganization period. Christine's main duty is to reassure customers that business is to be continued as normal and to project a bright future under new ownership to key employees in order to prevent them from leaving the firm.

GP immediately sets to work on this case. It sorts through its existing database of potential buyers and contacts all viable suitors for a second time. Some suitors are no longer interested in the firm. They believe that the bankruptcy filing has put the company on a downhill path that will be too difficult to reverse or overcome. Other suitors that formerly had passed on this deal are now back in the game expecting an affordable price tag. Suitors, formerly deemed as too small to afford to acquire ITC, now are considered of suitable size by the investment bankers due to the lower current firm price. Additional prospects initiate contact with GP Associates after becoming aware of the bankruptcy auction due to the customary public disclosures regarding such sales.

Soon, every firm within the metal stamping industry knows that ITC is for sale. Some potential buyers share information with each other. In a short period of time, a large number of buyers contact GP regarding this upcoming bankruptcy auction. A GP Associates principal comments that "by its nature, bankruptcy attracts a lot of bottom feeders intending to steal the bankrupt company at a ridiculously low price, turn it around and resell it at a profit, or just sell off the pieces for a profit".

On December 20, 2001, everyone gathers at the bankruptcy court downtown. There are about 25 buyers with their respective attorneys, an excellent turnout to allow for heated competition and maximum price. The board and the management of the company sit in the front-row of the courtroom right before the judge. In the back row, some employees are impatiently waiting for the outcome of the case. After all, their jobs depend on the new owner. Since this company is an ESOP (Employee Stock Ownership Plan) owned firm, each employee actually owns shares in the company and directly benefits from a high sale price.

The judge is not present during the auction. Dan Masilus, the firm's bankruptcy attorney, starts the auction. He establishes nine bidding lots, as presented in Exhibit 1. Bidding for lot 1 amounts to purchasing the company as a whole. By bidding for lots 2 to 9, a suitor may buy certain parts of the firm broken down in pieces. Since the company consists of a stamping and a fabricating division, lots 2 and 3 are set along these natural lines of division. Bidding on lot 2 amounts to an offer to purchase the whole metal stamping business including the inventory, accounts receivable, machinery and equipment, real estate, etc. Lot 3 is the metal fabricating business as a whole. Lots 4 and 5 include accounts receivable (AR), inventory, and machinery and equipment (M&E) for each line of business separately. The real estate holding of the firm is not included in lots 4 and 5, primarily due to the fact that the land is environmentally impacted. Accounts receivable have an added intangible value, since they reveal a comprehensive list of past customers and their respective volumes. Therefore, lot 6 allows buyers to bid for accounts receivable (and customer list) separately. Lot 7 consists of inventory for both businesses and lot 8 includes all M&E. The environmentally impacted real estate (with adequate disclosures on required environmental cleanup) is included in lot 9.

As usual, supply and demand forces determine the price in this bankruptcy. Time is a binding constraint, as the company has to be sold immediately. It seems that every day that the firm is under bankruptcy protection its value diminishes. Specifically, the three key customers have set the auction day as their unofficial deadline for leaving the firm. If the company is not successfully sold on that day, they will switch to a different supplier, in effect cutting the company's revenues by 80% and forcing it into piecemeal liquidation.

Exhibit 1: BIDDING LOTS	
1	Entire company
2	Metal stamping business as a whole
3	Fabricating business as a whole
4	Stamping AR, inventory, and M&E
5	Fabricating AR, inventory, and M&E
6	Accounts Receivable (and Customer List)
7	Inventory for both businesses only
8	All Machinery and Equipment (M&E)
9	Real Estate

Prior to the auction, all interested parties had to submit a bid on the desired bidding lots outlined in Exhibit 1. The highest bid was given the "stalking horse" designation by the board. It serves as the opening bid and as an encouragement for other bidders to submit higher bids. To draw this first bid, the firm offered a customary breakup fee (of $500,000 in this case) as compensation to the stalking horse in case that it did not win in the auction.

Dan Masilus starts with the solicitation of bids on lot 1 (bids for the entire company). There are no additional bids for lot 1, therefore the stalking horse bid is selected as the highest bid for this lot. Then Dan Masilus proceeds with soliciting bids for individual lots. At this point, most buyers seem confused about the auction mechanism. After a series of bidder questions and responses by Mr. Masilus, it becomes apparent to all that Dan himself does not have a whole lot of experience in auctions.

When asked if buyers had a chance to increase their bids at a later time, he responded that a chance to overbid would always exist. Based on this information, buyers for lots 2 through 9 did not put their highest bid into place, strategically waiting to increase their bid at a later round of bidding.

When the first round of bids for individual pieces of the company was completed, Mr. Masulis calculated the sum, and it turned out that the sum of all the individual bids was lower than the stalking horse bid of $15 million for the entire firm. Consequently, Dan Masilus decided that soliciting bids for the entire firm (lot 1 alone) was an optimal solution.

Once this decision is announced, Oracle Industries puts in a bid of $15.25 million for the entire firm. Meanwhile, all bidders for smaller lots are informed that their bid has been rejected on the grounds that it is deemed sub-optimal to sell the firm in smaller lots. In effect, these bidders did not have a chance to increase their bids after all. That places a large number of bidders, who are only interested in some parts of the firm, out of the bidding process.

After departure of bidders for pieces of the firm, it seems that the two bidders for the entire firm (lot 1) sense a substantial decrease in competitive pressure. As a consequence, Oracle Industries uses a textbook example for decreasing its previous bid by spelling out a condition that requires a dollar-by-dollar adjustment of the purchase price for any decrease in accounts receivable after the filing date. This condition effectively decreases that offer to $14.5 million. In turn, the stalking horse bidder senses that it too may decrease its offer down to a straight $14.6 million on the grounds that it has not asked for an adjustment as required by Oracle Industries.

Dan Masilus as well as the firm get worried about this turn of events and ask for a short recess in the auction process to discuss the current two offers. At an emergency board meeting during this recess, ITC discusses its need to accept and finalize a deal that day. Following a short discussion, the board hastily votes to end the auction process and to accept the reduced stalking horse offer of $14.6 million.

Following the recess, Mr. Masulis announces the board's decision and closes the auction. The successful bidder is overheard boasting that he was authorized to pay as much as $21 million for the entire company and is laughing about how he has "gotten a steal". Meanwhile, the other bidders are voicing their dissatisfaction with the bidding process.

Following the conclusion of the auction process, the judge receives a short briefing on the auction result and the process employed therein by a court-employed trustee that witnessed the entire process. The trustee advises that the bidding was fair and equitable.

Since the secured creditor is owed about $8.6 million, and the unsecured creditors and the trade debts amount to another $4 million, the shareholders are expected to receive $0.4 million after the payment of administrative bankruptcy costs of about $1.6 million. Since even the unsecured creditors are paid in full and considering that the successful bidder offers to retain all 210 employees in their current jobs, the judge is satisfied and approves the sale of the company at $14.6 million to the highest bidder.

Every bidder, except for the highest bidder, feels that the auction was not carried out properly. Certainly, the outcome of this auction process is not optimal and could be vastly improved with a more efficient process.

Notes