BANKRUPTCY ARTICLE

ROBINSON BRADSHAW & HINSON

APRIL 2009

Asset Sales under the Bankruptcy Code

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Last month, Garland Cassada concluded his article *Purchasing Business Assets in Troubled Markets* by advising that, in some situations, a seller can obtain fair value for its assets only by selling them in bankruptcy. He noted that a purchaser acquiring assets through a bankruptcy can obtain the highest level of protection against claims by the seller's creditors. In this article, I will pick up where Garland left off and identify some of the advantages and disadvantages of a bankruptcy sale transaction. Then, because the parties can bring about the sale either under § 363 of the Bankruptcy Code or as part of a Chapter 11 plan of reorganization, I will analyze some of the differences between those two types of sales.

<u>Advantages and Disadvantages of Bankruptcy Transactions Generally</u>

Whether done pursuant to § 363 or a Chapter 11 plan, a sale transaction through bankruptcy provides a purchaser with several advantages. Perhaps most importantly, the Bankruptcy Code enables the purchaser to accomplish what it may not otherwise accomplish outside of bankruptcy: substantial reduction, if not complete elimination, of its risk of liability for the seller's debts and obligations. The purchaser's risk will be reduced because the bankruptcy court will enter an order, binding on the seller's creditors, approving the transfer of title to the assets free and clear of almost all liabilities. A purchase made with bankruptcy court approval also binds dissenting creditors and shareholders. Additionally, the parties can often obtain an expedited ruling on any potential legal issues or disputes that might otherwise thwart a proposed purchase because bankruptcy courts generally have authority over all of the seller's property regardless of its location and can hear and determine matters on short notice.

The Bankruptcy Code also makes it easier for the purchaser to receive an assignment of the seller's contracts with third parties perceived by the purchaser as valuable or desirable. The purchaser can use the bankruptcy process to force third parties to identify the seller's existing defaults, to cause the seller to cure those defaults and to compel third parties to honor contracts assigned to the purchaser when the third parties might have the right under non-bankruptcy law to terminate those contracts. A purchaser also can use the bankruptcy process to avoid taking on unwanted contracts and leave any resulting liability with the seller.

In addition to these legal advantages, a purchaser in a bankruptcy transaction will also be dealing with a well-formed marketplace with standardized sale procedures and knowledgeable bankruptcy professionals available to help. Bankruptcy permits a seller to preserve the going-concern value of its business and provide the purchaser the benefit of acquiring a functioning business, not simply a collection of assets.

Despite these advantages, a purchase through bankruptcy has notable drawbacks. Any control a purchaser may have in a non-bankruptcy transaction will diminish significantly in bankruptcy because of the required bankruptcy court oversight. A bankruptcy sale may also lead to increased competition for the seller's assets. The sale will be subject to notice and may attract higher and better offers at an auction, so a purchaser may have to increase its offer in order to secure the deal. Because of bankruptcy procedures, a sale transaction also may take longer to consummate; a purchaser should expect a transaction to take at least 30 to 45 additional days to close. Bankruptcy sale transactions also tend to cost more than non-bankruptcy transactions because a purchaser normally will need to engage bankruptcy counsel as part of its "deal team." Moreover, because bankruptcy transactions by their very nature often arise in crisis situations and compel expedited decisions about whether to pursue transactions, the purchaser may need to use more attorneys and other professionals to complete the due diligence process than it would normally. A purchaser also needs to take into account that a seller not already in bankruptcy may resist the suggestion of a bankruptcy sale because of the risk that a bankruptcy trustee, a creditors' committee or someone else may sue the seller's management and shareholders.

Distinctions between Transactions under § 363 and a Confirmed Plan of Reorganization

Chapter 11 of the Bankruptcy Code historically has been used to allow debtors to reorganize their financial affairs and continue their business under a court-approved plan. Now, it is also viewed as a flexible vehicle for a debtor-seller to liquidate its assets. In fact, a sale that occurs in a Chapter 11 case is more likely to be conducted under the authority of § 363 but outside the context of the Chapter 11 plan. The parties will rely on § 363 when a sale transaction occurs before a Chapter 11 plan is confirmed. Section 363 authorizes the debtor's sale of assets and, when the sale is outside the ordinary course of business, requires bankruptcy court approval. The key feature of a § 363 sale is that, if certain conditions are met, the purchaser acquires the assets "free and clear" of all liens, claims and encumbrances on, or interests in, the assets. A § 363 sale can be effected more rapidly than a sale under a Chapter 11 plan of reorganization. Consequently -- and particularly in the current economic conditions and credit markets -- sellers increasingly are using § 363 to sell assets early in the bankruptcy process.

Because a § 363 sale must maximize the value of the assets for the benefit of the seller's creditors, it is virtually always conducted in an auction or competitive bidding process. The bankruptcy court must examine and approve the sales procedures (including appropriate notice to creditors and potential competing bidders) and the sale itself (including the terms and conditions of the sale). The court then authorizes the sale under an order discharging the claims, liens and encumbrances on the assets and converting the liens on the assets into liens on the sale proceeds. A prospective purchaser that is interested in distressed assets can obtain a competitive advantage by striking a deal with the seller and, thus, becoming the "stalking horse" in the auction process (a term of art used in the § 363 sale process). The stalking horse's purchase terms and form of agreement will serve as the "floor" for the transaction against which all competing bids will be measured. Just as importantly, the stalking horse also can negotiate favorable bidding procedures that materially increase the likelihood it will not be outbid at the auction. These procedures include the length of the notice period before the auction, the requirements for a competing bidder to be a qualified bidder at the auction, the minimum amount for the first overbid to the stalking horse's initial bid, and a break-up fee to be paid and out-of-pocket costs to be reimbursed to the stalking horse should it not ultimately submit the highest bid at the auction. To become the stalking horse, the purchaser should connect with the seller early and complete its due diligence ahead of other purchasers.

Despite these advantages of a § 363 sale, a confirmed Chapter 11 plan gives the parties more flexibility because the purchaser can acquire either the seller's assets or the seller's equity interests. A Chapter 11 plan purchaser is also more likely to succeed in cutting off the debtor's liabilities and preventing them from tracking the purchased property because of provisions typically included in reorganization plans. Additionally, a prospective buyer whom the seller does not support often can use the bankruptcy rules to compel the disclosure of more information about the property than the seller would voluntarily provide. The primary disadvantages to a Chapter 11 plan transaction are that it takes longer than a § 363 sale and is often more expensive because of the elaborate confirmation process designed to fully protect the rights of creditors. A purchaser should expect that the plan confirmation process will take at least 75 days from the filing of a Chapter 11 plan, but it often takes months after an initial bankruptcy filing for the seller to actually file its Chapter 11 plan.

The current economic climate invites opportunistic investors to acquire assets at prices not seen in some time. There are advantages and disadvantages to pursuing transactions in bankruptcy and important distinctions between a § 363 asset transaction and a transaction under a Chapter 11 plan of reorganization. The balancing of these pluses and minuses is an art, not a science, and the decision will likely depend on the specific facts and circumstances. If you have an opportunity to purchase business assets, our bankruptcy and creditors' rights group would be pleased to assist you in evaluating your purchase decision and formulating an appropriate strategy.

Mr. Schilli gratefully acknowledges the assistance of Andy Tarr in preparing this article.