Winners and losers:

They call Alabama the Crimson Tide, call me Deacon Blues*

David Conaway looks at the winners and losers of Section 363 sales

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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 reorganising or selling a financially distressed business. If a reorganisation is not possible, a sale of assets may create investment opportunities for strategic buyers, investment banks, and private equity to acquire assets at a discount.

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.

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, and assets can be sold without further erosion due to ongoing operating losses.
- The allocation of the proceeds of sale among competing interests occurs 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" and acquire assets at a discount.
- Buyers favor Section 363 sales, as good faith purchasers who are not subject to later challenge. Dissatisfied creditors who do not expressly consent to the transaction are bound by the sale.
- A Section 363 sale normally begins with a "stalking horse" asset purchaser whose asset purchase agreement contains the initial bid.
- A "Bankruptcy Court" auction is conducted where interested buyers are permitted to overbid the stalking horse bid, based on "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.

Secured lenders

- Secured lenders interest in a Section 363 sale arises from a lien on the debtor's assets to secure loans made to the debtor. Section 363 can be an

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efficient tool to liquidate collateral.
- Chapter 11 sales can create additional costs for lenders, in addition to the transactional costs associated with the sale.
- 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. 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, which are often considered "executory contracts".
- The Bankruptcy Code provides debtors the 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. The debtor also has the right to assume and assign a contract, which requires that "cure" of existing defaults.
- Section 363 sale buyers often determine which contracts are assumed or rejected by the debtor, and assigned to the buyer.
- An asset purchase agreement normally includes in the purchase price the cure amounts for contracts assumed and assigned to the buyer.
- 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, whose goal is payment of its secured debt, while other creditors seek a sale 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.
- Section 363 sales may be "short sales" where the proceeds of sale do not cover the secured debt, much less provide a dividend for unsecured creditors.
- Bankruptcy Courts have required secured lenders to pay certain administrative claims associated with the Chapter proceeding, euphemistically referred to as the "pay to play" rule.
- 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. 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.
- Unsecured creditors may also be "critical vendors" who provide goods or services essential to a debtor's ability to continue operating. An asset purchaser may insist that the vendor be paid.
- Unsecured creditors may face preference claims for the return of payments within ninety (90) days prior to the bankruptcy filing. Post-sale, a key remaining asset is "avoidance actions" including preference claims.
- 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 and re-distributed equitably to all creditors. Actually, there is little correlation between the amount paid back into the estate and the amount actually distributed to creditors, after administrative costs. Unsecured creditors can often negotiate an effective waiver of preference claims, as part of the 363 sale, as asset purchasers do not favor residual litigation against their ongoing suppliers.

Shareholders

- 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 able to liquidate 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. However, aggressive creditors can improve the 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. ■

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

> **SECTION 363 SALES ARE A POWERFUL TOOL FOR CHAPTER 11 DEBTORS TO EFFICIENTLY SELL SUBSTANTIALLY ALL OF THEIR ASSETS**