Asset Sales in Bankruptcy: The Financial Advisor's Perspective

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The authors review the practical aspects of Bankruptcy Code Section 363, governing sales of assets in bankruptcy.

Section 363 sales in bankruptcy, which are named for the Bankruptcy Code provision that governs them, have become a prominent and important feature in Chapter 11 over the last several years. Section 363 of the Code permits the bankruptcy trustee or, in most Chapter 11 cases, the company itself (called the "debtor in possession") to sell, lease or use property outside the company's ordinary course of business.

SELLING ASSETS "FREE AND CLEAR"

A Section 363 sale has characteristics that have no corollary outside of bankruptcy, notably that an asset can be sold "free and clear" of interests. This means that liens and other interests are stripped off the asset to be sold and attached to the proceeds of the sale. As an example, say a debtor wants to sell its inventory, in which the debtor's lender holds a security interest. Section 363 permits the security interest to be separated

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from the inventory. The buyer acquires the latter free of the bank's interest. The bank doesn't lose its lien, but instead of attaching to the inventory, the lien rights are in the proceeds, which remain within the debtor's bankruptcy estate.

Another big advantage of Section 363 sales is the protection afforded the buyer. Like the lienholder in the above example, claim holders can look only to the proceeds of the sale and the buyer is immunized from most successor liability claims. Moreover, because most Section 363 sales are finally approved by the bankruptcy court (some courts won't sign a sale order if no one complains) and the order will include findings that the sale is in the best interests of the bankruptcy estate and is a good faith transaction, the buyer is protected against attacks on the sale transaction itself.

(A disclaimer is in order here. Just about any property can be sold via a Section 363 sale, which forces us to talk in generalities. Specific types of assets may be governed by state or federal law in a way that diminishes to some degree the ability of the buyer to acquire the property "free and clear" of all interests.)

VARIOUS PARTIES' INTERESTS

It might seem as if Section 363 was designed to tilt heavily in favor of the buyer, but the seller, and the bankruptcy estate's creditors, also benefit from these sales. Most obviously, the property is likely to command a higher price if it can be sold without its liabilities. This creates a larger pool of cash that the debtor can distribute to creditors. A debtor might also make use of Section 363 early in its case to create needed cash flow or it might sell off property, such as a manufacturing line, that has proven to be unprofitable and a drain on the company's resources. Whatever the reason for the sale, the debtor's decisions are tempered by the fiduciary duty it owes to creditors, who must be made better off by virtue of the sale.

There is no "typical" Section 363 sale. The property subject to such a sale can range from a single car to an operating company. Trustees in consumer cases and large companies that are trying to reorganize make similar use of the Section 363 sale option. Whether the sale is small or large, simple or complex, the procedures for effectuating the sale are largely the same.

THE ADVISOR'S ROLE

However, the greater the complexity of the transaction, the more likely it is that financial advisors will play crucial roles for both seller and buyer. Financial advisors can be thought of generally as the business counterpart to the legal expertise the attorneys provide and can be valuable in moving the sale forward and ensuring that it's done right.

On the seller's side, one of the first tasks for the financial advisor is to market the asset. Usually, the financial advisor creates a package of vital information about the asset, along with information about how the sale will proceed and how a potential buyer should respond, and then finds a way to get packages into the hands of likely buyers. Some marketing avenues are obvious, while others require some creativity. Take a car, for example. An ordinary car of average value will be marketed differently than a vintage model and a fleet of Bentleys will not pique the interest of the same crowd as a Chevrolet dealership's inventory.

Once the package is sent to the target market, the financial advisor's job is to "work the room" as it were, figuring out who will have a genuine interest in bidding on the property. Ideally, the financial advisor will find among this smaller group of potential bidders one that will be the "stalking horse," which is to say someone interested enough to perform the necessary due diligence and work out terms of a sale.

The seller is almost always better off if a stalking horse bidder can be found because a good amount of uncertainty is eliminated. The sale terms negotiated between the seller and the stalking horse bidder will form the basis of the notice that will go out to all affected parties, which means that the notice itself will be more specific. In addition, the seller knows its worst case scenario; if no one makes a higher or better offer, the seller has a buyer and can move forward with the sale.

THE NEGOTIATIONS

Financial advisors often play a lead role in negotiations with stalking horse bidders, who are not only interested in buying the asset, but also in protecting themselves against subsequent bidders who often rely on the stalking horse's due diligence and negotiated sale terms (formed with the aid of their own financial advisors) to form their bids.

Part of the financial advisor's job, then, is to negotiate appropriate "break up" or "termination" fees, which give the stalking horse bidder some compensation for the work it has done in the event it is not the winning bidder. The goal here is to strike the appropriate balance between what the stalking horse bidder wants and what is in the best interest of the bankruptcy estate. Courts examine break up fees carefully and will disapprove those that are excessive or that will chill the bidding process.

(Another disclaimer: Just what a court will approve can vary by jurisdiction and different courts have their own preferences and pet peeves, not just with break up fees, but with many aspects of the sale. Know your jurisdiction!)

Another important aspect of the negotiations is over bid increments, to which the courts also give careful scrutiny. Again, the concern is the best interest of the bankruptcy estate and the courts will view with disfavor bid increments that discourage others from making their own offers for the property. Indeed, any fees or other terms that seem designed to ensure that the stalking horse is the winning bidder could jeopardize sale approval by the court.

If no stalking horse bidder is found, the financial advisor faces the task of finding out why. It could be that the property needs to be reevaluated and a different marketing strategy created. In some cases, the property will go to auction without a stalking horse.

With or without the stalking horse bidder, Section 363 requires that proper notice be given to all parties who may have an interest in the property or its sale, and anyone with an objection must be provided an opportunity to be heard. This requirement is the most important in effectuating the Section 363 sale and is the means by which the buyer is able to take the property free and clear.

THE NOTICE

The content of the notice may vary depending on the property, but there are certain aspects that are true in all cases, in which the notice

- Alerts those with an interest in the property of the sale and advises them of the effects of the sale;
- Informs parties how the sale will take place and what the terms are;
- Describes the property to be sold;
- Explains why the sale is in the best interest of the bankruptcy estate, including a discussion of the fair value of the property; and
- Includes all details that are pertinent to the purchaser, including that the sale is an arms-length transaction and is made in good faith.

The notice may trigger objections or, if there is a stalking horse, additional bids for the property. With respect to the latter, the financial advisor will evaluate the terms and assist with a determination of whether any subsequent offer is better than the stalking horse bid; just because a bid is for a higher dollar amount does not mean it is a better offer. The financial advisor may conclude, for example, that the higher offer has contingencies or less certain financing, which may have a negative effect on the estate.

To confirm a sale the bankruptcy court must find that there is a sound business purpose for the sale, the notice given is reasonable and accurate and the price paid is fair and reasonable.

Any number of objections to the sale may be raised. A party may, for example, assert its own right in the property. There might also be allegations that a bidder is not acting in good faith, that the sale is, in essence, a plan of reorganization disguised as a sale (called a "sub rosa plan"), that there is collusive bidding or that bidding devices, such as break up fees, are unreasonable or geared toward limiting alternative bidding.

Also, courts are unlikely to approve sales for a price that is less than the value of liens on the property. Although the attorneys take the lead on matters that go before the court, the financial advisor may be called to testify about the substance of the transaction, such as the good faith of the parties' negotiations or why the sale price represents the fair value of the property. The court may also require that the financial advisor testify about the scope and nature of the marketing of the assets.

In general, courts tend to defer to the seller's business judgment. Some circumstances will trigger closer judicial scrutiny, such as when the assets are being sold to a company insider. But these are exceptions to the general rule that provision of notice and an opportunity to be heard is the key to Section 363 sale approval.

THE AFTERMATH

Once the bankruptcy court approves a Section 363 sale, it is very difficult to mount any sort of legal challenge to the sale's terms. A party that wants to appeal must do so within ten days and must get a stay of the sale order pending appeal. Absent a stay, an appellate court will consider only the limited question of whether the sale is to a good faith purchaser. Even with a stay, there will likely be a heavy dose of deference to the bankruptcy court's findings.

In other words, a properly noticed and approved Section 363 sale is practically bulletproof, which, along with stripping off the liabilities, makes the advantages and appeal of Section 363 — and the need for the right professionals throughout the process — apparent.