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FAQs – Bankruptcy Asset Sales: A Primer

Introduction

Chapter 11 bankruptcy filings are up 12 percent year over year from 2019, largely due to the COVID-19 crisis. Many companies are filing expressly in order to sell their assets, while others are dual-tracking standalone reorganizations with sale processes. Bankruptcy sales offer significant opportunities and advantages to strategic and financial buyers that are open to acquiring distressed assets. This high-level overview answers key questions about the bankruptcy sale process. For further information, please feel free to contact Hugh M. McDonald (hugh.mcdonald@troutman.com), Deborah Kovsky-Apap (kovskyd@pepperlaw.com), and Andrew L. Buck (andrew.buck@troutman.com).

Can assets be sold in a bankruptcy proceeding outside of a plan of reorganization?

Yes. Section 363 of the Bankruptcy Code allows a debtor to sell some or all of its assets free and clear of all interests in the assets (with those interests instead attaching to the sale proceeds) without confirming a Chapter 11 plan (363 Sales). 363 Sales typically take place at the outset of a bankruptcy case, so a buyer does not need to wait through the lengthy plan process in order to acquire a debtor's assets.

What are the benefits to a 363 Sale?

A 363 Sale allows a debtor to sell all or a portion of its assets free and clear of liens, claims and interests, generally including successor liability claims. Among other things, a purchaser at a 363 Sale benefits from the ability to "cherry pick" favorable contracts and leases to be included in the sale, exclusions from state laws regarding bulk sales and shareholder approval, a shorter waiting period under federal antitrust laws, and protection from fraudulent transfer claims and subsequent challenges to the reasonableness of the sale.

Are there any drawbacks to a 363 Sale?

It depends on the transaction. The bankruptcy itself may result in negative publicity for the target business, as well as increased costs and time due to the court approval process. The auction process and court involvement may result in a higher price for the assets than what might be achieved in an out-of-court sale or in losing the assets to a higher and better bid.

What does the 363 Sale process look like?

Companies can begin the 363 Sale process even before the bankruptcy filing, and will often hire professionals such as financial advisers, investment bankers and bankruptcy counsel to assist with identifying and negotiating with potential purchasers with the goal of identifying a "Stalking Horse" bidder willing to enter into a purchase and sale agreement prior to or soon after a bankruptcy case is filed. In the current financial crisis, many debtors may be forced to file more precipitously than they otherwise might have done, often without a Stalking Horse bidder in place. Others may file with their pre-petition secured lenders credit bidding their debt to serve as the Stalking Horse.

Once the bankruptcy case has been commenced, the 363 Sale process will usually begin with the debtor filing a motion seeking the bankruptcy court's approval to sell assets at an auction and establishing procedures related to bidding and the auction process. Qualified prospective bidders are given access to diligence materials, usually through an electronic data room, for a specified period. The due diligence period in bankruptcy is rarely more than four to six weeks, and often is shorter.

If more than one qualified bid is received by the bid deadline, the debtor will hold an auction. The debtor has wide latitude to run the auction in any way it wishes, consistent with its duty to maximize value for the estate. The debtor then determines what it believes is the highest and best offer for its assets, which may be a single bid or a combination of bids. The winning bid(s) are still subject to court approval.

Is there always an auction?

It depends. If the sale process was run before the bankruptcy, the post-filing sale process can be truncated, with the winning bid presented to the court for approval, subject to any higher or better offers. A similar result can be obtained after the filing, but usually will have some competitive bidding involved. Auction and bidding procedures will vary from case to case, but will typically involve a means for identifying potential bidders and giving them access to due diligence materials for a brief period of time. If only one qualified bidder comes forward by the bid deadline, the auction will be cancelled and that bid will be presented to the court for approval.

How long does the sale process take?

Notice of the sale generally must be mailed at least 21 days before the sale to all creditors and other parties in interest in the bankruptcy case, though this period may be shortened if the debtor can show the court that a compressed time frame is necessary.

What is the purpose of a "Stalking Horse" in the bankruptcy sale process, and what are the pros and cons of serving as one?

A Stalking Horse bid effectively sets the "floor" for the sale of the debtor's assets, as well as signaling to other potential purchasers (and creditors and constituents) that a debtor's assets have value. The Stalking Horse bidder is usually required to put down an earnest money deposit (10 percent is standard), which is returned if the debtor consummates a transaction with another party.

At the same time a prospective debtor is negotiating with potential Stalking Horse bidders, it is often also seeking to secure post-petition financing to fund the costs of the bankruptcy case and operations. Thus, it is not uncommon for a Stalking Horse bidder to be the source of the debtor's post-petition financing in a "loan-to-own" transaction.

In exchange for agreeing to set the floor of the auction, a Stalking Horse receives important advantages in a bankruptcy sale, including the ability to negotiate the terms of the proposed bid procedures, order and bid protections (such as a break-up fee, expense reimbursement and minimum over-bid), a customary no-shop period until entry of the bid procedures order, and (often) a head start in discussions with important customers and vendors. A Stalking Horse will usually insist on deadlines for the approval process in the bankruptcy court and has leverage to push for a compressed auction timeline, giving it an edge over potential competing bidders.

There are also potential disadvantages to serving as a Stalking Horse bidder. While the debtor's obligations under the Stalking Horse agreement will always be subject to bankruptcy court approval, the Stalking Horse is bound upon execution. The Stalking Horse agreement is publicly disclosed, even if the Stalking Horse is not ultimately the prevailing purchaser. Depending on the level of diligence required, the break-up fee and expense reimbursement may not fully compensate the Stalking Horse for the lost opportunity if it is outbid.

The COVID-19 crisis adds an additional risk: As their conditions have deteriorated, some debtors have asked the courts, in effect, to mothball their cases — suspending virtually all deadlines, payments and other activities — for weeks or months. If that occurs, it could be problematic if time is of the essence for the Stalking Horse. It also means that the earnest money deposit could be tied up for much longer than expected.

What are the key features of a bankruptcy purchase agreement?

A bankruptcy purchase agreement differs from an out-of-court agreement in a number of key ways. Both the Stalking Horse agreement (if any) and the prevailing bidder's agreement (if different) are almost always made public, including the financial terms. Additionally, a bankruptcy purchase agreement typically contains far fewer representations, warranties and indemnifications from a debtor, and the acquirer generally cannot rely on much protection from these provisions since the debtor usually winds up through a liquidating plan of reorganization promptly after the sale and ceases to exist. For the same reason, while many bankruptcy purchase agreements include a working capital adjustment, the post-closing true-up period is often truncated.

May a debtor's contracts and leases be included in a 363 Sale?

Yes. As part of the 363 Sale process, the debtor may generally assume and assign to a purchaser any contract or lease the purchaser desires. To assume and assign a contract or lease, the debtor must cure all past defaults (including all monetary defaults), and the purchaser must provide adequate assurance that the purchaser will be able to perform under the contract or lease going forward. As a practical matter, the purchaser must include in its purchase price sufficient proceeds to cure all monetary defaults for assumed contracts and leases.

In addition, anti-assignment provisions in a contract or lease generally are unenforceable in a bankruptcy case. However, there is a limited exception for certain types of contracts where state or other nonbankruptcy law requires consent of the nondebtor party to the contract. Examples can include personal service contracts, nonexclusive IP licenses, and certain rights under partnership and LLC agreements. If the purchaser wishes to take assignment of those contracts, it must first obtain the consent of the counterparty. Contracts and leases the purchaser does not desire may be rejected by the debtor and become an unsecured claim of the bankruptcy estate, with no liability passing to the purchaser.

How does a 363 Sale address latent defects?

As with an asset acquisition outside of bankruptcy, a purchaser at a 363 Sale will need to deal with the potential for latent defects and other liabilities. Due diligence is necessary to identify issues prior to closing. Often, bankruptcy sales are viewed as final. Thus, absent a reserve or indemnity, recourse back to the estate may not be possible for any defects or liabilities that are discovered post-closing.

How does a 363 Sale address successor liability?

Successor liability for certain liabilities is possible in certain limited instances, such as environmental contamination, product liability and ERISA-related claims. The potential purchaser should be careful to ensure that the order approving the 363 Sale clearly addresses the liabilities of which the assets are being sold free and clear and that all parties with potential claims related to the assets have been given notice of the proposed sale so that they will be bound by the sale order.