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Committees: Asset Sales

Section 363 vs. Out-of-Court Sales

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Over the past several years, financially distressed companies have increasingly used bankruptcy as the preferred method to sell significant assets or entire businesses. Section 363 of the Bankruptcy Code allows a chapter 11 debtor to sell assets outside the ordinary course of the debtor's business, clear of existing liens and claims, if the debtor demonstrates a good business reason for the sale. Depending on the facts and circumstances, however, a sale of distressed assets via an out-of-court transaction may be the best path forward. This article examines the pros and cons of a sale pursuant to § 363 of the Bankruptcy Code ("363 sales") versus an out-of-court transaction. This article is not meant to be an exhaustive outline of *all* of the pros and cons of these alternatives, but it is meant to provide a macro view of the major considerations required when acting as an advisor to an insolvent business or its creditors.



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When engaged as an advisor for an insolvent business seeking to sell its assets, the first question we have to ask ourselves is, "For what purpose are we doing this?" Every situation we encounter is different in its facts and circumstances, along with the numerous players involved — each having their own agendas and desired outcomes. When representing the company, once it has become insolvent, we need to act as an advocate with the fiduciary responsibility for all creditors (in order of priority), as well as the equityholders.

General criteria requiring consideration include:

- the ability to bind nonconsenting creditors;
- the fiduciary duties of the directors and officers of the insolvent enterprise;
- the fiduciary duties of management;
- the ability to auction the company and/or its assets;
- existing agreements, licenses, etc. with third parties that may require court approval for their transfer;
- the ability to sell assets free and clear of all liens and claims; and

the various constituencies of the company, which may include trade creditors, bondholders, tort claimants, creditors' committees (both secured and unsecured), lessors, secured and unsecured creditors individually, employees, governmental entities, the U.S. Trustee and the bankruptcy court.

General Overview of 363 Sales

In general, 363 sales proceed as follows:

Most 363 sales start with a stalking-horse purchaser, whose bid is a general template for other bids. A stalking horse is an interested buyer of a debtor's assets that is offered incentives for being the first to announce its intent to purchase the assets and set the baseline for subsequent bids, if any;

The debtor is typically required to shop for additional bids to participate in an auction to maximize value for creditors and bankruptcy estates; and

The 363 sale is approved by the bankruptcy court and is generally free and clear of liens, claims and interests.

Pros and Cons of a 363 Sale

363 sales offer a purchaser some advantages over out-of-court deals:

The biggest advantage of purchasing assets from a bankrupt debtor is the ability to buy assets of a debtor free and clear of liens, claims and interests that cannot be done outside of bankruptcy;

A secured creditor can credit bid the value of its debt.;

A sale order will be issued by the bankruptcy court, which is advantageous since once the sale order is final, it cannot be undone at a later time; and

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The Bankruptcy Code allows the buyer to choose which contracts and leases it does not want to take and which ones it wishes to have assumed and assigned to it by the debtor. The buyer does not have to take any contract it believes is above-market or contains onerous provisions, but it can assume any favorable contracts.

One of the primary disadvantages of a 363 sale is the compressed time frame typically allowed for these sales by the debtor's secured lenders, which limits the amount of time available to conduct due diligence on the assets being sold. Another disadvantage is the lack of exclusivity involved in the open auction process, along with having to deal with the multiple players in the process, including the DIP lenders, trustee, creditors' committee, and parties asserting liens on any of the assets being sold. Also, 363 sales are generally on an as-is, where-is basis, so there are no meaningful post-closing protections for the buyer.

Pros and Cons of Out-of-Court Sales

In some circumstances, conducting out-of-court distressed-asset sales may offer advantages over pursuing the 363 sale process. For instance:

Out-of-court transactions can avoid some of the costs, delays and public nature of a bankruptcy process;

Out-of-court sales are not bound by the § 363 notice and auction requirements;

There is no creditors' committee to contend with, or other parties that could seek to block the sale approval;

The seller and buyer can maintain control of the sale process and the timing of the sale, whereas in a bankruptcy, the creditors have a voice in the process, and the bankruptcy court has the final say on the process and the timing of the sale, and must approve the sale; and

In a bankruptcy proceeding, two-party negotiations between the buyer and seller may wind up being multiparty negotiations with secured and unsecured creditors.

On the other hand, out-of-court buyers face risks that buyers in bankruptcy do not: fraudulent conveyance and successor-liability risk. In an out-of-court sale, if the seller subsequently files for bankruptcy, the sale could be attacked, and ultimately voided, as a fraudulent conveyance, especially if the sale is for less than reasonably equivalent value or is viewed as a means of evading the debtor's creditors. Buyers in out-of-court sales face successor-liability risk, since they cannot always fully insulate themselves from potential liabilities — and, depending on the particularities of state law, the buyer may be liable for certain post-sale liabilities, such as product-liability, environmental and employment claims.

Summary

Acknowledging the various industry forecasts for potential downswings in, among others, the retail, restaurant and possibly automotive industries, fully comprehending the benefits of selling assets under § 363 of the Bankruptcy Code to maximize value is key. In the meantime, it is critical to evaluate the pros and cons of conducting out-of-court distressed-asset sales over pursuing the 363 sales process.

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