Section 363 of the Bankruptcy Code – A Tool for Buying and Selling Financially Distressed Assets

By Cass S. Weil

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Moss & Barnett is pleased to report that an article retired shareholder, Cass S. Weil, wrote for our Fall 2013 Firm Newsletter, *"Section 363 of the Bankruptcy Code – A Tool for Buying and Selling Financially Distressed Assets," has been included in a Harvard Business School (HBS) Case Study written by Professor Nori Gerardo Leitz and Alexander W. Schultz, "The U-Turns of National Truck Stops," Case No. N9-217-062 (May 17, 2017). The HBS case study is a teaching vehicle that presents students with a critical management issue and serves as a springboard to lively classroom debate in which participants present and defend their analysis and prescriptions. It goes without saying that this is a tremendous endorsement of the quality of the article written by Cass. We are reprinting the article here.*

Consider these common "distressed asset" scenarios: A business only has capital to operate for a short time. A lender or potential purchaser is willing to provide only short-term financing to a struggling business. A potential purchaser says that it will pay more for assets if it can acquire the assets "free and clear" of existing liens and interests and be assured that the sale will not be set aside by a court. A quick transaction may preserve the value of business assets, including relationships and employee loyalty, but there is resistance from one or more constituent groups.

In each of the foregoing circumstances, the provisions of Section 363 of the Bankruptcy Code may provide a useful tool for accomplishing objectives of both buyers and sellers. Since the changes to the Bankruptcy Code in 2005, sales of assets of businesses of all sizes pursuant to Section 363 of the Bankruptcy Code, as opposed to reorganization and restructuring through the full process of Chapter 11, have become increasingly popular as a method by which buyers and sellers transfer financially distressed assets.

A Section 363 sale is a procedure by which debtors can fulfill their fiduciary obligations to creditors and ownership by maximizing value and minimizing transaction costs.

> *"A well-known Section 363 sale is the liquidation of Lehman Brothers Holdings, Inc., in 2008. Approximately $639 billion dollars worth of debtor's assets, were sold to Barclays within five days of the bankruptcy filing."*

Purchasers get enhanced value by proceeding quickly in often deteriorating circumstances and obtaining the protections afforded by a sale "free and clear" of preexisting liens and interests, as well as enhanced finality compared to sales outside of bankruptcy.

What is a "Section 363" Sale?

"Section 363" refers to the portion of the Bankruptcy Code that authorizes a debtor to sell its assets "outside the ordinary course of business." Sales of assets "outside the ordinary course of business" are sales that are either dissimilar to the sales that the debtor would engage in as part of its day-to-day operations or different from the type of transactions that the debtor typically engaged in before it sought bankruptcy protection. A Section 363 sale transfers the debtor's assets to a buyer in a discrete transaction that will be approved by the bankruptcy court if the debtor can demonstrate a "substantial business justification" for the sale. Unlike a full Chapter 11, a Section 363 sale does not require the debtor to propose and gain acceptance of an overall plan of reorganization before the sale can be consummated. In fact, debtors' cases can be converted to liquidations after consummation of the Section 363 sale.

Advantages of Section 363 Sales

Because it can be accomplished quickly, the sale of a debtor's assets under Section 363 requires less cash or credit to keep the debtor's business going to preserve the value of assets by, among other things, maintaining uninterrupted business relationships and retaining employees, than would be required for a non-bankruptcy sale process or Chapter 11 reorganization. Typically, Section 363 sales can be accomplished in 60 to 90 days. Under the appropriate circumstances, however, the time from the bankruptcy filing through completion of a sale can be much shorter. A well-known example is the liquidation of Lehman Brothers Holdings, Inc., in 2008. The debtor's assets, valued at approximately $639 billion dollars, were sold to Barclays within five days of the bankruptcy filing. Other notable examples of rapid sales of substantial amounts of assets in a short time include General Motors and Chrysler.

Section 363 permits the sale of assets "free and clear" of existing liens and interests. Another notable benefit is that the bankruptcy court approves the purchase price as fair consideration for the acquired assets, thus minimizing the chance that the sale will be challenged as a fraudulent transfer or that the purchaser will incur

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successor liability. Section 363(m) protects Section 363 sales made "in good faith" from reversal on appeal unless the court stays implementation of the sale order while the appeal is pending. Section 363(m) provides a degree of finality unavailable outside of bankruptcy. The provision essentially moots the ability of any party to appeal a sale order once the sale has closed. When Section 363(m) is considered in conjunction with a sale "free and clear," the allure of Section 363 sales to potential purchasers becomes very clear.

Finally, Section 363 allows a debtor to assign to the purchaser or a third party favorable unexpired leases and executory contracts (contracts unperformed by both parties), but does not require the purchaser to assume the debtor's obligations under less attractive contracts. For example, a buyer can acquire a brand and production facilities along with ongoing sales contracts without assuming a union contract with employees. The ability to selectively transfer contracts is one of the most attractive facets of a full Chapter 11 reorganization that can be accomplished through a Section 363 sale, without having to satisfy Chapter 11's voting and solicitation requirements.

Because of these benefits, some buyers may be willing to pay more for assets acquired with the protections offered by Section 363. More often, buyers may be unwilling to buy distressed assets without Section 363 sale protections.

Limitations of Section 363 Sales

Section 363 sales cannot be used to "short circuit" the reorganization process set out in detail in Chapter 11 by altering creditor rights or by providing releases beyond the typical terms applicable to a buyer of assets. Courts have struggled to differentiate between allowable Section 363 sales and disguised reorganization plans. For example, in an early Section 363 case, the Fifth Circuit Court of Appeals, in *Pension Benefit Guaranty Corp. v. Braniff Airways, Inc.*, refused to approve a Section 363 sale because the proposed sale, which would have transferred ownership of Braniff Airways' cash, airplanes, and terminal leases, significantly restructured the rights of its creditors and provided for-profit participation in the new company, essentially amounting to a backdoor reorganization effort. Careful consideration of the nature and extent of relief to be sought in addition to the sale of assets in light of emerging case law is a necessary step in deciding whether a Section 363 sale is a viable alternative.

A feature of the Section 363 sale process that gives pause to some potential purchasers is that it takes place in the relatively transparent atmosphere of a bankruptcy case. Although protection of sensitive information is possible, the public nature of the proceedings must be balanced against the advantages noted above.

Another limitation on Section 363 sales is provided by Section 363(f)(3), which allows sales of assets "free and clear" of all liens as long as the price at which the assets are sold is greater than the aggregate value of all liens on the property. In other words, it is not possible to sell debtor's assets free and clear of "underwater" liens without the underwater lien holders' consent. If the lien is subject to "*bona fide* dispute," however, Section 363(f)(4) permits the sale of property subject to the disputed lien over the objections of the secured party.

The Section 363 Sale Process

Because both potential buyers and sellers intend to proceed rapidly once the seller/debtor files for bankruptcy, careful and thorough planning in advance of initiating bankruptcy is necessary. Because Section 363 sales are often undertaken at the behest of a creditor or potential purchaser who is supplying the debtor with cash to continue to operate, the potential purchaser or creditor will often have completed its "due diligence" in advance of the bankruptcy filing. The initiating party often serves as the initial bidder for the debtor's assets. The initial bid establishes a floor price for the assets to be sold. The initial bidder is called a "stalking horse." In addition to establishing the floor price and ensuring that there is at least one bidder for the assets, the stalking horse negotiates a form asset purchase agreement that can be shopped around to other potential bidders.

To protect the stalking horse bidder if it does not become the successful purchaser of the assets, many Section 363 sales agreements contain provision for a "breakup fee," which is a specified amount to be paid to the stalking horse in the event that it is not the winning bidder. The amount of the "breakup fee" must be approved by the bankruptcy court. The bankruptcy court will apply either a "business judgment" test or a "necessary to preserve the value of the estate" test to determine whether to approve a breakup fee. Under the "business judgment" test, breakup fees are presumably valid, and the court simply asks whether there was reasonable basis for the breakup fee and whether the amount was established in good faith and with due care. Under the "necessary to preserve" test, the court must find that the breakup fee actually benefited the estate by inducing or preserving the stalking horse bid. The test that the court will apply varies, but, under either formulation, courts will generally approve a breakup fee of two to four percent of the initial purchase price.

The identification of a stalking horse bidder and negotiation of a form asset purchase agreement is just the first step in the process. The debtor must not only apply to the bankruptcy court for approval of the

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stalking horse bid, form of asset purchase agreement, and the breakup fee, but must also obtain approval of bidding procedures for soliciting higher and better offers. This is typically accomplished through a sales procedures motion. The sales procedures will specify, among other things, the auction time and place, the extent and manner of the notice to be given of the auction, the deadline for qualified bidders to submit bids, and the deadline for any objections to the sale. To gain approval of the sale procedures, the court and interested parties must be convinced that the sale procedures are designed to ensure a fair and competitive bidding process that maximizes the value of the assets to be sold. Other interested parties, such as secured creditors and the unsecured creditors committee, are typically engaged in negotiations about the terms of the sale procedures motion. They will get notice of the proposed sales procedures and have an opportunity to object. For that reason, having prior agreement to the proposed procedures is preferable.

Once a stalking horse bidder has stepped forward and the sales procedures have been approved by the court, other qualified bidders are afforded the opportunity to submit bids. The sales procedures order will specify where and how information about the opportunity to bid on the assets offered for sale will be made available. The order will also define who may be a "qualified bidder" and what constitutes a "qualified bid." Generally, a "qualified bidder" is an entity that is willing and financially able to submit an irrevocable offer, in the form of a "marked up" version of the stalking horse's purchase agreement, that is greater than the amount of the stalking horse's bid. The sales procedure order will specify the increment by which a "qualified bid" must exceed the stalking horse bid. To minimize the possibility of a bidder's default, a common requirement for a qualified bid is evidence of the bidder's financial ability to perform, payment of a deposit, or both.

Many Section 363 sales garner no bids beyond the stalking horse bid. However, it is not uncommon for there to be more than one qualified bidder. When there is more than one bidder, the assets are sold at auction. In structuring the auction, care should be taken that bidding procedures are clear, that such essential items as the time and place for submitting bids, minimum bids, and bidding increments are specified, and that the method for evaluating competing bids is understood.

Interested parties, including the debtor, the debtor's creditors, and potential purchasers should all participate in formulating the sales procedures order to avoid any misunderstandings. Because bids can be in the form of cash, credit for existing liens, equity in the reorganized entity, or equity in the bidding entity, a method for comparing the value of bids containing differing proportions of the various allowed "currencies" is important. Failure to reach prior agreement on this issue can result in delay and a significant increase in transaction costs. A case involving the Polaroid Corporation serves as an example of what can happen if the parties do not agree on a procedure for determining the "highest and best" bid. In the Polaroid case, two bidders each proposed to fund a purchase through a combination of cash and equity in a reorganized debtor. The debtor and the unsecured creditors committee could not agree which bid was worth more. After the debtor declared a winner under the sale procedures order, the unsecured creditors committee contested the approval of the winning bid, arguing that the equity portion of the bid that was rejected by the debtor had to be evaluated differently from the equity portion of the bid chosen as the winner by the debtor. The bankruptcy court ultimately upheld the unsecured creditors committee's argument, observing that, because the committee members would be the future equity holders, the committee's preference should control. The dispute over which bid was the "highest and best" added significantly to the cost of the proceeding.

Final Thoughts

A Section 363 sale is a valuable tool for anyone considering the sale or acquisition of financially distressed assets. With careful advance planning that makes use of experienced and knowledgeable financial advisors and legal counsel, a transaction that maximizes value for both buyers and sellers can be structured in many cases. Unlike a sale outside of bankruptcy, a Section 363 sale can maximize the value received for the debtor's assets through a swift transaction that gives the successful purchaser assurances of finality and freedom from claims by existing creditors. Maximizing the value of the debtor's assets fulfills management's and the debtor's fiduciary obligations to creditors. The acquiring party in a Section 363 sale gets the benefits of a speedily completed transaction and the added protections afforded by Section 363(m).

The efficacy of Section 363 sales is demonstrated by their growing popularity and their use in such iconic cases as *General Motors*, *Chrysler*, *Polaroid*, and *Kodak*. To take advantage of Section 363 sales, seek the advice of experienced financial advisors and attorneys.