Bankruptcy Court Addresses Challenges to a Right of First Offer in Revised Plan

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The following discussion examines the Chapter 11 bankruptcy decision regarding Plant Insulation Company. The plan proponents proposed a "right of first offer" (ROFO) process, designed to facilitate buy-sell terms that would benefit both owner-managers and a passive, but controlling, investor. The approval of the plan by the bankruptcy court provided affirmation of the soundness of the plan, suggesting that the ROFO process and related terms may prove to be useful in other private buy-sell agreements.

Introduction

In the case of *In re: Plant Insulation Company*,[1] the bankruptcy court dealt with the issue of how to properly incentivize management shareholders in a reorganized company, yet provide a fair process for other holders to eventually cash out their shares. The answer turned out to be a cleverly constructed right of first offer process as part of a buy-sell agreement among the parties.

The Facts of the Case[2]

This Chapter 11 bankruptcy case revolved around the appellate decision of the United States Court of Appeals for the Ninth Circuit to reverse the bankruptcy court's initial order confirming the plan of reorganization of Chapter 11 debtor Plant Insulation Company (PIC).[3] PIC was a California corporation that sold and installed asbestos-based insulation in commercial projects in the San Francisco Bay area.

PIC was a successful business until it was hit by a flood of lawsuits arising from claims against the company and its primary supplier, Fiberboard, for asbestos-related diseases beginning in the 1970s. Initially PIC was defended by Fiberboard and later by PIC's own insurers. But Fiberboard went into bankruptcy itself and, one-by-one, the insurers announced that PIC had exhausted its coverage, even though PIC later objected that this was not correct. The company also went into decline. By the time PIC filed for bankruptcy on May 20, 2009, its only meaningful remaining assets were its insurance policies and the various lawsuits demanding that the insurers provide coverage where the aggregate limits of their policies had not truly been exhausted.

The insurance policies held by PIC were either in the form of cash settlements received from insurers that repurchased their policies under guarantees for complete peace from future asbestos litigation (the Settling Insurers), or in the form of the still unresolved litigation as to the amount of future duties of the remaining insurers to pay for the asbestos disease claims (the Nonsettling Insurers). The Nonsettling Insurers litigation was known as "the coverage action."

In many asbestos-related corporate bankruptcy plans, a trust is formed to hold cash insurance settlements and own securities of the reorganized debtor in order to pay claims arising from the asbestos lawsuits. This allows the reorganized corporation to continue its business operations and to provide an evergreen source of funds to the trust in the form of dividends and proceeds from the eventual sale of its securities as claims are satisfied and later wind down.

In order to assist this technique, 11 U.S.C. Section 524(g) was passed by Congress in 1994, which allowed a bankruptcy plan to cut off and channel any future asbestos litigation solely to the trust. The Johns-Manville bankruptcy is an example of this type of reorganization.

One of the provisions of Section 524 requires the trust to obtain (or be able to obtain) control of the reorganized debtor. Another provision requires that the debtor be an operating company. In the case of PIC, the company had been recombined with a successor company (called Bayside) that had taken over the installation contracting business from PIC and was owned and run by two former executives of PIC.

As part of the reorganization plan the trust would purchase 40 percent of the voting shares and also purchase a warrant that would enable it to obtain another 11 percent of the reorganized company. These two securities would result in a 51 percent control block for the trust. The two executives would own the other 49 percent. There were a number of other provisions concerning the shares, including a buy-sell agreement with call rights and a right of first refusal that effectively made sale of the securities to anyone other than the executives or the company impossible. This original plan was filed in June of 2010.

The bankruptcy court approved the original plan after an extensive hearing.[4]

The Nonsettling Insurers, which had an incentive to see any reorganization plan collapse in order to increase their chances to avoid further exposure to litigation in the coverage action, appealed the decision to the district court, which affirmed the bankruptcy court's decision.[5]

The Ninth Circuit Court of Appeals then heard a further appeal and reversed the decision. The appellate court felt that the warrant did not satisfy the control test because it did not make it possible for the trust to obtain control on advantageous terms "either after confirmation or at any point where control would meaningfully benefit the trust."[6] Part of the problem for the appeals court was the price to be paid for the warrant and the binding nature of the buy-sell agreement provisions.

As soon as the Ninth Circuit issued its reversal, the plan proponents (the unsecured creditors committee, the company, and the trustee of the trust)[7] amended the plan and returned to bankruptcy court for approval of the revised plan under the remand.

The Plan Proponents' Position

The revised plan solved the appeals court's concern by including the following procedures:

1. Changing the exercise price of the warrant from the per share price paid for the 40 percent block of shares to one dollar, to give the trust a clearly advantageous price.
2. Changing the buy-sell agreement terms to eliminate the call rights, so that the trust had complete control over the timing of the disposition of its securities.
3. Changing the buy-sell agreement to provide for put rights so that the trust can put its shares and warrant to the company (or the executives).
4. Changing the buy-sell agreement to substitute a right of first offer (ROFO) process in place of the right of first refusal. This responded to the Nonsettling Insurers' concern that the right of first refusal would prevent any serious attempt by the parties to arrive at a fair price because of its chilling effect on attracting an outside buyer.
5. The ROFO allowed the executives (either personally or through the company) to make the first offer. The trust could go shop the securities with potential bona fide outside buyers. If the trust and the executives could not reach an agreement to sell at a price, or to a party, both approved, then the trust could put the securities to the company or the executives at a value determined by an expert appraisal commissioned by the trust. The company had to provide all the data requested by the trust during the ROFO process.
6. The executives could submit their own expert appraisal if they did not like the trust's appraisal. A neutral arbitrator would select which party's appraisal would be the basis for the obligation to buy the trust's securities. This type of selection process wherein the arbitrator must pick either one side's value or the other's value is often called "baseball arbitration" because it is most prominently seen in deciding Major League Baseball players' salary contracts.

7. The trust would provide favorable financing in the form of a long-term loan for the party (either the executives, the company, or an outside buyer) that purchased its securities.

It is worth noting that ROFOs are commonly seen in the real estate industry. Building tenants often have lease agreements with ROFOs to allow the tenant to remain in their facilities under a new lease or even have first offer to purchase the facilities.

In this case it was believed that the ROFO would incentivize the executives to run the company profitably. This is because the executives would have the first offer to buy at a reasonable price and thus regain 100 percent ownership and control over the company. Because the executives could not just wait to match an outside offer and any value could become subject to baseball arbitration, the ROFO process would discourage a low-ball offer.

The plan proponents also noted that the ROFO process provided a greater chance to avoid expensive and time-consuming litigation among the owners, including any dissolution actions under California Corporations Code 2000.

The Plan Opponents' Position

The plan opponents, the remaining Nonsettling Insurers, countered that:

1. The revised plan still did not satisfy Section 524. The overall price paid for the securities, both common and the warrant, was too much.
2. The revised plan did not satisfy the feasibility requirement of Section 1129(a) (11), because the plan proponent could not show that confirmation was not likely to be followed by the liquidation or further reorganization of PIC.
3. A public auction was the only reliable way to determine the value of the trust's securities.
4. The ROFO process would not allow the trust to receive the fair market value of the reorganized debtor's securities it would acquire when it decided to sell.

The Court's Decision

After agreed upon discovery and submission of all additional evidence and a hearing, the bankruptcy judge confirmed the revised plan.

The areas of analysis in the parties' positions, previous rulings, and the law that drew the judge's particular attention were as follows:

1. The court decided that the Nonsettling Insurers' argument that the overall price paid for both securities was too high was inconsistent with the plain language of Section 524. All the trust must do is hold securities that allowed it to obtain control of the reorganized debtor. And, the trust would obtain control by the payment of one dollar for the warrant—a price clearly advantageous and below fair market value. That was all Section 524 required.
2. The language and purpose of Section 524 does not require that the shares representing control of the reorganized debtor be free of any restrictions on transfer.
3. In closely held corporations like the subject company, it is customary to have restrictions on transfer, such as buy-sell agreements. Both sides' experts agreed on that fact.
4. California corporation law allows reasonable restrictions on the right to transfer private company shares.
5. The ROFO may enhance the value of the trust's securities by eliciting greater efforts from the executives.
6. It was far from certain that the trust would find a purchaser for its 51 percent ownership interest in the company in a public auction market. Any buyer of the shares, or of the entire company, would have to deal with the existing owner-executives in any acquisition transaction. This would include any post-deal agreement regarding competing against their former company if the executives were not going to stay.
7. Because the executives may end up being the only parties interested in buying the trust's shares, the ROFO helps to keep them from gaming the process and submitting a low-ball bid when it comes time to sell.
8. The baseball arbitration process within the ROFO encourages both parties to submit reasonable offers and impartial appraisals.

continued to page 84

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Right of First Offer

continued from page 81

9. For a number of reasons, the feasibility requirement was met as the evidence showed that the reorganized company would continue to operate profitably. The costs to cooperate in processing the asbestos claims would be reimbursed by the trust and ultimately paid from the proceeds of the PIC insurance policies.

Summary and Conclusion

The ROFO process adopted by the plan proponents in this matter, and approved by the bankruptcy court, was a good solution to a difficult issue regarding how to arrange buy-sell terms that would benefit both owner-managers and a passive, but controlling, investor. Similar ROFO terms could be useful in other private businesses' buy-sell agreements.

Notes:

1. In re: Plant Insulation Company, No. 09-31347 TEC, U.S. Bankruptcy Court for the Northern District of California, Memorandum following Remand, filed February 24, 2014.
2. Because this case was complicated and long running, we have condensed and otherwise simplified a number of background facts and elements of the case.
3. In re: Plant Insulation Co., Debtor, No. 12-17466, D.C. No. 3:12-cv-01887-RS, U.S. Court of Appeals (9th Cir., filed October 28, 2013).
4. In re Plant Insulation Co., 469 B.R. 843 (Bnkr. N.D. Cal. 2012) aka Plant I.
5. In re Plant Insulation Co., 485 B.R. 203 (N.D. Cal. 2012) aka Plant II.
6. In re Plant Insulation Co., 734 F.3d 900 (9th Cir. 2013) aka Plant III.
7. The unsecured creditors were essentially all the existing asbestos claimants, and the trust would represent all the future claimants. The trustee of the trust was thus called the Futures Representative.

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