Distressed M&A: Bankruptcy Code Section 363 Sales

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Because there is not currently enough credit available to fund the reorganization of troubled smaller and mid-sized businesses, the authors predict that there will be increase in the number of Bankruptcy Code Section 363 asset sales. This article discusses the process of asset sales with an eye toward maximizing the value of a debtor's assets.

Many experts are predicting a dramatic spike in corporate debt defaults and bankruptcy filings in 2009. The head waters of this perfect storm, namely, the economic slowdown, excessive debt leverage and a frozen credit market present a falling knife syndrome to potential buyers of distressed companies. A decision to acquire a distressed company requires careful navigation through a complex field of credit agreements, corporate structures, bankruptcy and creditors rights issues.

Amendments to the Bankruptcy Code in 2005, which shorten the time for a debtor in Bankruptcy to terminate or assume real estate leases to 210 days, and the scarcity of debtor-in-possession financing to fund inventory and working capital during a bankruptcy, will likely cause an increase in sales of bankrupt businesses under §363. Secured lenders today are not

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willing to incur the substantial expense and delay in allowing a debtor to propose a reorganization plan and as a result, debtors are forced early after a bankruptcy filing to make a decision to sell their assets under § 363.

We believe that the current credit crisis is likely to spur an increase in the number of such sales, especially of small and mid-sized businesses. Simply put, there is not currently enough credit available to fund the reorganization of troubled smaller and mid-sized businesses. Indeed, the Lehman Brothers bankruptcy filings demonstrate that even the large company is forced to "reorganize" through asset sales under § 363. Moreover, although not without risks, a sale under § 363 provides certain benefits in connection with the sale of a business that are not available under a U.C.C. Article 9 secured party sale. Perhaps the greatest benefits of a § 363 sale is that the buyer can acquire the assets of a business free and clear of liens and most claims.

SECTION 363 ASSET SALE

As under Article 9, a sale under § 363 is most likely to be an asset sale. Indeed, if the business being sold is in bankruptcy, its stock is not an asset of the bankruptcy estate and generally could not be sold under § 363, although if the debtor is a holding company, its stock in its subsidiaries may be sold pursuant to § 363. Early cases under the Bankruptcy Code tended to limit sales of all or substantially all of a debtor's assets to dispositions pursuant to a plan of reorganization. However, it became clear that, for many debtors, the most effective way to maximize the value of the debtor's assets for creditors was by a sale of either all or substantially all of the debtor's assets or (as is being done in the Lehman Brothers bankruptcies) sale of business units prior to the filing of the plan. Therefore, most bankruptcy courts now approve these sales, provided the debtor can demonstrate that the sale has a sound business purpose.

THE PROCESS

The benefits to a sale under § 363 include simplicity, avoidance of the corporate law requirement to obtain majority shareholder approval, and

the sale will generally be free and clear of most liens and encumbrances. The exception to the "free and clear of all claims" rule is possible successor liability for products liability and certain employment and environmental claims against the debtor.

The Bankruptcy Code permits a debtor to determine which of its contracts it wishes to assume and assign to the buyer of its assets. An assignment of a debtor's contracts, however, requires the buyer (because the debtor is usually unable to do so) to cure all payment defaults under the assigned contracts and provide and adequate assurance of future performance under the contract. Therefore, a buyer of a debtor's assets must carefully choose the contracts to be assumed and assigned. Additionally, a debtor is not authorized to assume and assign all of its contracts. A debtor cannot assign a contract if, under applicable non-bankruptcy law, the non-debtor party would be excused from accepting performance under the contract from any person or entity other than the debtor. These would include patent licenses and government contracts. Real estate leases where the debtor is the tenant may be assumed and assigned, notwithstanding a non-assignment clause in the lease, provided the lease is assumed within 210 days from the bankruptcy filing.

"Stalking Horse" Buyer

Before bringing a motion to sell its assets under § 363, a debtor generally locates a "stalking horse" buyer. The debtor then files a motion to approve the sale to the stalking horse buyer, subject (as is required under the Bankruptcy Code) to higher and better offers. Motions for the sales under § 363 typically seek two hearings. The first is a hearing on bidding and sale procedures. Those hearings are often held on shortened notice. At that hearing the bankruptcy court may be asked to enter an order:

- prohibiting the debtor from shopping the assets;
- setting the time for and manner of submitted competing bids;
- setting forth the required minimum terms of competing bids;
- setting a date for an auction of the debtor's assets; and

- setting a final hearing on the sale.

The court may also be asked to approve a break-up fee to compensate the stalking horse buyer in the event that its bid is not the winning bid for the expenses it has incurred and the efforts it has undertaken in becoming the stalking horse buyer. Bidding procedures and break-up fees or topping fees have generated substantial litigation because they tend to chill bidding at a sale. Rulings of the applicable bankruptcy courts and Courts of Appeal on bidding procedures and break up fees generally allow, as a rule of thumb, a break-up or topping fee of no more than three percent of the total consideration paid for the debtor's assets.

Auction Sale

The auction sale of the debtor's assets will occur after bidding and sale procedures hearing. It typically takes place in the office of the debtor's counsel. However, if there is sufficient interest in the debtor's assets, the auction may take place in a public venue, such as the bankruptcy court, although bankruptcy judges typically are not present at the auction. The auction may, however, take place before the bankruptcy judge at the final hearing. Such auctions are more likely to happen at the sale of smaller debtors or only units of a debtor's business. If there is competitive bidding, a back-up bidder may be chosen in the event that the successful bidder cannot or does not consummate the sale.

Financing

Most debtors need some type of financing to function in bankruptcy, even if the debtor needs only to operate long enough to consummate a sale of its assets. Since debtor-in-possession financing is tight, we believe stalking horse bidders may be the source of debtor-in-possession financing, especially in smaller cases. This will have the effect of maximizing the stalking horse bidder's leverage and likely success in purchasing the debtor's assets since its post-petition loan will have to be paid in full by any successful bidder for the debtor's assets.

Timing

At the hearing on the bidding and sale procedures, the bankruptcy court will generally set a final hearing to approve the sale. That sale can be heard on the same day as the auction if one is held, or it may be later. At the final hearing, assuming that all of the requirements of §§ 363 and 365 and any other applicable provisions of the Bankruptcy Code have been satisfied, the sale will be approved.

The § 363 sale process may move very quickly, although the process must take at least 20 days from the filing of the initial motion. This short time period may make presenting a competing bid difficult. There will be little time for due diligence and obtaining financing. Under such tight time constraints, it may be difficult or even impossible to obtain regulatory approvals. A potential competing bidder generally has no standing to challenge bidding procedures. As with any other transaction in bankruptcy, the parties to § 363 sale must act in good faith. Hence, collusive bidding is prohibited. Parties guilty of collusive bidding that depresses the sale price of the debtor's assets may be liable for damages.

LIMITATION ON THE USE OF SECTION 363

One important limitation on the use of § 363 sales is either the debtor or, if one has been appointed, the trustee, must consent to the sale and, in fact, must be the party bringing the sale motion. As the law currently stands, creditors cannot compel a debtor to file a § 363 motion. Another drawback of a § 363 sale is that it must be subject to higher and better offers. In other words, a stalking horse buyer could lose a bid. Given the benefits available to the successful bidder for a debtor's assets and the relatively speed at which a § 363 sale can be held, financially distressed debtors and their creditors should consider such a sale as a means of maximizing a recovery of at least the debtor's secured creditors. For a buyer, early involvement with a debtor, specifically prior to filing the bankruptcy petition, presents a valuable opportunity to acquire a distressed company with protection from claims by the debtors' creditors in a very timely fashion.

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CONCLUSION

M&A strategies to acquire a distressed company range from Article 9 secured party sales, Bankruptcy Code § 363 sales and the strategic acquisition of the debt or equity securities of a distressed company at an appropriate level to gain control of the company. Choosing the right strategy amid the turmoil in the current market and the complexity of these options requires knowledge, experience and sound financial and legal advice.