Top 10 Questions About Bankruptcy Sales – A Primer on Sales Under Section 363 of the Bankruptcy Code

What do I need to know?

A bankruptcy sale is an opportunity to potentially acquire assets at distressed pricing. A bankruptcy sale also presents prospective bidders with a level playing field to conduct due diligence, submit a bid, and compete directly against all other bidders at an auction. Bankruptcy sales have other positive attributes, including the ability to purchase assets free and clear of liens and finality through court approval of the transaction. There are, however, certain limitations. Assets are sold "as-is, where-is," a debtor-seller will provide only limited representations and warranties, no post-closing indemnification or other recourse, and the timeline is expedited as compared to typical non-distressed M&A situations. Further, a potential buyer in a bankruptcy sale must be able to bid without due diligence and financing contingencies. A savvy strategic or financial bidder will balance these pros and cons to source highly accretive acquisitions.

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Question 1

What is a bankruptcy sale under Section 363 of the Bankruptcy Code?

- Section 363 of the Bankruptcy Code authorizes a debtor, after notice and a hearing, to sell the debtor's property outside of the ordinary course of business ("Section 363 Sale").
- A Section 363 Sale is usually a public process, governed by specific bidding procedures and run by an investment banker, that culminates in an auction. Once a winning bid is selected after the auction, the debtor seeks bankruptcy court approval of the sale transaction. A debtor has discretion, consistent with its business judgment, to select the highest or otherwise best bid as the winning bid, and unless it agrees otherwise, the debtor can typically under the bid procedures change its position based upon its fiduciary duties until a sale is approved by the bankruptcy court.
- A private Section 363 Sale is less common but is permitted where the assets are de minimis in value or the facts and circumstances do not warrant a robust sale process (a debtor will need to demonstrate with evidence that a public process is not reasonably likely to generate more value).
- A Section 363 Sale can be (a) a sale of all or substantially all of the debtor's assets (in bulk or in lots) or (b) the sale of an entire business (*i.e.*, a sale of equity).

Question 2

How does a Section 363 sale generally work?

- **Pre-Bankruptcy.** A soon-to-be debtor ordinarily commences a marketing and sale process prior to filing bankruptcy. This pre-filing process involves two workstreams.
  - **First**, the debtor seeks a "stalking horse" bidder who will sign a purchase agreement with the debtor before the debtor files bankruptcy. A stalking horse provides the debtor with transaction certainty and sets a bid structure, contract terms, and baseline price that other bidders must match. In return, the debtor provides the stalking horse with "bid protections" in the form of a break-up fee and expense reimbursement. Additional stalking horse bidder specifics are found below.
  - **Second**, regardless of whether a debtor secures a stalking horse bidder, the debtor often conducts a pre-filing sale process to help minimize the length of time necessary to run the Section 363 Sale process during the debtor's bankruptcy case.
- **Post-Filing.** Once the debtor has filed bankruptcy, the debtor files a motion to approve bidding procedures. Bidding procedures establish the process, procedures, and deadlines for the bidding, sale, and auction process, and include, for example: (i) the required components of a qualified bid, (ii) preliminary and final bid deadlines, (iii) procedures for the treatment of executory contracts, and (iv) the dates of the auction and the hearing to approve a sale to the winning bidder. In addition, if a stalking horse bidder is not selected pre-filing, a stalking horse bidder may be selected prior to the bid deadline. A bidder who wants to participate in the auction must comply with the qualified bid requirements set forth in the bidding procedures. Typically, the debtor's secured creditor is deemed to be a qualified bidder, with the right to credit bid its secured debt (subject to any challenge rights).
- **Approval Process.** Two different bankruptcy court approvals are required during a Section 363 Sale process.
  - **First**, the bankruptcy court will typically hold a hearing at least 21 days after the motion seeking approval of bidding procedures is filed to approve the bidding procedures. At this hearing, the debtor must submit evidence to establish that the bidding procedures are appropriately tailored to maximize the value of the debtor's assets.
  - **Second**, the bankruptcy court will hold a hearing at the conclusion of the marketing, sale, and auction process to approve the sale to the winning bidder. At this hearing, the debtor must submit evidence to establish that the winning bidder submitted the highest or otherwise best bid and the process was conducted in good faith and at arm's length. If a secured creditor is the winning bidder, the bankruptcy court will also consider the secured creditor's right to credit bid.
- **Timeline.** The timeline for a Section 363 Sale process can vary dramatically. How long it takes to maximize value is principally driven by (i) the size and complexity of the assets or business being sold, (ii) whether and how long the pre-filing process was, and (iii) how much liquidity the debtor has to run a longer process while in bankruptcy. Annexed hereto is an illustrative timeline for reference.

- **Good Faith Purchaser Protection.** Section 363(m) of the Bankruptcy Code protects a purchaser from the effects of a reversal or modification of a Section 363 Sale if appealed *so long as* the bankruptcy court makes adequate findings that the purchaser acted in good faith and the appellant failed to obtain a stay of the sale. This is an important protection — if the mere existence of an appeal (which can be a long and drawn-out process) prevented a debtor-seller and buyer from closing a transaction, only a fraction of Section 363 Sale transactions would occur.

Question 3

What are the benefits of purchasing assets through a Section 363 Sale?

- **Free and Clear Order.** Most importantly, assets sold through a Section 363 Sale are sold free and clear of any liens, claims, interests, and encumbrances, including successor liability. The free and clear nature of the sale is an explicit finding in the bankruptcy court order approving the sale, which also includes other findings such as the consideration paid was fair and reasonable and all parties acted in good faith and free of any collusion. The bankruptcy court order provides finality and helps fend off any post-closing challenges. The existence of a court order favorably distinguishes a Section 363 Sale from any distressed out-of-court M&A transaction.
- **Asset Selection.** A bidder is entitled to cherry-pick whichever assets it would like to purchase. Self-selection of assets provides a bidder with far more latitude than they would otherwise have outside of a Section 363 Sale process.
- **Contract or Lease Selection.** A Section 363 Sale process provides a bidder with the ability to select favorable contracts, licenses, leases, or other agreements that will be "assumed" by the debtor and "assigned" to the bidder as part of its bid. The Bankruptcy Code also provides that anti-assignment clauses embedded in such contracts, licenses, leases, or other agreements are generally unenforceable, with certain exceptions (e.g., personal services contracts, financial accommodations, and contracts that are not assignable as a matter of the governing state or federal law). On the other hand, unfavorable contracts, licenses, leases, or other agreements can be "rejected" by the debtor, with liabilities associated with those contracts, licenses, and other agreements not assumed by the bidder with purchased assets.
- **Streamlined Process.** The debtor-seller does not need to obtain shareholder approval to sell all or substantially of its assets, the filing of the motion and bankruptcy court approval of the sale is all that is necessary.

Question 4

What are the downsides of purchasing assets through a Section 363 Sale?

- **Asset and Contract / Lease Limitations.** A winning bidder in a Section 363 Sale will almost always be required to purchase assets on an "as-is, where-is" basis with limited representations or warranties and no post-closing indemnification or other recourse against a debtor. Because of these limitations, a bidder must perform all necessary due diligence on the assets and contracts, leases, licenses, or other agreements prior to submitting a bid. This includes, determining the cost of "curing" any monetary default (*i.e.*, money owned) and non-monetary defaults in connection with any contract, lease, license, or other agreement to be assumed by the debtor and assigned to the purchaser as part of the transaction.
- **Transition Services.** In a typical Section 363 Sale, the debtor will liquidate shortly after the sale closes and will not be able to provide typical tail services to the buyer. It is not unusual for transition services to be unavailable entirely, or if available, to be limited to a thirty (30) day period. If transition services are required, the bid may need to include funding for the debtor post-closing to permit continued operations during the transition period.
- **Condensed Timeframe.** It is not uncommon for the bidding procedures to provide a finite period of time (oftentimes between 30-60 days) to perform all due diligence before the bid deadline. This timeline is tight for many institutional bidders and requires active deployment of resources and coordination throughout the process. The amount of legal and financial due diligence available to potential bidders in a Section 363 Sale is also generally limited to what the debtor's professionals have prepared, which may be less than a bidder receives in a non-distressed M&A transaction.
- **Publicity.** A Section 363 Sale process is typically a public process, thereby inviting many interested parties to perform due diligence and potentially bid. A bidder has to be comfortable that its identity may become public as a result of the process, either because it is

publicly named as the winning bidder or because the debtor's conflict disclosures through the bankruptcy process require all interested parties to be publicly disclosed.

- **Competition.** Apart from the competitive nature of a public marketing and sale process, an existing lender who has a lien on the assets to-be-sold has the right to "credit bid" its debt in lieu of cash as part of a Section 363 Sale, subject to a challenge for cause. The right to credit bid can be "chilling" to the process because bidders do not believe that the assets are worth more than the debt, and as a result, the lender's right to credit bid its full debt is viewed as providing the bid floor. This may discourage a third-party buyer who would be required to pay cash for the debtor's assets or business.

Question 5

What tactical considerations must a potential bidder be aware of?

- **Cost vs. Benefit Analysis.** A potential bidder needs to quickly determine whether the cost of hiring counsel and engaging in due diligence is potentially worth the benefit of purchasing the target assets or business. Sometimes this is a non-factor, especially for a strategic bidder vs. a financial bidder. The most efficient way to gauge the costs and benefits of participation is to execute a non-disclosure agreement with the debtor, get access to the data room of financial and legal due diligence available to all interested bidders, and to perform a targeted review focused on financial information to determine the potential return on investment. Note, however, typically non-disclosure agreements will prohibit the potential bidder from using the confidential information for any purpose other than, or even talking to any other person about, the potential transaction unless carve-outs are negotiated or consent is provided. In addition, competitors may be subject to disclosure of information being filtered through a clean room process, attorneys' eyes only limitations, or other conditions.
- **Scope of a Qualified Bid.** The bidding procedures will include a lengthy list of items that must be submitted and affirmative statements required for a bid to be considered a "qualified bid." Usually, only those bidders that have submitted a qualified bid will be entitled to attend the auction.
  - A representative list of the items to be submitted may include: (i) a purchase agreement signed by the bidder, together with schedules and exhibits, that is irrevocable until a transaction is consummated; (ii) a refundable good faith deposit usually equal to a percentage (5% to 10%) of the purchase price; (iii) proof of the bidder's financial ability to perform, including redacted bank statements, fully-executed third-party financial commitments, or other financial information or credit-quality support information; (iv) authorization or approval from the bidder's board or comparable body with respect to the bid; and (v) identification of all contracts or leases to be assumed by the debtor and assigned to the bidder as part of the transaction.
  - A representative list of affirmative statements that must be made in connection with a bid may include confirmation that: (i) the bid is not conditioned on obtaining financing or internal approvals; (ii) the bidder has conducted all necessary due diligence and the bid is not conditioned upon any additional or further review of due diligence; (iii) the bidder will serve as the "back-up bidder" if their bid is not selected as the winning bid; and (iv) the bidder did not engage in any collusive conduct and acted in good faith in submitting its bid.

Question 6

Should I serve as the stalking horse bidder?

- A debtor almost always favors a stalking horse led process as compared to running a naked sale process. In the absence of a third-party stalking horse, a debtor's existing lender will often step in as a stalking horse to provide the debtor with a credit bid floor and transaction certainty.
- There are several advantages and other considerations when a party is considering whether to be a stalking horse bidder, including:
  - **Bid Protections.** A stalking horse bidder agrees to subject its stalking horse bid to a competitive bidding process. To compensate the stalking horse for the risk that they are eventually outbid, a debtor agrees to pay the stalking horse a break-up fee, calculated as a percentage (typically between 3%to 5% of the purchase price) of the stalking horse bid and an expense reimbursement for legal fees expended (up to a cap) to prepare the stalking horse bid. These expenses are usually afforded administrative expense status (and made senior to the secured creditor's liens), meaning that they must be paid in cash in full before the debtor can exit bankruptcy. The stalking horse bidder also typically

has some discretion over the terms of the bidding procedures, including the minimum overbid amount and other aspects of the auction process.

- **Due Diligence Period.** If the debtor engages in a pre-filing process to source a stalking horse, those parties vying for the stalking horse role often have more time to conduct due diligence and to favorably structure the terms of their stalking horse bid. If a stalking horse is sought post-filing, the process is naturally more condensed.
- **Baseline Bid.** The stalking horse bidder provides the debtor with transaction certainty and its bid structure, contract terms, and bid price must be matched or improved by all other bidders. If time permits, the stalking horse bidder is in the best position to determine the structure of the deal, including the universe of purchased assets and excluded assets. Subsequent bidders will likely be required to bid against the transaction structure established by stalking horse bidder.
- **Consensus Building.** Early involvement by the stalking horse provides them with a first-mover advantage and opportunity to develop consensus with the debtor's management team and other key constituencies in the case, including, in some instances, the debtor's secured and unsecured creditors. Such involvement could streamline the bid process, especially if certain of those constituencies have consent or consultation rights under the bidding procedures.
- **Regulatory Hurdles.** Early involvement in the process provides a stalking horse bidder with additional time to develop a gameplan for securing necessary regulatory approvals.

Question 7

What are the disadvantages to serving as a stalking horse bidder?

- There are several disadvantages and other considerations when a party is considering whether to be a stalking horse bidder, including:
  - **Binding Offer.** The stalking horse bidder will execute a binding purchase agreement with the debtor, which is typically approved by the bankruptcy court. The stalking horse is bound to consummate the transaction unless another bidder "tops" the stalking horse bid with a higher or otherwise better bid.
  - **Risk of Overbidding.** The stalking horse bidder sets the minimum purchase price. If no qualified bids are received, the stalking horse is bound to consummate the sale transaction in accordance with its bid.
  - **Court Approval of Bid Protections.** The bankruptcy court must approve the bid protections provided to a stalking horse bidder. In many bankruptcy courts, including in Delaware, break-up fees are capped at no greater than 3% of the cash purchase price of a bid. A higher break-up fee is possible, but it will be determined on a case-by-case basis depending on the facts and circumstances of the case. The quantum of an expense reimbursement will also be subject to scrutiny, not just by the bankruptcy court but also from key constituencies like a creditors' committee or secured creditors.
  - **Competitive Dynamic.** Ultimately, the debtor will decide (sometimes after consultation with its secured creditors or the unsecured creditors' committee) which bid is the highest and best or winning bid. A stalking horse, or any bidder for that matter, may disagree with the debtor's rationale for determining that one bid is superior to another, but the debtor has a significant degree of discretion in making its determination. This creates a competitive dynamic where bidders are pitted against each other and could result in litigation in the bankruptcy case over the structure, price, or certainty of closing on different bids.

Question 8

What does it mean to buy assets "free and clear"?

- **Section 363(f) of the Bankruptcy Code.** This provision of the Bankruptcy Code entitles a debtor to sell "free and clear" of any "interest" in the property being sold, assuming at least one of five conditions is met. These conditions are:
  - Applicable non-bankruptcy law permits the sale of such property free and clear of such interests
  - The lienholder consents
  - The interest is a lien and the price the asset is to be sold at is greater than the aggregate value of all liens on the asset
  - The interest is in bona fide dispute
  - The seller could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest
- **Practical Implication.** The term "interest" as used in section 363(f) of the Bankruptcy Code is not defined in the Bankruptcy Code and can be subject to interpretation and litigation, but one clear meaning of "interest" is a "lien." Therefore, assets sold "free and clear" are sold free and clear of any liens attached to the assets. The ability to sell "free and clear" through a bankruptcy process, with a bankruptcy court order affirming the sale "free and clear," is incredibly valuable to a buyer because clean title is passed, which often enhances the value of the assets being sold.
- **Satisfying One of the Conditions in Section 363(f).** The most common condition that is satisfied to trigger a "free and clear" sale is when a lienholder consents to the release of its lien as part of the sale. If a lienholder agrees to such treatment, it usually does so on the condition that its lien attaches to the proceeds of the sale. The other conditions are often the subject of litigation but can be utilized by a debtor-seller when available.

Question 9

How are contracts and leases treated through a Section 363 Sale?

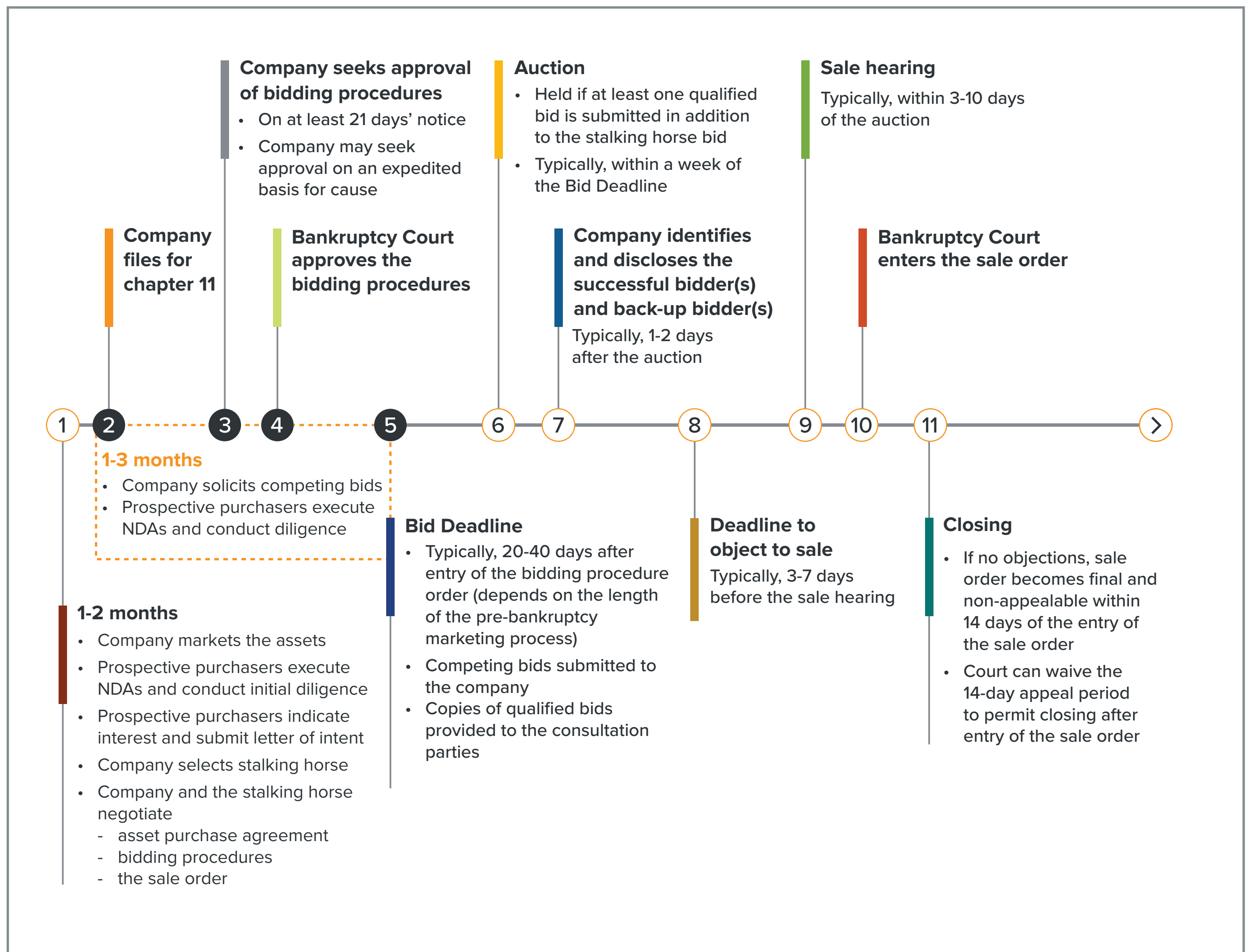
- **Section 365 of the Bankruptcy Code — "Rejection" vs. "Assumption" vs. "Assumption and Assignment."** A buyer in a Section 363 Sale has wide latitude to determine whether to assume the debtor's contracts, licenses, leases, or other agreements. Section 365 of the Bankruptcy Code provides a debtor with three options with respect to "executory" contracts or unexpired leases — "rejection" (material breach as of the petition date), "assumption" (the debtor agrees to continue performance), and "assumption and assignment" (the debtor assumes the contract and assigns it to a third-party who is obligated to continue performance). As noted above, the Bankruptcy Code also provides that, with certain exceptions (notably in the intellectual property license context), anti-assignment clauses embedded in a contract, license, or other agreement are generally unenforceable.
- **What is an Executory Contract?** An executory contract is a contract where both parties to the contract have material unperformed obligations remaining. An "executory" contract is a generic term and can mean any type of contract, license, or other agreement between the debtor and a third-party. It is often clear from a review of the agreement that there remain material unperformed obligations, but oftentimes it is less clear. Whether a contract is executory or not can be a source of litigation in a bankruptcy case.
- **Cure All Defaults.** If a buyer wants a debtor to assume and assign an executory contract or unexpired lease, the buyer must "cure" all defaults consistent with section 365 of the Bankruptcy Code. The "cure" requirement does not apply to a breach of the executory contract or unexpired lease based on the insolvency or financial condition of the debtor — that is an *ipso facto* provision and is unenforceable under the Bankruptcy Code. The "cure" requirement, however, applies to any monetary and non-monetary default.

Question 10

Other considerations to be aware of or addressed?

- **Governmental Approvals.** A Section 363 Sale transaction involving a foreign purchaser may be subject to regulatory review by the Committee on Foreign Investment in the United States (CFIUS). To the extent that a Section 363 Sale transaction qualifies for review consistent with the thresholds under the Hart-Scott-Rodino Act (HSR), governmental review and approval consistent with HSR will also be required.
- **Regulatory Approvals.** When buying assets in a regulated industry, regardless of whether the potential purchaser is the stalking horse bidder or a third-party, ordinary regulatory approvals will still be required. In certain instances, where parties want to close a sale prior to obtaining such approvals, the debtor and the winning bidder will often enter into a transition services agreement.
- **Litigation Risks.** A Section 363 Sale of assets "free and clear" may not release a buyer from certain mass tort liabilities, products liabilities, intellectual property infringement liabilities, environmental liabilities, and labor liabilities. A potential bidder must perform appropriate due diligence to identify whether these liabilities exist and thereafter work with legal counsel to determine whether any of these liabilities may attach to the assets or a business purchased in a Section 363 Sale.

Illustrative Section 363 Sale Timeline



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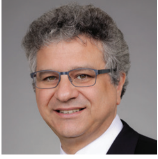

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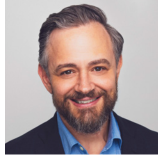

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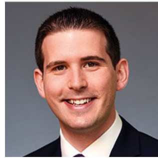

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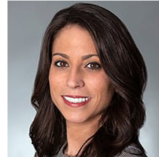

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