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SHUMAKER, LOOP & KENDRICK, LLP

Winners and Losers: They Call Alabama the Crimson Tide, Call me Deacon Blues[1]

"A sale of assets may create investment opportunities for strategic buyers . . .."

"Aggressive creditors can improve the potential outcome for payment on their claims . . .."

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In Bankruptcy Code Section 363 sales of assets, there are winners and losers.

Chapter 11 is known as a forum for reorganizing or selling a financially distressed business. If a Chapter 11 reorganization is not possible, a sale of assets may create investment opportunities for strategic buyers, investment banks, and private equity to take advantage of the "distress" normally associated with Chapter 11 to acquire assets at a discount, exemplifying Warren Buffet's "value" buying.

Whether a stakeholder's interest is as a debtor company, a financial institution with an at-risk loan, a supplier to or customer of a debtor, counter-party to a contract with a debtor, or a company interested in purchasing assets, a Chapter 11 Section 363 sale impacts every stakeholder's business. This article will examine each stakeholder's position in a Section 363 sale, and their risks and opportunities.

Debtor

- Section 363 of the Bankruptcy Code allows a debtor to sell substantially all of its assets free and clear of liens with liens attaching to proceeds of sale.
- This allows for the quick and efficient liquidation of a debtor's assets without having to first resolve the extent, validity and priority of liens on assets. Assets can be sold quickly and without further erosion of value due to ongoing operating losses.
- The allocation of the proceeds of sale among competing interests and stakeholders is finalized later.

Asset Purchaser

- Section 363 sales can provide significant investment opportunities for strategic buyers, competitors or private equity, who can take advantage of the "distress" normally associated with Chapter 11 companies to acquire assets at a discount.
- Buyers of assets often favor acquiring assets in a Section 363 sale since sales to good faith purchasers are not subject to later challenge, and can bind dissatisfied creditors who do not expressly consent to the transaction.
- A Section 363 sale normally begins with a "stalking horse" asset purchaser whose asset purchase agreement contains the initial bid.
- After appropriate advertising and marketing, a "Bankruptcy Court" auction is conducted where interested buyers are permitted to overbid the stalking horse bid for the estate to obtain the greatest possible value for its assets. There are usually "bidding procedures" approved by the Bankruptcy Court, including a percentage bidding increment and the stalking horse bidder often has bid protection in the form of a break-up fee and expense reimbursement.

[1]Lyrics of "Deacon Blues" by Walter Becker and Donald Fagen, from Steely Dan's 1978 Grammy-winning album Aja.

Secured Lenders

- Secured lenders have a primary interest in a Section 363 sale, arising from a lien on the debtor's assets to secure loans made to the debtor. As lenders are not in the business of owning and operating assets of its loan customers, Section 363 can be an efficient tool to liquidate collateral.

- Lenders favor a Chapter 11 sale for this purpose because asset purchasers prefer the efficiency of the Chapter 11 sale process, as well as the clear title delivered in such transactions.

- However, Chapter 11 sales can create additional costs for lenders. Lenders are usually willing to pay the transactional costs associated with the sale such as professional fees associated with an asset purchase agreement and related documents to effect the sale transaction.

- Lenders are often compelled to provide DIP financing to cover the debtor's operating expenses from the time of the Chapter 11 filing until closing or the disbursement of sales proceeds. There may be additional administrative costs associated with claims relating to property and other taxes, employee obligations, obligations due on key contracts and certain claims of unsecured creditors.

Counter-Party to Contracts

- Chapter 11 debtors are inevitably parties to various pre-petition contracts including leases, supply contracts, licensing agreements or collective bargaining agreements. Such contracts would often be considered "executory contracts", which is the Bankruptcy Code term given to essentially any contract between a debtor and a non-debtor party where both parties owe material performance to the other.

- The Bankruptcy Code provides debtors the unfettered right to assume or reject executory contracts and leases. If a debtor rejects an executory contract, the non-debtor party receives a general unsecured claim for damages arising from the debtor's breach of contract. Thus, the debtor escapes the contract with little cost. On the other hand, the debtor also has the right to assume and assign a contract. In this instance, the Bankruptcy Code requires that the debtor "cure" existing defaults, usually payment of the pre-petition obligation owed.

- In the context of a Section 363 sale, it is often the buyer of assets that determines which contracts are assumed or rejected by the debtor. To be assigned to the buyer, the contract must first be assumed.

- If a pre-petition contract is favorable to the counter-party, the optimal outcome is for the debtor to assume and assign the contract to the purchaser in conjunction with the asset sale. Typically, an asset purchase agreement would provide for the purchase price to include cure amounts for contracts assumed and assigned to the buyer. If the contract is not favorable to the counter-party, the debtor is likely able to assume and assign it despite objection.

- If the debtor assumes and assigns the contract as part of the Section 363 sale, asset purchasers will often attempt to negotiate a reduced cure amount and an extended payment.

Unsecured Creditors

- Unsecured creditors generally stand to lose the most in a Chapter 11 Section 363 sale. There is an inherit tension between the secured lender who asserts liens on the assets being sold and unsecured creditors. The secured lender's goal is payment of its secured debt, while other creditors seek a sale in excess of the secured lender's debt to generate proceeds for other creditors. The quickest sale does not necessarily produce the best sale, however, a prolonged sale has the disadvantage of higher administrative costs.

- With increasing frequency, Section 363 sales have been "short sales" where the proceeds of sale do not cover the secured debt, much less provide a dividend for unsecured creditors.

- However, many courts have required the secured lender to pay administrative claims associated with the Chapter proceeding to obtain the benefits of the Chapter 11 process and protections. This has been euphemistically referred to as the "pay to play" rule, based on the policy that Chapter 11 should not be used for the benefit of one creditor.

- In addition, Section 503(b)(9) of the Bankruptcy Code provides suppliers of goods an administrative expense priority claim for goods sold and delivered to the debtor within twenty (20) days prior to the bankruptcy filing. These claims are pari passu with the claims of professionals employed by the debtor's estate, although sometimes DIP financing orders can alter that equality. In many cases, unsecured creditors are able to negotiate either a carve-out or a provision in the liquidation budget for the payment of Section 503(b)(9) claims.

- In addition, unsecured creditors should consider utilizing the "critical vendor" remedy, where the uninterrupted supply of goods or services provided by a vendor is so essential to a debtor's ability to continue operating, the asset purchaser insists that the vendor be paid. Whether the asset purchaser or the lender ultimately bears this cost is a matter for negotiation among the parties.

- In any Chapter 11 case, unsecured creditors face the prospect of preference claims for the return of payments within ninety (90) days prior to the bankruptcy filing. In a Section 363 sale, once the assets have been sold to the asset purchaser, the debtor becomes a shell corporation with little remaining assets to administer. One of the residual assets is "avoidance actions" including preference claims.

- In many cases, the debtor's estate, either directly or through a liquidation trust controlled by the former creditors' committee, can pursue avoidance actions "for the benefit of the estate". In theory, pre-petition payments to creditors are returned back to the estate and re-distributed equitably to all creditors. In practice, however, there is little correlation between the amount paid back into the estate and the amount actually distributed to creditors, after accounting for administrative costs. By using a variety of mechanisms, unsecured creditors can often negotiate an effective waiver of preference claims. This negotiation can occur in connection with the 363 sale, as asset purchasers do not favor residual litigation against their ongoing suppliers.

Shareholders

- Shareholders almost always lose whatever equity investment they had in the debtor entity. Since the Bankruptcy Code places equity interests at the bottom of the payment priority scheme, there is almost never a distribution on equity interests.

- Shareholders may also be officers and directors of the debtor and face various avoidance or insider claims including claims for breaches of fiduciary duty.

Section 363 sales are a powerful tool for Chapter 11 debtors to efficiently sell substantially all of their assets. Asset purchasers are often the biggest winners acquiring assets at below market prices. Secured lenders are generally considered to be winners in the context of a Section 363 sale, as they efficiently liquidate their collateral at the best price under the circumstances to resolve the customer loan.

Unsecured creditors very often lose the majority of the value of their sales to the debtor customer. Many Section 363 sales produce a single digit dividend for unsecured creditors; a 50% dividend would be quite successful; and a 75% and above dividend would be considered a homerun. Aggressive creditors can improve the potential outcome for payment on their claims by pursuing a Section 503(b)(9) claim, payment as a critical vendor, a carve-out for creditors, or an assumption of an executory contract.

We hope you found this useful and informative. Please contact us if you have any questions about this, or any other matter.