Fire Sales: What to Expect

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Introduction

When a private company seeks to sell assets or its equity securities for a discounted value (sometimes heavily discounted), such offering is known as a "Fire Sale." Given recent economic pressures, many private companies are facing a stark reality: sell the company or face bankruptcy. While there are several ways private companies raise money in downturned markets (see our article *Down Rounds 101*), for many private companies, the only option is to consummate a Fire Sale, avoiding bankruptcy, where investors and founders alike will recover last following repayment to all creditors, with certain exceptions. This article explores some of the considerations a private company should consider when a Fire Sale is a realistic option for them.

Documenting Pricing

One of the first hurdles the management of a private company will face in a Fire Sale is documenting the price of the assets or equity securities proposed to be sold. This is due to what are known as "Revlon Duties", which provide that, in the sale of a company or other change of control situations, a company's board of directors or other management body must take reasonable steps to obtain the highest value for a company. While the Revlon Duties used to require a board or management body to conduct an auction when the company is for sale, more recent case law has revised the standard to impose a single, highly general obligation of good faith and fair dealing based upon reasonably informed judgment. And, more generally, directors are often faced with the Duty of Care (the duty to make careful, informed decisions) and Duty of Loyalty (the duty to act in the best interest of the corporation and its stockholders), which overlap with the Revlon Duties, but Revlon Duties do not necessarily always apply. The Revlon Duties attach to a situation at the point a sale or break-up of a company is imminent (or otherwise inevitable).

So how is a private company's management body supposed to prove, in the event of a Fire Sale, that the discounted price being offered is a "fair" price, and thus meets the fiduciary obligations of the management body? The last thing a distressed company wants when contemplating a Fire Sale is disgruntled shareholders suing that the board or management body has breached the Revlon Duties or generally their fiduciary duties. When reviewing a dissenting shareholder litigation and, importantly, the sales price at issue, courts will apply two different standards depending on whether the Revlon Duties attach to the situation. Where Revlon Duties do not attach, courts will apply the Business Judgment Rule, whereby a court will determine whether or not a director (or manager) breached the Duty of Care to shareholders. The Business Judgment Rule establishes the presumption that the director acted in good faith, was reasonable and acted in the best interest of the company, and it is the burden of the dissenting shareholder to prove otherwise. If the dissenting shareholder cannot prove that the director (or manager) acted in bad faith and was unreasonable, courts will not intercede in the sale price determination methods taken by such director or manager.

Alternatively, if a court finds that Revlon Duties do attach, courts use a higher level of scrutiny—the director (or manager) has the burden of proving (1) that the decision making process was executed with proper care, and (2) that the action(s) were reasonable based on the then-existing facts and circumstances. While arguably a more onerous burden on the board or management body of a private company, there are still many steps a board or management body can take to make sure that they have sufficient evidence that even a discounted price for the equity of the company in a Fire Sale meet this standard.

Examples include detailed board meeting minutes detailing the step by step process the board or management body took in evaluating potential offers, comparable sales price data of similarly situated companies, whether in the same industry or not, third party valuation reports from reputable valuation firms, and other detailed examples of a fair sales price. Oftentimes, one of the easiest ways to show that the sales price is a fair price is through an auction process—whereby the company would solicit offers from several potential buyers and choose the best price based on available offers.

In summary, the board or management body of a private company will face several hurdles in determining what sales price is a fair price in a Fire Sale context, as there may be heavy discounts on what shareholders believe is the value of the company. In order to best protect the company, the shareholders and themselves, all board or management members should keep detailed records of how a Fire Sale price was determined, the methodologies used, and the information that informed this decision to make clear that the sale price was based on a careful, informed basis and were necessary to ensure the best possible return for shareholders and investors.

Pace of Play

In a Fire Sale process, the need for speed is paramount. The reality facing a private company contemplating a Fire Sale is that, within a short time period, the company will have no cash for operations and face the reality of bankruptcy. The board or management body of the private company should quickly determine what the company's runway is—i.e., how long can the company be run on available cash reserves. Among other things, knowing your runway can inform how the Fire Sale process is conducted and how much time you have to collect data to inform a pricing decision.

In situations where there is ample runway, private companies may consider conducting an auction process. As discussed above, a tangible benefit of an auction process is using third party offers as a baseline for what a fair sales price would be. Additionally, in many instances, the auction process can actually benefit the company and shareholders by soliciting better terms from potential buyers by having an active competitive process—leveraging offers against others to increase sales price or other sales considerations (such as indemnity terms, holdbacks, etc.). However, the auction process can be time consuming, as an investment bank will need to be retained, offer materials developed, bids solicited, and review periods before offers are submitted. If an auction process is considered, the board or management members should closely monitor their company's runway to ensure there is sufficient time to complete the entire process.

Regardless of what process is used for soliciting offers from potential buyers, private companies should be prepared for an expedited diligence process. The diligence process is every potential buyer's first step and typically longest process in an acquisition context, and if the private company has a very short time frame to consummate the Fire Sale, preemptive efforts need to be taken to ensure the potential buyer can finish their diligence process (see our articles *Preparing for the sale of your company: tackling due diligence*, *Getting your business ready to* sell and *Seller due diligence: Are you ready for buyers' questions?* for more information). Effective communication between the private company's financial, tax and legal advisors, and those advisors of a potential buyer, will be key to ensuring efficient review of all diligence materials.

Underwater Equity: Communicating with Equity Holders

As partially covered above in the Documenting Pricing section, one of the key components to consummating a Fire Sale is clear communication with the private company's equity holders (including employees who may have incentive equity, options or other stock incentives) and ensuring there are no underlying issues with the sales process. A dissenting shareholder or disgruntled employee can be a thorn in the side of a company trying to consummate a Fire Sale and drastically slow things down. A key point that should be communicated early and often is the process of determining the sales price so that it is clear to all equity holders that the private company is taking diligent steps to ensure the most value possible in a sale-or-bankruptcy situation.

We have seen several Fire Sales process play out, and in communicating with equity holders on the process of pricing and deal terms, if the company decides to proceed with a Fire Sale, it should take certain steps to avoid exposing the deal to lawsuit and delays:

1. Directors should first seek legal counsel to advise clearly of their fiduciary duties to the equityholders of the company; [1]
2. Form a committee of disinterested directors and investors to lead and price the Fire Sale—depending on the make-up of the private company's governing body, being seen as having goals that are not in-line with those of all equity holders may appear to lack the level of care necessary to overcome any shareholder objections;
3. With the assistance of counsel, draft a detailed information statement to equityholders, which sets forth (1) the distressed situation the company is in; (2) options for raising capital; (3) potential sales options and qualitative pricing options; and (4) soliciting approval for the sales process;
4. With the assistance of financial advisors, create a model that reflects the value to equityholders between various alternatives—showing equityholders the value they can receive in the Fire Sale process, as opposed to bankruptcy or other viable alternatives, can be a great way to increase equityholder confidence in the proposed plan;
5. Obtaining an independent third-party valuation (noting that this may be ineffective if there are strict cost restraints); and
6. Clear and detailed documentation of the pricing and approval process—there should be detailed board minutes outlining all alternatives discussed, all data used in the decision making process, outside financial and/or legal advice on alternatives, discussions of value maximization for shareholders, and all other steps taken in the process of completing the Fire Sale.

In essence, showing all the cards to your equityholders and being clear and up-front about how a Fire Sale will impact a return on their equity, as opposed to the more bleak alternatives, will help the private company put the best foot forward in avoiding conflicts with shareholders or other equityholders, and may stave off litigation or attempts to delay the Fire Sale process.

Conclusion

Although unpleasant to think about and being subject to many business and legal challenges, Fire Sales are a tool that private companies can use in extreme circumstances to maximize shareholder or other equityholder returns and continue the operation of the company for distressed companies. There are many factors to consider when contemplating a Fire Sale, including viable alternatives to increase cash-flow and continue operations, the shifting fiduciary duties applicable to directors and officers during insolvency, if applicable, and the management body of any private company which is contemplating a Fire Sale should carefully consider timing issues, pricing issues, and equityholder concerns and carefully document all discussions to ensure a smooth, efficient process.

[1] Directors have certain common law fiduciary duties owed to the company and its equityholders, such as duty of loyalty (showing that the directors' actions were fair and in the best interest of the company and equityholders), duty of care (business judgment rule), duty of disclosure, and the duty of good faith (probably diligence was done before arriving at a decision). It should be noted that, given the risk of insolvency for companies where a fire sale is being considered, particular

attention should be paid here as creditors will have standing in an insolvency to bring breach of fiduciary duty claims against directors and officers of the insolvent company.
