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presents

Section 363 Bankruptcy Sales

Navigating the Sale Process, Negotiating the Asset Purchase Agreement, and Conducting Due Diligence

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

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ANATOMY OF A SECTION 363 SALE

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GENERAL BANKRUPTCY CONCEPTS

- (1) An automatic stay halts most creditors from collecting against the debtor under 11 U.S.C. § 362(a).
- (2) 11 U.S.C. § 541 automatically creates a legal “estate” to allow for the effective management of the debtor’s assets.
- (3) Debtor in possession – 11 U.S.C. § 1107

- “Property of the estate” includes all legal or equitable interests of the debtor in property as of the date that the bankruptcy case is commenced. 11 U.S.C. § 541(a); In re Whitehall Jewelers Hldgs., Inc., 2008 WL 2951974 at *5-*7 (Bankr. D. Del. 2008).
 - Unless a particular federal interest requires a different result, property interests are created and defined by reference to state law. Butner v. U.S., 440 U.S. 48 (1979).
 - Includes the debtor’s interest in executory contracts.
 - Property becomes property of the estate only to the extent of the debtor’s interest.
- The estate is managed by the debtor-in-possession or a trustee.

Section 363 Sales

Section 363 generally governs the use, sale or lease of property of the bankruptcy estate.

- Only “property of the estate” can be sold in a § 363 sale. The estate must have an interest in the property sold.
- A sale in the ordinary course of business does not require bankruptcy court approval or notice.
- A sale outside the ordinary course of business requires notice to parties in interest (21 days) and court approval. 11 U.S.C. §363(b); Fed. R. Bankr. P. 2002.

A two-step inquiry determines whether a transaction is in the ordinary course of business:

Horizontal Test – whether the transaction is of a kind commonly undertaken by companies in that industry based on an industry-wide perspective.

Vertical Test- analysis of the transaction from a creditor's perspective which asks whether the transaction would subject such creditor to an economic risk different from that which the creditor accepted when deciding to extend credit.

Dangers of failing to obtain court approval – 11 U.S.C. § 549

Bankruptcy Sales vs. Non-Bankruptcy Judicial Sales vs. Private Sales

- Timing
- Expense
- Control of the Process
- Ability to Direct Liens, Encumbrances and Other Interests
- Ability to Override Anti-Assignment Provisions in Executory Contracts
- Finality

The Players in a Section 363 Sale

- Debtor
- Debtor's Secured Creditor(s)
- Debtor's Marketing Professionals
- Stalking Horse Bidder
 - The “Stalking Horse” is the party that initially contracts to purchase the debtor's assets.
- Creditors Committee
- Title Company
- Bankruptcy Court

Procedures for Selling Assets Outside the Ordinary Course of Business

- When a debtor seeks to sell assets outside of the ordinary course of business under section 363(b), the debtor usually procures a stalking horse.
- The debtor and stalking horse negotiate and execute an agreement that will serve as the benchmark for subsequent bidders. The stalking horse agreement usually requires the debtor to obtain bankruptcy court approval of bidding procedures within a certain period of time.

Procedures for Selling Assets Outside the Ordinary Course of Business

- Sales may either be by public auction or private sale.
- Private sales are generally rare in bankruptcy absent a compelling reason for such a sale.
- Once a sale has been agreed to, the debtor typically files a two-part motion with the Bankruptcy Court.
 - Sale procedures motion, which seeks the approval of procedures for the sale and auction process, including proposed protections for the stalking horse.
 - Sale motion seeking approval of the sale itself to the successful bidder at the auction.

Sale Procedures

- The Sales Procedures Motion will typically:
 - (1) request a date for an auction and sale hearing to consider the sale to the proposed purchaser,
 - (2) request that the terms and conditions of any competing bids be fixed in relation to the stalking horse bid,
 - (3) request approval of a “break up” fee to be paid to the Stalking Horse in the event that the Stalking Horse is ultimately outbid and other bid protections; and
 - (4) establish the form of notice for the sale hearing and bid terms.

Key Concepts in Sales Procedures

- **Initial Overbid** – the debtor will not consider a higher or better offer unless it equals the Stalking Horse bid plus what is known as an “initial overbid amount.” Initial overbids generally range from 2.00% - 3.5% of the total sale value.

- **Break-Up Fee** – an amount of money paid by the Seller to a Stalking Horse if the contemplated transaction fails to be consummated for reasons covered in the purchase agreement, including the seller’s acceptance of a competing bid. The Break-Up Fee is often the incentive for a party to serve as the Stalking Horse.

- **Expense Reimbursement** – the portion of expenses incurred by a Stalking Horse to negotiate and prepare the purchase agreement that will be reimbursed by seller in the event that the seller commits a material breach of the Stalking Horse Agreement.

- **No-Shop Clauses** – provisions forbidding the debtor from seeking other bidders. No-Shop clauses are generally not permitted in the bankruptcy context. Such provisions may be allowed in unusual circumstances if they are necessary to obtain a sale, they are consistent with the debtor's fiduciary duties and they do not chill the receipt of higher or better offers.

- **Modified no-shop clauses** - requiring that a seller not actively shop assets, but allowing the seller to respond to good faith inquiries, on notice to the Stalking Horse, have been approved.
- **Fiduciary Out** - The adverse effects of a no-shop clause or other bid protection can be mitigated by adding a clause permitting the debtor to consider other offers to the extent its fiduciary duties require it to do so.

Standards for Approving Break-Up Fees and Other Bid Protections

- **Modified Business Judgment Rule** – considers (a) whether the relationship between the parties was tainted by self-dealing, (b) whether the break-up fee chills bidding rather than encourages it and (c) whether the amount of the fee is reasonable in light of the purchase price. Off. Comm. Of Subordinated Bondholders v. Integrated Research, Inc., 147 B.R. 650, 657 (S.D.N.Y. 1992).
- A Break-Up Fee can be found to chill bidding if it is so large as to make competing bids too costly. In such a case, the Break-Up Fee is not protected by the Business Judgment Rule. Samjens Ptrs I. v. Burlington Indus., 663 F. Supp. 614 (S.D.N.Y. 1987).

- **Best Interests of the Estate Test** – fees are examined in light of whether the interests of the debtors, creditors and equityholders are alike best served by the Break-Up Fee. In re American West Airlines, Inc., 166 B.R. 908, 911 (Bankr. D. Ariz. 1994); In re Wilde Horse Enters., Inc., 136 B.R. 830 (Bankr. C.D. Cal. 1991).
- **Administrative Expense Claim Test** – allowance of the Break-Up Fee depends on the requesting party’s ability to show that the fees were necessary to preserve the value of the estate. In re O’Brien Envtl. Energy, Inc., 181 F.3d 527 (3d Cir. 1999).

The Asset Purchase Agreement

- Representations and warranties
- Contingencies
- Employee issues
- Operation of the assets pending closing

Free and Clear Sales Under Section 363(f) and Their Limits

- Section 363(f) permits a sale “free and clear” of any “interest” in such property by an entity, other than the estate, in the following circumstances:
 - (1) applicable non-bankruptcy law permits sale of such property free and clear of such interest;
 - (2) such entity consents;
 - (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on the property;
 - (4) such interest is in bona fide dispute; or
 - (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Free and Clear Sales Under Section 363(f) and Their Limits

Clear Channel Outdoor, Inc. v. DB Burbank, LLC, (In re PW LLC), 391 B.R. 25 (B.A.P 9th Cir. 2008)

- Clear Channel has generated a substantial amount of controversy by taking a very narrow view of the scope of the protections available to a buyer in connection with a “free and clear” sale and holding that § 363(f) does not permit the stripping of a junior lienholder’s interest in the debtor’s property where the sale price is less than the amount of all claims secured by the debtor’s property.

What is an interest?

- The term “interest” is not defined in the Bankruptcy Code even though the terms “claim” and “lien” are defined. See 11 U.S.C. §101(5) and 101(37).
- Under § 363(f)(3), a “lien” is included as a type of interest – so an interest is presumably something *more* than a “lien,” but does “interest in such property” also encompass “claims”?

What is an interest?

- A majority of courts have adopted a broad view of “interest in property” to include other obligations that stem from the ownership of property as opposed to being limited to traditional *in rem* interests. See, e.g., Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 545 (7th Cir. 2003) (the use of the term “any” before the term “interest” counsels for a broad interpretation of “interest”); In re Leckie Smokeless Coal Co., 99 F.3d 573, 581-82 (4th Cir. 1996); In re Trans World Airlines, Inc., 322 F.3d 288-89 (3d Cir. 2003).

■ A minority of courts have taken the narrow construction of “interest in such property” to mean only traditional *in rem* interests, which include, e.g., liens, mortgages, judgments, etc. These courts have concluded that claims that are simply *in personam* claims against a debtor, and therefore not tied to any specific property of the debtor, are not considered to be “interests in such property” which can be sold free and clear under § 363(f). See, e.g., In re White Motor Credit Corp., 75 B.R. 944 (Bankr. N.D. Ohio 1987); In re New England Fish Co., 19 B.R. 323, 326 (Bankr. W.D. Wash. 1982).

Successor Liability Under § 363(f) Sales

- Expansive interpretations of the phrase “interest in such property” has led some courts to consider whether future claims for successor liability constitute “interests in such property” that can be stripped away under a §363(f) sale.
- Some courts have found that a “free and clear” sale under §363(f) does not preclude future claims that arise after bankruptcy. See, e.g. In re Autostyle Plastics, Inc., 227 B.R. 797, 800 (Bankr. W.D. Mich. 1998); Ninth Avenue Remedial Group v. Allis-Chalmers Corp., 195 B.R. 716, 732 (N.D. Ind. 1996); In re Fairchild Aircraft Corp., 184 B.R. 910 (Bankr. W.D. Tex. 1995).

By contrast, many bankruptcy courts have also rejected the notion that successor liability claims can be imposed on a purchaser of assets pursuant to a §363(f) sale. See, e.g., In re White Motor Credit Corp., 75 B.R. 944, 948 (N.D. Ohio 1987); In re Leckie Smokeless Coal Company, 99 F.3d 573 (4th Cir. 1996); In re Transworld Airlines, Inc., 322 F.3d 283 (3d Cir. 2003); In re All American Ashburn, Inc., 56 BR 186, 190 (N.D. Ga. 1986); In re New England Fish Co., 19 BR 323, 328 (W.D. Wash. 1982).

Section 365 – Assignment of Executory Contracts and Unexpired Leases

- A contract is “executory” if obligations remain by both parties to the contract and where the failure of either party to perform under the contract would constitute a material breach excusing the performance of the other party. In re Teligent, Inc., 268 B.R. 723, 730 (Bankr. S.D.N.Y. 2001).
- Executory contracts can generally be assigned to the purchaser in a § 363 sale.
 - Anti-assignment clauses generally not enforceable.
 - Certain kinds of contracts cannot be assigned.

Contracts That Cannot Be Assigned

- Section 363 does not expand the property rights of the debtor more than as they exist under non-bankruptcy law which creates the property rights. Therefore, certain executory contracts cannot be sold or assigned without consent.
- These non-assignable contracts include, among others: (1) personal services contracts, (2) contracts for a loan or extension of debt financing or financial accommodations, to or for the benefit of the debtor and (3) certain trademark licenses and IP Contracts (such as non-exclusive copyright licenses and patent licenses without consent of the licensor, etc.) 11 U.S.C. §365(c).
- Additionally, an executory contract or unexpired lease can only be assigned in its entirety, including both benefits and burdens. Partial assignments are prohibited.

Due Diligence

- Once the bidding procedures are approved, competing bidders will have a fixed amount of time to complete diligence and submit bids.
 - Financing contingencies
 - Flexibility to modify the terms of the stalking horse bids
 - Bids for less than all of the assets
 - Timing
 - Good faith deposits
 - Closing conditions

The Auction Process

- Pre-qualification of bidders
- Time and place
- Open bidding vs. sealed bids vs. right of first refusal
- Credit bidding - §363(k)
- “Back-up bidders”

Credit Bidding Under Section 363(k)

- At a sale of the debtor's property, a secured lienholder may generally bid for the property and offset its claim against the purchase price, unless the court orders otherwise. 11 U.S.C. §363(k).
- The Third Circuit has recently held, however, that a secured lender does not have an absolute right to credit bid when its collateral is sold pursuant to a plan of reorganization under §1123(a)(5)(D) of the Bankruptcy Code, if such secured creditor is being provided with the “indubitable equivalent” of its secured interest in accordance with the cramdown provisions of §1129(b)(2)(A). In re Philadelphia Newspapers, LLC, et al. 599 F.3d 298 (3d Cir. 2010).

Legal Standard for Bankruptcy Court Approval

- There must be some specified business justification for the sale other than the appeasement of creditors or certain especially vocal groups. In re Lionel Corp., 722 F. 2d 1063 (2d Cir. 1983).
- The bankruptcy court will generally defer to a debtor's business judgment, but the ultimate business judgment rests with the judge.

- The factors to be considered when approving a sale include:
 - The proportionate value of the asset to the estate as whole;
 - The likelihood that a plan will be proposed and confirmed in the near future;
 - The effect of the proposed distribution on a future plan;
 - The proceeds to be obtained from the disposition as compared to any property appraisals;
 - Whether a use, sale or lease of the property is sought;
 - Whether the asset is increasing or decreasing in value (often the most important factor).

Legal Standard for Bankruptcy Court Approval

- When a bankruptcy court authorizes a sale of assets pursuant to section 363(b)(1), it is required to make a finding with respect to the "good faith" of the purchaser. In re Abbotts Dairies of PA, Inc., 788 F.2d 143 (3d Cir. 1986).
- Court should have some evidentiary basis for its finding, even if only a proffer.

Legal Standard for Bankruptcy Court Approval

- The requirement that a purchaser act in good faith ... speaks to the integrity of his conduct in the course of the sale proceedings. Typically, the misconduct that would destroy a purchaser's good faith status at a judicial sale involves “fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders.” In re Abbotts Dairies of PA, Inc., 788 F.2d 143 (3d Cir. 1986).
- 11 U.S.C. § 363(n) – Trustee may avoid a sale based on a finding of collusion; see also 18 U.S.C. §152

Sub Rosa Plans and the Chrysler Case

- The Bankruptcy Code contemplates reorganization of a debtor through the proposal and confirmation of a chapter 11 plan with its various procedural protections for creditors and equityholders, including disclosure, solicitation, voting and compliance with various confirmation requirements.
- Some courts have prohibited a proposed sale of assets under §363, however, if a sale of all of the debtor's assets is contemplated and the transactions involve not only (a) a sale of the debtor's property but also (b) the disposition and treatment of claims against the debtor's estate, thus allowing the debtor to sidestep the protections afforded by a chapter 11 plan. In re Brainiff Airways, Inc., 700 F.2d 935 (5th Cir. 1983).

Sub Rosa Plans and the Chrysler Case

Since Braniff, the sale of substantially all of a debtor's assets outside a plan of reorganization has grown increasingly common. See, e.g., In re Trans World Airlines, No. 01-00056, 2001 WL 1820326 (Bankr D. Del. Apr. 2, 2001); see also, In re Chrysler LLC, 405 B.R. 84 (Bankr. S.D.N.Y. 2009).

Liquidating chapter 11 cases are the norm, as reflected by the recent sales of Chrysler and GM.

Good Faith Protections and Section 363(m)

- If a purchase is in good faith, section 363(m) protects parties from the consequences of the reversal or modification of the authorization of a sale on appeal unless such authorization and the sale/lease were stayed pending appeal. 11 U.S.C. §363(m).
 - In cases involving egregious wrongs, relief may be available under Bankruptcy Rule 9024 which incorporates Fed. R. Civ. P. 60(b).
- Pursuant to Bankruptcy Rule 6004(h), any order authorizing the use, sale or lease of property (other than cash collateral) is stayed until 14 days after entry of such an order. Fed. R. Bankr. P. 6004(h).

Good Faith Protections and Section 363(m)

- Appeal of a sale order is not moot if the sale is not made to a good faith purchaser. In re RBB, Inc., 211 F.3d 475 (9th Cir. 2000).
- An unstayed sale order is reviewed on appeal only on the limited issue of whether the sale was made to a good faith purchaser. In re Gucci, 105 F.3d 837 (2d Cir. 1997).
- Waiver of automatic 14 day stay of the Sale order under Bankruptcy Rule 6004(b)

Transfer Taxes

- Section 1146(a) of the Bankruptcy Code provides “[t]he issuance, transfer, or exchange of a security, or the making or a delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax.” 11 U.S.C. § 1146(a).
- It was common practice for debtors to seek court orders allowing the sale of assets and prohibiting state and local governments from assessing transfer taxes in reliance of §1146(a) prior to the Supreme Court opinion in Picadilly.

■ In **Florida Dept. of Revenue v. Picadilly Cafeterias, Inc.**, the Supreme Court held that the exemption from transfer taxes contained in the §1146(a) does not apply to a sale that has not been confirmed pursuant to a plan of reorganization by the bankruptcy court. 128 S. Ct. 2326 (2008).

Post-Sale Strategies

- Liquidating Plans
- Conversion
- Dismissal
- “Structured Dismissals”