KIRKLANDPEN

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KIRKLAND & ELLIS LLP

Private Equity Newsletter

Bankruptcy Buyers Beware: Free and Clear May Not be Free and Clear on Appeal

PENpoints

A recent Bankruptcy Court decision goes against precedent and threatens the "free and clear" provisions of section 363 sale orders.

Private equity firms have long recognized the advantages of buying assets out of bankruptcy through a sale under section 363(b) of the Bankruptcy Code. One of the key benefits is the "free and clear" relief that a bankruptcy court order provides under section 363(f) of the Bankruptcy Code. If a purchase qualifies for section 363(f) relief,[1] the purchaser acquires the assets free and clear of all liens, encumbrances, or interests that attach to the property, including liens arising from borrowed money as well as statutory (e.g., judgment, mechanics and tax) liens.

Some courts have used 363(f) broadly to cut off employee-related claims (such as pension obligations), as well as leasehold claims, intellectual property claims and state tax claims. Buyers have also sought to use 363(f) even more broadly to eliminate successor liability theories that attach to the assets under applicable state law (such as product liability, environmental liability and retiree liability), although this area of law is complex and not clearly settled.

In the past, even if a party objecting to the sale appealed a sale order, most purchasers did not wait for the appeal to be final and instead closed the transaction, relying on a rule (referred to as the "mootness rule") under Bankruptcy Code section 363(m), which provides that, so long as the buyer is a good faith purchaser and the court does not stay the closing pending appeal, a sale order issued under section 363 of the Bankruptcy Code will not be overturned on appeal.

The Ninth Circuit Bankruptcy Appellate Panel's ("BAP") recent opinion in *Clear Channel v. Knupfer*, 391 B.R. 25 (B.A.P. 9th Cir. 2008), threatens the sanctity of the mootness rule by permitting a party to challenge the free and clear relief on appeal even if it did not obtain a stay pending appeal and even if the purchaser has already closed the sale.

The Clear Channel Decision

In *Clear Channel*, the bankruptcy court approved a sale of property free and clear of Clear Channel's lien. Clear Channel unsuccessfully objected to the sale, then appealed and petitioned for a stay pending appeal, which stay was denied. The buyer then closed the sale.

On appeal, the BAP determined that although the closing of the sale made review of the sale itself moot, it could still reinstate Clear Channel's lien and hear the case.

The BAP analyzed the "free and clear" relief in the sale order and held that the bankruptcy court had not applied the correct legal standard. It then reversed the lower court and reinstated Clear Channel's lien, with the result that the sale was not free and clear of Clear Channel's lien after all.

The *Clear Channel* Court Did Not Follow Precedent

The *Clear Channel* decision failed to follow controlling precedent. The Ninth Circuit in earlier decisions had addressed the very issue considered by *Clear Channel*, concluding that the Bankruptcy Code does protect buyers and "free and clear" relief against subsequent challenges if the sale was not stayed. Oddly, the BAP in *Clear Channel* did not address or cite either the Ninth Circuit decisions or cases outside the Ninth Circuit that protect good faith purchasers in these circumstances.

Conclusion

Purchasers of assets out of bankruptcy should be aware of the *Clear Channel* decision and its implications. *Clear Channel* invites disgruntled parties to challenge the "free and clear" provisions of section 363 sale orders without obtaining a stay pending appeal. In so doing, it cuts against the long-standing and well-established body of case law that holds that section 363(m) protection is necessary to promote finality of bankruptcy sales. Because *Clear Channel* conflicts with numerous cases, including precedent from the Ninth Circuit, we believe that *Clear Channel* should not be followed. However, until the case is affirmatively overruled, purchasers should proceed with caution if closing in the face of an appeal and consult your bankruptcy counsel to ensure that all possible precautions are taken to maximize the chances that the "free and clear" provisions of the sale order survive on appeal.

[1] In order to qualify for section 363(f) relief, one of five conditions must be met: (i) non-bankruptcy law permits a sale of the assets free and clear of such interest; (ii) the interest holder consents; (iii) the interest is a lien and the price for assets is greater than the aggregate value of all liens on such property; (iv) the interest is in a bona fide dispute; or (v) the holder of the interest could be compelled to accept a money satisfaction in a legal or equitable proceeding.

If you have any questions about the matters addressed in this Kirkland PEN article, please contact the following Kirkland authors or your regular Kirkland contact.

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Delaware Case Addresses Material Adverse Effect

PENpoints

The Delaware Chancery Court has again ruled that proving an MAE is a very high hurdle under Delaware law.

The well-known dispute over the buyout of Huntsman Corp. by Apollo-sponsored Hexion Specialty Chemicals, Inc. was recently settled, but the related litigation produced an important decision under Delaware law. In its order deciding motions for declaratory judgment, the Delaware Chancery Court addressed several legal issues of interest to buyout professionals:

- What does it take to demonstrate that a material adverse effect (MAE) has occurred? The Court confirmed that (absent clear language in the acquisition agreement to the contrary) establishing an MAE under Delaware law is a very high hurdle. A party will have to show that (again, absent clear contrary language in the acquisition agreement) the deterioration in a target's performance is likely to last years into the future and that the deterioration is significant when compared to the target's historic performance. As the Court said:

> "In the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy. The important consideration therefore is whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months. … A buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close. *Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence.*" [Emphasis added]

This holding is a stark reminder that buyers who want to walk from a deal if the target's performance deteriorates (such as a specified decline in EBITDA) must include specific language to that effect in the definition of MAE or in the closing conditions.

- Who bears the burden of proving an MAE occurred? The person seeking to avoid its obligation under a contract will bear the burden of proving an MAE. Significantly, if a buyer disclaims reliance on the target's projections—a common feature of acquisition agreements—the buyer will not be able to use those projections to prove its case.

- What constitutes a "knowing and intentional" breach of contract? The answer to this question was a critical issue in the Huntsman/Hexion litigation because the cap on damages (i.e., the negotiated termination fees) in the merger agreement did not apply to knowing and intentional breaches. The court held that a "knowing and intentional" breach is one "that is a direct consequence of a deliberate act undertaken by the breaching party," even if the acting party did not know the act constituted a breach at that time—a relatively low standard that is judged in hindsight. Because the Court found that Hexion had knowingly and intentionally breached the contract, its liability to the target was uncapped. Given this result, buyers should resist any carveout from caps on damages, or very narrowly define a "knowing and intentional" breach to an act that is specifically intended to result in a breach of the agreement.

If you would like more details about the Court's decision and its reasoning, please see our recent *Kirkland M&A Update*.

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German Government Seeks "Public Interest or Security" Review Right for Acquisitions of Businesses By Non-European Investors

PENpoints

A proposed German law seeks to restrict acquisitions of 25% or more of German businesses by non-European investors.

In the middle of a fervid public discussion about the growing influence of foreign sovereign wealth funds and private equity investors, the German government proposed a law seeking to impose restrictions on business acquisitions in Germany by non-European investors for reasons of "public interest and security." The relevant 13th Amendment Act to the German Foreign Trade Act (*Außenwirtschaftsgesetz*) and the Foreign Trade Regulation (*Außenwirtschaftsverordnung*) ("AFTA"), which will be the subject of a parliamentary hearing on January 26, 2009, provides as follows:

Acquisition of 25% or more of the voting rights subject to review if "public interest or security" is impaired

AFTA will apply to a direct or indirect acquisition of 25% or more of the voting rights in a German business (including the acquisition of a non-European firm that owns 25% of the voting rights of a German company) if it is determined that "public interest and security within the meaning of Articles 46 and 52 of the Treaty on the European Union" could be impaired.

AFTA does not specify which businesses or

industry sectors will be subject to additional scrutiny, so it is not clear which acquisitions might impair "public interest and security." This vague standard has triggered substantial criticism, as investors will find it difficult to know in advance whether a deal will be subject to review, but firms that provide vital basic services, such as telecommunications, energy and other strategic services will likely be covered.

AFTA applies only to non-European investors

A non-European buyer is defined as any person that is not resident in the European Community (EC) or European Free Trade Association (EFTA). Investors resident on the Channel Islands (Guernsey and Jersey) as well as on the Isle of Man (where a large number of UK funds have their registered offices) are considered as resident in the EC; however, investors registered in the British Virgin Islands or Cayman Islands (where a large number of U.S. funds are registered) are not.

No filing duty; three-month review after signing of purchase agreement; possibility of voluntary clearance

There is no mandatory filing obligation under AFTA upon an acquisition in Germany. However, the Federal Ministry of Economics and Technology (*Bundesministerium für Wirtschaft und Technologie*) ("MoE") will have the right to initiate a review of any transaction within three months after signing the acquisition agreement.

An investor who wants to avoid uncertainty whether an acquisition will be subject to review under AFTA may make a voluntary filing with the MoE requesting clearance of the acquisition.

The MoE will have two months after its receipt of all required documentation to reach its decision. If the MoE decides to block a deal or impose conditions, then all of the ministries of the German government must approve, substantially increasing the political risks to the transaction.

Illegality of acquisition agreement if MoE blocks acquisition

If an acquisition has already been signed or closed, and the MoE subsequently blocks the acquisition, the acquisition agreement will become unenforceable under German law, and the parties will have to rescind any completion actions taken, such as returning the target's shares or assets to the seller. The MoE also has the right to appoint a trustee to rescind any blocked transaction.

German companies have been attractive targets for non-European investors in the past years, and AFTA should not adversely change the investment climate in Germany, given the government's statements that AFTA should apply only in very rare cases. However, non-European investors considering an investment that would result in the direct or indirect ownership of 25% or more of a sensitive business in Germany should be aware of the review possibilities under AFTA, and should consider a voluntary notification to the MoE.

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PENbriefs

SEC Releases Updated Financial Reporting Manual

On December 9, 2008, the Staff of the Division of Corporation Finance of the U.S. Securities and Exchange Commission publicly released its Financial Reporting Manual, a reference guide for Division staff members that addresses many important aspects of the financial reporting and disclosure rules applicable to SEC reporting companies. The updated manual replaces the Staff's prior "Accounting Disclosure Rules and Practices: An Overview," a similar document that was issued in 2000 but released publicly only on an informal basis. For a more detailed analysis of the updated manual, please see our recent *Kirkland Alert*.

Treasury Department Publishes CFIUS Final Rules

In April 2008 the Department of the Treasury promulgated proposed rules implementing the recent Foreign Investment and National Security Act of 2007, which codified certain aspects of the structure, role, process and responsibilities of the Committee on Foreign Investment in the United States ("CFIUS"). On November 21, 2008, the Treasury published its final CFIUS regulations, and while the final rules do not allay all concerns about the predictability of the CFIUS process, they are an improvement over the April proposals. For a more detailed analysis of the final CFIUS rules, please see our recent *Kirkland Alert*.

Kirkland Partners Honored by the Illinois Venture Capital Association, World Finance

Kirkland partner Kevin R. Evanich was honored with The Stanley C. Golder medal on December 8, 2008, at the Illinois Venture Capital Association's (IVCA) Annual Awards Dinner. This award acknowledges individuals who have made profound and lasting contributions to the private equity industry in Illinois. The IVCA's Annual Awards Dinner is an opportunity to honor individual achievements in Illinois' private equity community while celebrating larger advances in the field.

Kirkland partner Kirk A. Radke was named Best Private Equity Lawyer of the Year (U.S.A.) in the World Finance Legal Awards 2009. The winners will be listed in the January/February 2009 issue of World Finance. The World Finance Awards were created in 2007 to identify industry leaders, individuals, teams and organizations that represent the best of the financial and business world.

Kirkland Announces New Hong Kong Office Location

Kirkland & Ellis announced a new location for its Hong Kong office on November 10, 2008. The new office is in the 26th Floor of the Gloucester Tower, The Landmark, 15 Queen's Road Central, in Hong Kong.

Beginning in January, Kirkland will have15 private equity lawyers in Hong Kong, and more than 25 lawyers in its China practice group worldwide, the majority of whom are Chinese natives and speak Mandarin. Since the Firm's Hong Kong office opened in 2006, it has represented more than 20 private equity funds in their LBOs, growth equity investments, fund formations and other complex deals in Asia.

PENnotes

University of Miami's Heckerling Institute on Estate Planning
Miami, Florida
January 12-16, 2009
The Heckerling Institute on Estate Planning is the nation's leading conference for estate planning professionals. It is designed for attorneys, trust officers, accountants, insurance advisors, and wealth management professionals who are familiar with the principles of estate planning. Kirkland partner David A. Handler will discuss "Advanced Private Investment Fund Planning Issues."

PLI's Eighth Annual Institute on Securities Regulation in Europe"
London, England
January 12-13, 2009
PLI's Institute on Securities Regulation in Europe: A Contrast in EU & U.S. Provisions will feature leading practitioners active in U.S. and European securities law. This year's institute will focus on developments in cross-border M&A, including the return of TransAtlantic hostile deals, trends in regulatory convergence, recent enforcement and regulatory issues and key developments in European leveraged finance and private equity. Kirkland partner James L. Learner will speak on January 13, 2009.

The Columbia Business School Private Equity and Venture Capital Conference
New York, New York
January 30, 2009
This conference will draw some 700 alumni, professionals and students for informative discussions on emerging trends in the private equity and venture capital communities. Kirkland partners Richard M. Cieri and Kirk A. Radke will speak.

The 15th Annual Venture Capital & Private Equity Conference
Boston, Massachusetts
January 31, 2009
The Harvard Business School Venture Capital & Private Equity Club hosts its 15th annual conference, which aims to address the key issues and trends relevant to venture capitalists, private equity investors and entrepreneurs. Kirkland partners Kirk A. Radke, Jonathan S. Henes, Nathaniel M. Marrs and Andrew Wright will all participate as panelists.

American Securitization Forum 2009
Las Vegas, Nevada
February 8 - 11, 2009
The American Securitization Forum draws a critical mass of securitization market professionals from all asset classes and product sectors. The Kirkland-sponsored conference will feature an extensive, current and topical agenda designed by industry professionals while offering a robust business networking environment.

2009 Kellogg Private Equity and Venture Capital Conference
Chicago, Illinois
February 20, 2009
The Kellogg School of Management's Private Equity and Venture Capital Conference brings together some of the brightest minds involved in venture capital and buyouts. The conference will provide an open forum for discussing such trends and challenges, exchanging ideas and views, and debating current hot topics in the industry. Kirkland is a sponsor of this event.

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Kirkland & Ellis LLP's Private Equity Practice

Kirkland & Ellis LLP's private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms in every major market around the world.

Kirkland has been widely recognized for its preeminent private equity practice. In 2008, Mergermarket ranked Kirkland first by volume for Global and North American Buyouts in its "League Tables of Legal Advisers to Global M&A for Full Year 2007." Also in 2008, Kirkland received prestigious first-tier rankings in both private equity and fund formation from Chambers & Partners.

The Lawyer magazine recently recognized Kirkland as one of the firms in "The Transatlantic Elite," noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent." In addition, Kirkland's London office was recently named the 2008 "Banking Team of the Year" at the Dow Jones *Private Equity News* Awards for Excellence in Advisory Services.

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