Due Diligence Issues in Bankruptcy Sales and Auctions

This article discusses the practical issues arising from due diligence problems in bankruptcy sales. Many investors and investment funds believe there are opportunities for bargains in bankruptcy sales. For others the risks (or the perception of risk) in buying from distressed sellers is simply too great. Which point of view is correct largely depends on the ability of the seller's financial advisor and auctioneer to create a reliable bid package and a predictable auction process.

Buyers seeking bargains benefit from (1) the difficulty in assembling accurate bid information and (2) the need for speed in selling assets of financially distressed companies. In the bankruptcy acquisition game strategic buyers often have an advantage over financial investors. Strategic purchasers have the ability to combine acquired operations into their existing business and realize synergistic cost savings. Strategic purchasers can act quickly because they often understand the seller's business, start with a basic understanding of how the assets to be acquired can be put to productive use, and have a team of employees able to do necessary due diligence. Since a distressed sale often happens within ninety days after a case is filed, the need for speed favors the strategic purchaser who needs less time for due diligence. In these situations a bidder may press the seller to move very quickly in an attempt to discourage competing bidders.

Strategic purchasers may need less information than financial investors and may have better ability to ignore erroneous data or to fill in missing pieces. In a case where I represented the buyer of assets from a toy manufacturing company, the seller was unable to provide accurate cost information. Since the client was in the toy business, it could reverse engineer the seller's products and quickly create its own manufacturing cost model for the assets to be acquired. This independent knowledge enabled it to discover hidden value in the seller's assets and to confidently outbid other bidders.

Unreliable seller data is a major obstacle to maximizing creditor recoveries in bankruptcy sales. As a company winds down little attention is given to the need to preserve records and information that may ultimately be crucial to evaluating and transferring assets. An important role for the auctioneer is to help the seller gather and preserve data necessary for bidders to discern value. For high-tech, new economy and e-commerce assets there are many due diligence twists and turns to navigate, including:

- who owns the domain name, technology, software, patent licenses and other intellectual property
- is a customer list worth anything if it can only be transferred in violation of the seller's customer privacy policy, and, by the way, just what is the privacy policy
- can value be attributed to a "dark" website
- after the key employees are fired, is anyone left to explain the seller's technology in enough detail to create an accurate bid package.

To get the highest price a seller needs accurate bid packages, proper marketing and creative auction strategies. An auctioneer's credibility depends on the accuracy and completeness of the information describing what is being sold. Since assets usually are sold 'as is', without warranties or representations, bidders may be reluctant to bid without accurate information. Putting due diligence information on the auctioneer's website or in an online document room lets bidders conveniently examine legal documents and written due diligence information. Additional information can be requested by e-mail, making it easier for bidders to complete their due diligence.

When the property to be sold is an operating business, creative auction strategies may be needed to address buyer reluctance caused by inadequate information. Sellers have entered into agreements to reimburse a portion of a prospective bidder's due diligence costs, with the understanding that if the bidder decides not to proceed then the results of the investigation will be given to the seller and will be available for review by other bidders, perhaps speeding up the sale process. Reimbursement of expenses is most common when a buyer has signed a sale contract which is subject to higher and better offers at a public sale. Most bankruptcy sales are auctions and bidders may need monetary inducements (called "bidding incentives") to be the first to sign a purchase contract which will then be subject to public notice and the solicitation of higher and better offers.