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ASSET SALES IN BANKRUPTCY

Bargains Await Buyers Skilled at Navigating Section 363 Minefields

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Despite the potential for reorganization under Chapter 11 of the U.S. Bankruptcy Code, a company that has filed for bankruptcy protection often will not experience a true restoration from the point of view of its owners. Instead, by one means or another, the company's assets often are sold to or become controlled by a new party or group. One of the most common procedures leading to this result is a sale of a company's assets under Section 363(b) of the Bankruptcy Code.

A company that files for bankruptcy obviously is faced with financial and/or operational distress. Whatever problems troubled companies had prior to bankruptcy may continue and even compound while they are in Chapter 11. While a bankruptcy filing may alleviate some immediate financial stress, a company is not protected from the competitive markets of which its customers, employees, suppliers, and lenders are a part. Sometimes, despite the best efforts of its leaders and turnaround consultants, a company's going concern value remains at risk or declines while it is in Chapter 11.

In connection with many Section 363 sales, a central question confronting a company is: Within what period of time must or should it accomplish a sale? How much staying power a company has — that is, the amount of time before it may lose a critical component of its working capital, customers, suppliers, and financing sources — greatly influences the length and breadth of the marketing and sale process. In some situations, the potential sale price of the company can be like an ice cube on a hot griddle — time is of essence to accomplish a sale before all value evaporates.

In many Chapter 11 cases, a company faces the prospect of running out of operating cash sometime in the not-too-distant future, or it confronts a deadline to accomplish a sale that is built into its post-bankruptcy financing arrangements. In addition, recent amendments to the U.S. Bankruptcy Code require commercial real estate leases to be assumed or rejected within 210 days after a bankruptcy filing. For retail chains and other companies that lease many of their facilities, this can be a crucial factor in the marketing and sale of assets.

> In a Section 363 proceeding, secured creditors, non-debtor parties to contracts and leases, unsecured creditors, the U.S. trustee, and others **all can become actively involved** before the Bankruptcy Court and in various aspects of a proposed sale.

On the other hand, the breathing space afforded to some companies in Chapter 11 can provide them with a last clear chance to make required changes and return to profitability. Perhaps it is the drastic nature of a bankruptcy filing that gets the attention of certain suppliers, customers, or other stakeholders and finally convinces them to alter their positions and therefore provide the foundation for improvement in a company's operations. A bankruptcy filing also may allow a company to ride out a storm that is temporary in nature, such as a spike in commodity or input prices. In such situations, time might be an ally and could foster improved viability and a potentially higher sale price.

Competing Interests

Compared to the traditional mergers and acquisitions (M&A) process, especially for a privately held company, perhaps the single most distinguishing characteristic of a Section 363 sale is that it occurs in the fishbowl of a bankruptcy case. Everything that leads up to a hearing on the sale of a company's assets, including the terms and conditions of the sale, are subject to review and approval by a Bankruptcy Court.

Notice on significant steps in the sale process must be issued to the company's creditors, who have the right to object and be heard on questions that arise. In a conventional sale outside of bankruptcy, negotiations and dealings primarily involve only the seller and the purchaser. In a Section 363 proceeding, secured creditors, non-debtor parties to contracts and leases, unsecured creditors, the U.S. trustee, and others all can become actively involved before the Bankruptcy Court and in various aspects of a proposed sale.

Although the bankruptcy rules contemplate the possibility of a "private sale," another core feature of most Section 363 sales is some form of an auction or organized competitive bidding process for a company's assets. This, of course, is in pursuit of maximizing the value of the bankruptcy estate and providing the best return to creditors.

Accordingly, at a final hearing before the Bankruptcy Court on approval of the sale of a company's assets, much of the inquiry by creditors and the court focuses on confirming that various parties were informed about the sale and had an opportunity to bid on the assets in direct or indirect competition with each other. In general, Bankruptcy Courts require a showing that a marketing process undertaken was appropriate under the circumstances before it will approve a sale to the party that has apparently made the "highest" and/or "best" bid for the assets.

In the review and scrutiny of a marketing and sale process in a Chapter 11 case, various

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questions may arise. Was the due diligence process level and fair for all prospective purchasers? For example, in the interests of saving their jobs after a sale, did management favor financial buyers over strategic buyers? Was management justifiably suspicious about the motives of a competitor in seeking sensitive information as a purported prospective purchaser?

Creditor conflicts may arise regarding the allocation of the purchase price among various assets. Secured lenders holding liens against different assets may find that sale proceeds are insufficient to pay all of the liens in full. Unsecured creditors will look for ways to reduce the sums paid to secured creditors to maximize the allocation of sale proceeds to any unencumbered assets that are included.

Other issues arise if the bid procedures established for a Section 363 sale allow competing offers to take different forms. Given the irreducible risk in getting any transaction to close, even after it is approved by the Bankruptcy Court, what is the proper method for comparing several bids on individual assets with a single bid on all of the assets? What if one offer is all cash with few conditions, while another is nominally higher but includes a note payable to the company over time, an "earn-out" feature, or some other contingent component?

In addition, some offers may contemplate a debtor assuming and assigning to the buyer all or virtually all contracts and leases, sometimes with the attendant costs for curing payment defaults under those agreements borne by the debtor. Other offers would result in the rejection of many contracts and leases, which often results in additional unsecured claims being brought against the estate for rejection damages. The potential impact on what might be recovered by various classes of creditors in such situations can be quite significant.

On the various issues that arise in connection with a sale process, a debtor company's determination or recommendation often carries a good deal of weight with the Bankruptcy Court. But creditors and other parties in interest whose recoveries may be affected by the outcome of the bidding also have opportunities to argue which offer they believe is best and therefore should be approved.

These parties can range from a lender providing post-bankruptcy financing and secured creditors with pre-bankruptcy claims to general unsecured creditors (usually represented by an official committee) and non-debtor parties involved with contracts and leases. Those who have important stakes in the company's future operations, such as employees and labor unions, also may become actively involved. In addition, various governmental agencies with environmental, tax, and other special claims may join in the proceedings.

In return for its jumpstarting the sales process and providing a pricing floor, various types of incentives often are put in place for a stalking horse bidder.

In some cases, the entire sale process for a company, including initial marketing efforts, might not begin until after a Chapter 11 case is commenced. In other situations, much of the marketing and even initial bidding on a company's assets might occur before the Chapter 11 case is filed. Nevertheless, those activities are subject to the same scrutiny once the company has entered bankruptcy. Whether the efforts occur before or after formal filing of a Chapter 11 case, if a Bankruptcy Court concludes that marketing and other processes were insufficient to identify, approach, and bring in prospective purchasers, it may require that the company do more before a final sale hearing will be held to choose a winning bid.

Jumpstarting a Sale

At some stage in a Section 363 sale process, particularly before the date that an auction is to be conducted, it often is a good idea for the debtor to announce a minimum price that it may be willing to accept for its assets. Doing so may demonstrate to the company's customers, suppliers, employees, and other stakeholders that its exit strategy of a sale is truly viable. The announcement also may pique new interest from parties that may have expected the company to fall into liquidation or otherwise fail to accomplish a going-concern sale. These potential buyers may include strategic players who had hoped to pick up some of the company's customers and business by default.

When a company has begun marketing its assets and perhaps has held discussions with multiple prospects about price and terms, one party may emerge early on as a strong or leading contender to purchase the assets. To establish a floor for the sale of its assets, a company may ask this party to become the "stalking horse" and enter into a definitive and viable agreement to purchase the company's assets with the understanding that the agreement will be shopped around to other prospective purchasers, who will be solicited to top its deal.

The stalking horse understands that other potential bidders could reproduce the agreement, schedules, and related documentation that it has prepared to accompany sale pleadings in Bankruptcy Court. At least to some degree, subsequent bidders may be able to piggyback on the due diligence that the stalking horse has conducted. Thus, simply by following the initial bidder's steps, these new bidders could incur less time and expense and then beat the stalking horse's price during additional bidding or an auction that follows.

In return for its jumpstarting the sales process and providing a pricing floor, various types of incentives often are put in place for a stalking horse bidder. One frequently used provision is an expense reimbursement that repays the stalking horse for the fees and expenses it incurs, usually up to a maximum amount, in conducting due diligence and pursuing its offer. Another common provision is a "break-up" or "topping" fee, which is paid to the stalking horse if it is outbid at auction or otherwise is not the successful purchaser of the company's assets.

These and other provisions that compensate a stalking horse for being the first mover in a Section 363 sale process must be approved by the Bankruptcy Court, typically in a preliminary hearing in which bidding rules and other procedures related to the sale are established. Again, creditors have an opportunity to be heard on whether and to what extent these provisions are worthwhile under the circumstances. While some Bankruptcy Courts are loath to accept any such protections, most have approved break-up fees in the range of 1 to 3 percent of the stalking horse's initially set purchase price.

For a prospective purchaser, a Section 363 sale presents an opportunity to obtain valuable assets at a bargain price. The process may include many potential bidders and/or an auction before approval of a purchase is obtained. But, compared to traditional sale processes outside of bankruptcy, there may be less overall competition among prospective purchasers in the bankruptcy arena. Many parties that are otherwise active in the M&A field may not have any interest in the assets because of the mere fact that a company is in

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bankruptcy. Others may pass because of the limited timeframe to conduct due diligence, which takes on even more importance with the assets and business of a troubled seller, and to submit a binding offer.

Further limiting the number of participants is that some of the usual buyer protections provided in traditional M&A deals are not practically possible or easy to obtain in the bankruptcy context. For example, various representations or warranties and the ability to hold back a portion of the purchase price against possible problems arising after closing may not be available in a Chapter 11 sale process. Such guarantees can be opposed by anxious creditors, and other bidders may omit or waive them as a competitive tactic, giving them an advantage over other bidders. Moreover, while the purchase price may eventually make the deal a bargain, the process of getting to the endpoint, particularly for an early entrant, can be more time-intensive and expensive than mainstream deals.

Especially for potential purchasers who are new to the process, navigating through the potential minefield involved in addressing the questions and concerns of a variety of parties interested in and potentially objecting to its bid can be challenging. A buyer may wish to retain legal and financial advisors who are experts with Section 363 sales in particular, as well as M&A transactions in general.

Although a successful purchaser typically obtains only limited representations and warranties from the selling company in a Chapter 11 case — and the practical worth of any it does obtain often are suspect anyway — it can take comfort in a fairly unique aspect of the Section 363 process. A standard request routinely granted by Bankruptcy Courts is for the assets to be transferred to the purchaser free and clear of all liens, claims, and encumbrances, other than those expressly assumed by the purchaser. However, creditors are entitled to notice and other due process considerations before their specific interests in the assets may be eliminated. Therefore, a purchaser's advisors and those of the company should be especially careful to ensure that notice of the sale proceeding has been issued to all possible creditors holdings claims or liens.

In addition, despite the apparent all-encompassing language of a free-and-clear order by a Bankruptcy Court, a few types of the selling company's liabilities may not actually be cut off by the order. For example, certain environmental and product liability claims can follow and remain viable against the assets even after they have passed to a new owner. Various duties imposed under labor laws also may pass to a new owner as a successor to the seller.

Figure 1: Acqusition of Assets: The Purchaser's Perspective

1 = Most Desirable / 3 = Least Desirable

	Outside of Bankruptcy	Section 363 Sale in Bankruptcy	Change of Ownership Under Plan
Speed / Expense	1	2	3
Extent of Involvement or Standing of Third Parties	1	2	3
Setting / Potential for Competitive Bidders	1	3	2
Purchaser Obtaining a Bargain	1	3	2
Flexibility on Types / Timing of Consideration Paid	2	3	1
Ability to Undertake Due Diligence / Review	3	2	1
Ability to Obtain Assignment of Contracts / Leases	3	2	1
Certainty in Avoiding Claims Existing Prior to Purchase	3	2	1
Releases, Injunctions, or other Provisions Favoring Purchaser	3	2	1
Treatment of Environmental, Product Liability, Tax, and Other Special Claims	3	2	1

Caveat Emptor

When compared to the alternatives of either acquiring a company outside of a bankruptcy or obtaining control of a company through funding a Chapter 11 plan of reorganization, purchasing a company in a Section 363 sale has advantages and disadvantages. **Figure 1** generally ranks a variety of factors that might be important to a purchaser within each of those three settings.

With the prospect of obtaining a bargain in a Section 363 sale continuing to be seen as outweighing the possible pitfalls for a purchaser, the array of entities that are dedicating resources to the acquisition of assets in distressed situations has continued to expand. Many hedge funds, simultaneously chasing yield and trying to deploy capital in a more diversified manner, have reallocated personnel to look more closely at distressed situations. Among other strategies is the increased use of the so-called loan-to-own approach. In such a scenario, an investor acquires the secured debt of a troubled company from a traditional lender, typically at a discount, with an eye toward perhaps becoming the owner of the company in the future through bidding the lien claim in a Section 363 sale.

New players in addition to hedge funds have joined the ranks of vulture investors as well. Further, funds that traditionally have been identified only with more mainstream investments are showing more interest in allocating resources to the turnaround and bankruptcy arena, bringing billions of dollars into play.

Section 363 sales have been and will continue to be one of the primary paths taken by companies in Chapter 11. Today and into the future, bargain prices are available to shrewd buyers in bankruptcy cases. However, especially in the world of bankruptcy, *caveat emptor* is the guiding rule. In pursuing an acquisition out of a bankruptcy case, a buyer and its advisors should carefully develop a detailed understanding of how it can truly achieve a good deal. CR

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