The Journal of the DuPage County Bar Association

363 Sales in Bankruptcy
By Michael J. Davis

There are three ways to buy assets from a Chapter 11 estate. First, assets can be purchased through a sale under §363 of the United States Bankruptcy Code (the "Code") prior to a Plan of Reorganization. Second, assets can be purchased as part of a confirmed Chapter 11 plan of reorganization. Third, many plans anticipate that assets of a bankrupt debtor may continue to be sold after confirmation of a Plan from a post-confirmation liquidating trust. This article will deal with buying assets under §363 of the Bankruptcy Code.

Under Section 363(f) of the Code, a bankruptcy trustee or debtor-in-possession may sell the bankruptcy estate's assets "free and clear of any interest in such property."

The "free and clear" provision provides a means for the debtor to consummate a sale of assets quickly because any competing interests in the property need not be resolved as a condition to the sale. This results in attracting buyers who acquire protection from any successor liability, subject to certain exceptions. Section 363 also allows a sale of an operating entity which continues in business, being run by the debtor in possession. The advantage to this is an operating entity is oftentimes more valuable than one that has been shut down and in which the assets are merely being liquidated in a forced sale. Under Section 363, any asset of a Chapter 11 estate may be sold including real and personal property, both tangible and intangible.

There are distinct advantages to buying assets under Section 363. First of all, it allows a buyer to obtain quick court approval of a purchase much faster than through a reorganization Plan or from a post-confirmation liquidating trust. In addition, the assets purchased are protected by a bankruptcy court order that transfers the assets largely intact. Finally, the Section 363 sale transfers the purchased assets free and clear of any liens, claims and encumbrances. It is possible for a pre-petition purchaser to condition the purchase of assets from a troubled entity on the filing of Chapter 11 proceeding in order purchase the assets "free and clear" thus protecting the purchaser from any successor liability.

There are, however, disadvantages to purchasing under Section 363 of the Code as well. First, and most important, a sale motion under Section 363 must go out only on 20 days notice and the due diligence period of a new buyer looking at the assets of the Debtor for the first time is considerably shortened. Though the sale process can be extended considerably longer than the notice period, any due diligence involved in a Section 363 sale will always be considerably shorter than the purchase of assets in the ordinary course. This shortened due diligence period gives an advantage to potential purchasers who had discussed a purchase with the debtor prior to the filing of the case or to potential purchasers in the same industry as the Debtor, thus familiarizing them with the particular aspects of a business that a purchaser must know in order to be informed.

The primary disadvantage to a Section 363 sale is that the bankruptcy sale process is public, and the sale is almost always subject to higher and better offers at an auction. Thus, predicting a certain outcome of a purchaser deciding to engage in the due diligence process is impossible.

Further, a potential purchaser must qualify to be a bidder and must show the ability to be able to fulfill the terms of the sale. One of those terms, inevitably, is the posting of a substantial down payment to even bid, meaning that a bidder must have cash on hand to not only bid, but also to close the sale.

A bid that comes into existence after the sale process is noticed up and the due diligence period begins is not as common as one that exists prior to the filing of the Section 363 sale motion. Generally, once a debtor has determined that they want to sell certain or all of their assets in a Section 363 sale, they usually attempt to find what is termed as a "stalking horse bidder" (the "SHB"). The presence of an SHB generally yields greater value than an open auction because the SHB bid sets a bidding floor, and all bids must be greater than the SHB's bid in certain increments.

The SHB is used to attract competing bidders who are willing to acquire the same assets on the same terms and conditions but at a "higher and better" price. Using a SHB defines the transaction anticipated by the 363 sale process because it is customary for the SHB to enter into an asset purchase agreement (the "APA") which sets the price and the other terms and conditions of the sale. The APA also usually sets the due diligence information relied on and contains, like a non-bankruptcy APA, representations and warranties of the Debtor.

In return for the SHB entering into the APA prior to the sale, it is typical for the SHB to negotiate bid protections in advance of the sale subject to approval of the bankruptcy court. This includes that any subsequent bidder other than the SHB must increase their bid over the SHB in a minimum set amount. Further, the SHB may negotiate a "breakup" fee in case the transaction is not consummated with the SHB in the event that another bidder wins at the auction or through some other default of the debtor in violation of the APA. The breakup fee is determined on a case-by-case basis, but is generally designed to compensate specific costs incurred by the SHB in participating in the sale process. The breakup fee in conjunction with the existence of minimum bid increments presumes that the participation of the SHB will yield more value to the bankruptcy estate, and thus the SHB is entitled to some compensation for that participation. The breakup fee is paid from the proceeds of a higher or better transaction entered into with the successful non- SHB bidder. Provisions regarding these fees must be disclosed in detail in the sale motion.

There is little doubt that the SHB has the inside track on purchasing the assets of the Debtor and that the negotiated aspects of the APA stated above is designed to discourage competitive bids. This is because the competing bid must exceed the stalking horse bid plus the breakup fee in order for the bankruptcy estate to benefit beyond what it would cost to accept the SHB offer. But, this inside track still comes with a degree of uncertainty which exists despite the favored position of the SHB.

The other party with a considerable amount of input into the sale process is the secured creditor with a security interest in the assets to be sold. Section 363(f) of the Code requires that the secured creditor consent to the sale or that there be some state law

provision which would allow the sale of the assets without the secured creditor's consent. An example of the latter would be a foreclosure sale where a first mortgage holder is foreclosing on property and there is also a second mortgage holder on the property. The second mortgage holder's interest can be extinguished under state law – as can any lien holders interest – if the foreclosure sale does not yield sufficient proceeds to pay off all the interests of the secured creditor. In that case, the lien holders would be paid in order of their priority to the extent of the proceeds. Thus, under Section 363(f), a junior lien holder can be forced to participate in the sale process because they can be forced to participate in a sale process under state law.

As a result, the lien holder with the first priority interest in the assets to be sold has a considerable amount to say about the 363 sale process. One provision that may satisfy the first priority lien holder is allowing the first priority lien holder the right to utilize a credit bid in whatever amount they are owed as one of the bids. This allows the lien holder to essentially be the successful bidder if the bid prices are not sufficient to pay them off in full, and to get the property just as they would in a foreclosure sale under state law or an Article 9 sale under state law. This provision also allows the lien holder to accept any inferior bids to its credit bid if it does not want title to the property being sold and is willing to accept whatever proceeds were available from the highest bid that was not the credit bid of the lienholder.

There are two factors which have evolved to make the 363 sale process very popular in today's world of diminishing assets values.

First, the remedies available to a secured creditor for the liquidation of business assets not related to real estate are very limited. A secured creditor with a security interest in business assets typically is required to put a loan in default once a business violates any of the loan covenants. This begins a predictable process of giving the Debtor a certain period of time to pay the loan in full (a virtual impossibility in today's lending environment), and then, once the Debtor fails to accomplish that, the secured creditor sues to enforce their rights and repossess the assets which form the basis of the collateral. Secured creditors, unfortunately, are not in the business of liquidating assets or collecting receivables and any attempt to do that usually results in a rapid decline in the value of the collateral they are trying to repossess.

A typical scenario is when a chapter 11 petition is filed to allow the Debtor to continue to operate the business, and, in the event refinancing cannot be acquired, sell the business assets but as an operating entity which presumably results in greater value being realized. Because it is in the best interests of the secured creditor to allow a sale process to move forward and the business assets to be marketed over a certain period of time to the highest bidder with all the supervision and protection of the Code, the filing of a bankruptcy case presents a creditor with the opportunity to get the highest and best value for its collateral while being protected. The addition of the ability of the secured creditor to credit bid in whatever they are owed as the minimum bid in the 363 sale process allows the secured creditor to realize the same benefits of the non-bankruptcy state law alternatives but without the necessity of assuming the responsibility of actually dealing with the collateral. Instead, the Debtor in Possession, under the supervision of the bankruptcy court, effectively runs its own liquidation sale through the 363 sale process.

The second change in circumstance which has allowed 363 sales to be more often used has been the willingness of bankruptcy courts to administer a chapter 11 to benefit the secured creditors alone, without any distribution going to the unsecured creditors. Historically, Chapter 11 was viewed as a device to protect the interests of unsecured creditors by maintaining value beyond the interest of the secured creditor. But recently, with the diminishing values of all assets, Chapter 11 has come to be viewed as a vehicle to keep a Debtor operating to liquidate assets even if the amount realized from the liquidation is sufficient only to pay the administrative expenses of the bankruptcy and provide some return to secured creditors. Any of the large homebuilder cases filed in the Northern District of Illinois have yielded nothing to unsecured creditors but have provided the payment of administrative claims as a carve out from payments to secured creditors and some return to secured creditors who felt more comfortable liquidating assets in the ordinary course of business under the auspices of the Debtor than attempting to have a forced sale in some form of liquidation. The willingness of bankruptcy courts to recognize that a secured creditor's interest is also an interest protected by a Chapter 11 filing has created new and fertile ground for the use 363 sales.

Perhaps more telling is the perspective gained from such large bankruptcy cases as K-Mart and United Airlines where unsecured creditors received no payment at all, but did receive stock in the reorganized entity based on a calculation which gave them stock worth pennies on the dollar in relation to whatever claim they were allowed. Ultimately, the administration of these cases were for the benefit of a whole host of other parties besides unsecured creditors who essentially received little or nothing from the reorganized debtor after a long and protracted reorganization proceeding.

As a result of these recent trends, knowledge of the 363 process in bankruptcy to dispose of the assets of a debtor in possession is valuable in being able to advise clients of non-state court options to the actions of a secured creditor. When the loan is in default and the lender has called the note and about to act on the collateral a Chapter 11 filing may make sense. The ability to maximize assets by selling an on-going business ultimately reduces the deficits that are usually generated by liquidation of assets, which ultimately reduces the liability of the guarantor after the sale. Knowledge of the 363 option will assist any practitioner in advising their business clients.

Michael J. Davis *is an attorney who concentrates his practice in advising both business and consumer debtors and creditors as to their options regarding bankruptcy, workouts, asset liquidation, State and Federal commercial litigation and bankruptcy litigation.*