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COVER STORY | BY PAULINE RENAUD

Section 363 sales in the US

The current financial crisis has dramatically increased the number of US companies filing for Chapter 11 bankruptcy protection in recent months. For investors, such situations provide them with an opportunity to acquire the assets of distressed companies at a discount, via the Section 363 bankruptcy sale process. The process can also be an appealing option for creditors and debtors, and it is increasingly the case that bankruptcy has become a vehicle for sales as much as for reorganisations. But while they offer great advantages for debtors, creditors and potential investors alike, Section 363 sales also require advance planning and a full understanding of the process. This is particularly important, as there are a number of potential pitfalls along the way.

An increase in 363 sales

A Section 363 sale allows the debtor to sell assets 'free and clear' of the company's liabilities, and the 363 sale process usually starts with the debtor selecting a so-called 'stalking horse' bidder and negotiating an asset purchase agreement (APA). "This APA serves as a floor against which all other bids for the assets will be made at auction," explains Robert Harris, a partner at Waller Lansden Dortch & Davis LLP, and chair of the firm's Finance and Restructuring practice. "In exchange for coming forward and negotiating the initial APA with the seller/debtor, the bankruptcy court often grants the stalking horse certain bidding protections, such as expense reimbursement, and break-up fees in the event its bid is exceeded." Following that, a bankruptcy court approves the procedures governing the sale, and an open auction process ensues, thereby ensuring that the assets are sold at a fair price. "The notice and auction procedures usually contemplate some sort of market testing procedure, either by way of a stalking horse proposal, which is tested against overbids from third parties, or without a stalking horse by way of an open or closed auction, or other bid process such as sealed bids," confirms Neil B. Glassman, a partner at Bayard, P.A. "Although such market testing procedures are not always required, the idea of a 363 sale is that the notice provisions for the sale and the 'auction' procedures are supposed to maximise value for the estate and its constituents."

Following that auction process, courts generally require only a 'sound business justification' to approve a sale, and are usually quite deferential to the debtor, particularly in cases where the future of the company is at stake. Typically, the bankruptcy court will approve the highest bid received at the auction or, if there are no other bidders, the stalking horse bid itself. The basic standard for a sale is usually that it has to be in the best interest of the estate and creditors. Finally, the court enters a sale order, approving the sale and clearing title to the assets. Most Section 363 sales usually follow that process but there have been several recent Section 363 sales that have been somewhat atypical, notes Nancy L. Sanborn, a partner at Davis Polk & Wardwell LLP. "This includes the sale of Lehman Brothers' investment banking business to Barclays, where the sale was approved only five days after the Chapter 11 filing, and the Chrysler and GM sales, where the sales included the provision by the purchasers of substantial amounts of cash and equity to junior claimants in connection with assumption of contracts or entry into new contracts with the junior claimants, notwithstanding that other unsecured and/or secured debt claims would not be paid in full." However, sales of this nature are unusual and likely to becoming rarer, particularly now that the market is seeing the early signs of recovery.

Amid the current crisis, there has been a substantial increase in the number of Section 363 sale cases, particularly in the retail and automotive sectors. Some experts believe that this is ▸▸

mainly the result of a growing availability of assets being offered for sale, rather than an increased availability of funds to purchase those assets. However, others explain that "in the current economic climate, distressed investors are becoming increasingly active in Section 363 sales. I have seen estimates that distressed takeovers, where creditors convert their prior debt positions into equity in a restructured or reorganised entity, are occurring at nearly double the pace of 2008. Additionally, it appears that the deals are significantly larger in size than in recent years," observes John Rapisardi, a partner and co-chair of Financial Restructuring at Cadwalader, Wickerman & Taft LLP. But others believe that with an increase in available capital, funds specialised in distressed investing will contribute to a jump in the amount of assets purchased, particularly in the real estate sector.

In addition, strategies, such as 'credit bidding' and 'loan to own' strategies, have also come into play, and are being used by investors to acquire distressed debt – either to force other bidders to pay a higher price or to obtain control of their collateral, notes Ms Sanborn. "There have been several interesting cases recently, where agent banks have submitted credit bids on behalf of lending syndicates. Although objecting lenders have argued that their consent should be obtained to authorise a credit bid, courts have held that credit bidding is simply an exercise of remedies. Accordingly, an agent bank may submit a credit bid on behalf of, and thereby bind, the lending syndicate if directed by the number of lenders who have the right to direct the agent bank to exercise its other remedies with respect to the collateral," she explains. There has also been an increase in the use of DIP financing strategies by potential buyers. Such loans typically include terms that are more favourable to the lender than traditional out-of-court loan agreements. And although DIP loans must be approved by a bankruptcy court, their approval does not require a formal bidding process. Furthermore, DIP financings can also lead to a shorter sale process, and increase the likelihood of closing the sale transaction. This is because they often put pressure on the company to proceed with a sale to comply with requirements and deadlines contained in the DIP financing agreement, triggering event of default and, potentially, causing the loan to become due immediately if these requirements are not satisfied.

Overcoming challenges

The different strategies used by investors to acquire assets under Section 363 sales illustrate the various benefits attached to the procedure for both acquirers and debtors. Firstly, it allows for a quick monetisation of assets at the maximum current value, given the competitive nature of the auction process. Furthermore, unlike a sale under a reorganisation plan, a Section 363 sale does not require the votes of creditors or shareholders, and comes with a more streamlined process for court approval. But for buyers, the main advantage is being able to take the assets free and clear of pre-bankruptcy liabilities, explains Faye Feinstein, a partner and Chicago office head of the Commercial Bankruptcy, Restructuring, and Creditors' Rights Group at Quarles & Brady LLP. "In some cases, buyers may be willing to pay more for assets that come with the protections offered by Section 363 or, more often, may be unwilling to enter into a transaction without them, particularly in light of the risk of a fraudulent conveyance challenge. Bankruptcy court sale orders can, among other things, transfer property free and clear of the interests of third parties, including liens, protect buyers against successor liability, require state recording offices and title companies to accept the sale order as proof of the release of encumbrances, and authorise assignment of contracts and leases without the consent of the counter-parties to those agreements," she says. "But one of the primary benefits is that the court approves the purchase price as fair consideration, a significant concern for buyers of distressed assets."

Another benefit is associated with Section 365 of the Bankruptcy Code, which allows a buyer to assume most contracts and leases without regard to non-assignment provisions, explains Mr Harris. "In essence, Section 365 permits a buyer to 'cherry-pick' below-market or otherwise competitive contracts that are assigned to it as part of the sale transaction, while leaving the above-market contracts with the seller/debtor in order to be rejected by the court. This is a powerful tool that helps the buyer right-size the business on a going forward basis," he says. But some consider this to be one of the main drawbacks of Section 363 sales, as it leaves undesired assets and liabilities for the debtor and its creditors to address. "The principal drawback of a Section 363 sale is a corollary to its primary advantage – while it allows the debtors and creditors to realise the current value of the assets, a Section 363 sale generally means foregoing the future upside potential of the assets because most of these transactions are cash sales," notes Ms Sanborn. "In addition, the Section 363 sale process is an open process, so customers, employees and others will be aware of the planned sale and behave accordingly." This is indeed a major drawback, as buyers usually prefer confidentiality and exclusivity – disclosure of bankruptcy sales can result in a buyer paying more than originally agreed, or even losing the deal.

For the proponents of a bankruptcy sale, another challenge lies in the possibility for stakeholders, creditors and other interested parties to object to the sale or challenge the terms of the APA, thereby delaying the process. This is particularly prevalent in certain sectors. "For certain healthcare companies, such as hospitals, the Bankruptcy Code can provide for the right to appoint a patient care ombudsperson, which gives certain expanded rights to the community in which the healthcare facility is located. The patient care ombudsperson's responsibility is to protect the interests of the patients to ensure that the quality of patient care is adequate. In the bankruptcy of a healthcare business, this can introduce another interested party that could object to or potentially slow any sale under Section 363," explains Mr Harris. If multiple objections are received, each objecting party can participate in the sale hearing, therefore eliminating one of the main benefits of Section 363 sales – that is, their rapidity. "For a seller looking to prevent or overcome objections, the best course of action for sale proponents is two-fold: first, the seller should conduct advance planning for the sale process that is consistent with the requirements of Section 363 and the realities of the market; second, they need to implement an auction that provides a full opportunity for all parties to bid for the assets," recommends Mr Rapisardi.

In general, the Bankruptcy Code favours secured creditors whose collateral is at stake. But other creditors, specifically unsecured ones, can challenge bid procedures, or the sale itself, to try to gain leverage. Challenges may include cases where the sale process chills the ability to obtain the best price, by requiring an unreasonably short marketing period, high break-up fees and large minimum overbids, explains Ms Feinstein. "Unsecured creditors are also en- ▸▸

titled to object if the sale substantively prejudices them by, for example, transferring avoidance actions, releasing non-debtor guarantors, or encumbering previously unencumbered assets in exchange for loans to keep the company operating pending sale," she adds. However, there are viable means for unsecured creditors to challenge such sales. "The most effective strategy for unsecured creditors is to attack the debtor's valuation of the assets being sold, and demonstrate that the proposed sale price is less than the assets could get in liquidation or other sale. Therefore, it is imperative that an unsecured creditor uses its own valuation expert when challenging the debtor's valuation," advises Mr Rapisardi. "However, in reality, the market usually dictates valuation, and an unsecured creditor must be prepared to produce a bona fide bidder to substantiate any asserted valuation. Otherwise, the debtor may effectively argue that the creditor's valuation should not be accepted by the court," he warns.

From an acquirer's perspective, another challenge is meeting the requirements of court-approved bidding and sale procedures. But from the debtor's perspective, "the main challenge is to balance the interest of having certainty from the stalking horse acquirer against the desire to have that stalking horse acquirer wait and be tested against the market," explains Mr Glassman. "Having said that, bankruptcy makes strange bedfellows and, to a large extent, debtor's counsel and buyer's counsel have an alignment of interest because a sale has to go through. In such cases, it can be very difficult to be the debtor's counsel and obtain the funding necessary to both consummate the sale and solicit and confirm a plan. But courts are inclined these days to approve 363 asset sales without any insurance that a plan will be confirmed, if for no other reason than to preserve jobs." To overcome those challenges, constant communication between all interested parties is recommended, to identify issues early on in the process and address them prior to closing the sale. Also, it is advised to use an experienced financial adviser and legal counsel throughout the process.

All in the details

Getting the details right is particularly important, as it is likely that more Section 363 sales will be conducted in the coming months. But such a procedure can meet some hurdles, particularly in the media or utilities industries. "Some of these very large companies are not so easily sold due to an understandably very limited universe of buyers and, therefore, end up being warehoused in Chapter 11," points out Mr Glassman. "In these situations, lenders find it better to keep letting their cash collateral be used along with some additional funds lent rather than liquidate. The reality is that it is not feasible to dispose of these types of enterprises for an enterprise value which is palatable to the constituents. Instead, they opt to await a change in the environment. The end result being these cases last longer because they can't do a quick sale followed by a conversion or a confirmation of a liquidating plan," he says.

Despite those different challenges and hurdles, Section 363 sales are still being used to convert assets into cash. Some bankruptcy cases are even filed only for the purpose of enabling a Section 363 sale, particularly when the buyer refuses to proceed without such protections. "The recent case of Clear Channel Outdoor Inc. v. Knupfer (In re PW, LLC) (9th Cir. B.A. P.) addressed the prevailing assumption that a secured creditor's successful credit bid may result in a transfer of the assets to that creditor free and clear of junior liens. The court suggested that some courts too quickly approve sales that prejudice third parties, without thoroughly analysing the limits actually imposed on sales by the Bankruptcy Code," explains Ms Feinstein. As a result, creditors and potential investors looking to acquire distressed assets must be ready to take active roles in the pre-auction process or risk losing important rights. Ultimately, having a broad understanding of the process and the potential issues that may arise is an essential element of a successful Section 363 sale that satisfies the parties involved. ■

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