Buy it Cheap, Buy it Right - Purchasing Assets out of Bankruptcy

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Introduction

Who doesn't like a bargain? Let's say that one of your competitors has filed for bankruptcy and approaches you about selling its assets to you. Why would you want to buy the tainted assets of a bankrupt? First, the price might be cheap relative to intrinsic value, especially if the assets have going-concern value. Second, the bankruptcy might be moving so quickly that other buyers won't be able to react with competitive bids. Third, even if another buyer outbids you, you might be able to recover your expenses and a fee for your trouble. Fourth, buyers often know what steps need to be taken to turn a troubled business around. Fifth, the bankruptcy court can protect a buyer from most creditor claims (in fact, some buyers insist upon a bankruptcy process when buying assets to insulate the purchase from creditor attack). Sixth, bankruptcy sales, even of large companies, are now common enough that the sale process has become relatively standardized, thereby reducing cost, time and uncertainty. If it sounds intriguing to you, join the crowd.

As more large companies are filing Chapter 11, more of them are electing to sell everything rather than reorganizing, and more buyers are taking advantage of the opportunity to buy. In fact, purchasing the assets of a distressed company in bankruptcy has become an attractive alternative to traditional merger and acquisition activity. Why? The reason is simple. Buyers are recognizing the advantages of buying assets out of bankruptcy.

This article will discuss the procedures used to purchase the assets of a bankrupt entity, the issues that may arise during and after the purchase, and the various protections provided to buyers.

Procedures for Purchasing the Assets of a Bankrupt Entity

Assets may be sold or transferred by the debtor at any time during the course of the Chapter 11 case under Section 363 of the Bankruptcy Code or at the conclusion of the case by the terms of a plan of reorganization confirmed by the Court under Section 1129 of the Bankruptcy Code.

11 U.S.C. § 363(b)(1). Section 363(b)(1) of the Bankruptcy Code governs the sale of assets outside of the ordinary course of business.[1] Pursuant to Section 363, the debtor's assets may be sold at any time after the commencement of the bankruptcy case by the trustee or the debtor-in-possession after notice and a hearing. Such a sale is usually outside of any Chapter 11 plan, and may take place as soon as the first 30 to 90 days after filing of the bankruptcy petition.[2] Since the goal of any Chapter 11 case is to maximize the value of the estate and achieve the highest return for the estate's creditors, the bankruptcy court will approve a sale prior to confirmation of a plan of reorganization only when the sale is in the bankruptcy estate's best interest.[3] Some factors used to determine whether a sale of assets under Section 363 is in the estate's best interest include[4]:

the proportionate value of the asset to the estate as a whole;
the amount of elapsed time since the filing of the bankruptcy petition;
the likelihood that a plan of reorganization will be proposed and confirmed in the near future;
the effect of the proposed disposition on future plans of reorganization;
the proceeds to be obtained from the sale in relation to any appraisals of the property;
whether the asset is increasing or decreasing in value.

Additionally, many bankruptcy courts will approve the sale if it is supported by an articulated business justification, or the debtor's sound business judgment.[5]

Generally, the procedure for a Section 363 sale begins with the court's approval of a sale procedures order. This order includes information regarding the form of notice of the sale, the entities that will be notified of the sale, whether the sale is subject to a higher bid, the identity of the proposed purchaser, the type of proposed sale (e.g., the sale of substantially all the debtor's assets or only certain assets), and the terms of the sale (e.g., whether the assets are being sold free and clear of liens). The sale procedures order will specify how other bidders may gather information on the assets to be sold, and how any auction for the assets will be conducted. Once a final offer is accepted by the trustee or the debtor-in-possession and the buyer tenders Purchase Agreement, a sale order is submitted to the court for its approval.

If you are a buyer, the sale procedures order is almost as important as the eventual order approving the sale itself. Without an appropriate sale procedures order, the buyer is at risk that due diligence by other parties, or that the bidding, will drag on. In addition, the sale procedures order should require that other bidders demonstrate their financial ability to consummate a purchase. The process for receiving overbids and the amount of overbids will be established. Most importantly, the sale procedures order should approve an expense reimbursement and break-up fee to protect the original bidder in case another party wins the auction.[6]

Plan of Reorganization. Section 1123 of the Bankruptcy Code provides an alternative means to acquire assets of the debtor pursuant to a Chapter 11 plan.[7] The plan may provide for the sale of only a few assets or the sale of all the debtor's property to one or more entities. A sale pursuant to a plan of reorganization is often more time consuming and more costly than a sale pursuant to Section 363. One reason is that for a sale to take place, the court must approve the plan of reorganization and before that can occur, certain procedural requirements of the Bankruptcy Code must be met. For example, a disclosure statement must be prepared and approved, creditors must vote in favor of or against the plan of reorganization, and a creditors' committee may even propose its own competing plan of reorganization.

Unlike most sales under Section 363, sales pursuant to a plan of reorganization often do not feature an opportunity for competitive bidding. This is because "[t]o the extent a confirmed Chapter 11 plan specifies the acquisition transaction (i.e., identity of purchaser, price, and terms), it is that transaction which must occur."[8] The court may refuse to substitute purchasers who make higher and better post-confirmation offers.[9] Thus, there might not be competitive bidding unless there are competing plans. Some courts, however, in an effort to ensure a fair process and the best recovery for the bankruptcy estate, will attempt to manufacture a bidding process in the context of a chapter 11 plan confirmation.

Issues Associated with Purchasing the Assets of a Bankrupt Entity

Objections by Parties in Interest. If a party in interest, such as a secured creditor, objects to the sale of the debtor's assets, the bankruptcy court may only approve the sale if it meets one of the following criteria:

applicable non-bankruptcy law permits the sale of the property free and clear of such interest;
the objecting entity consents;
such interest is a lien and the price at which the property is sold is greater than the aggregate value of all liens on such property;
such interest is in bona fide dispute; or
the objecting entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.[10]

In a Section 363 sale, a secured creditor's lien is discharged at the sale and transferred to the proceeds of the sale. The purchaser receives the purchased assets free and clear of the secured party's lien. However, the court will generally not order a sale without the secured party's consent unless that sale will produce a surplus to pay the secured party's lien in full.

Sometimes a Sale Order is Vacated. Generally, a bankruptcy court order approving a sale is final and will not be overturned. Courts usually hold that once the sale has closed, any appeal of the sale order is moot, and third parties cannot upset the sale.[11] Yet, occasionally, the court's sale order may be vacated. This can occur when a party in interest does not receive notice of sale process, and then objects, and perhaps tenders a higher offer to the trustee or the debtor-in-possession. In general, the courts give little attention to complaints about sale process if the objector is simply a bidder who didn't like the process, or whose bid was not selected. If the court determines, however, that the entity tendering the higher offer was entitled to notice of the sale, and such notice was not properly given, then the court may vacate its sale order approving the first sale.[12] However, the inadequacy of the sale price, in and of itself, is not a sufficient basis to vacate an order approving a sale unless it is "grossly inadequate".[13]

To avoid the possibility of a vacated sale order, the trustee or the debtor-in-possession and the proposed purchaser must ensure that all creditors and parties with an interest in the proposed sale assets receive proper notice of the sale and all motions associated with the sale.

Successor Liability. Outside of bankruptcy, an asset purchase generally does not impose successor liability on the purchaser.[14] Similarly, an asset purchase in bankruptcy generally does not impose successor liability on the purchaser where the liabilities arose before the sale or confirmation of the plan of reorganization.[15] Yet, in spite of the general rule against successor liability, the purchaser may become liable under certain circumstances.

First, a purchaser may be responsible for the liabilities of the seller if such liabilities are expressly or impliedly assumed. In determining implied assumption of liability, courts will often review the acquisition documents for ambiguous language, as well as the purchaser's conduct after the sale to determine whether the purchaser's intent was to assume the seller's liabilities.[16]

Second, successor liability may be imposed if the purchase of the debtor's business amounts to a "de facto merger".[17] A de facto merger occurs when:

- the debtor corporation stops its business operations, liquidates and dissolves;
- the purchaser assumes those liabilities and obligations of the seller necessary to continue the normal business operations of the seller;
- the shareholders of the seller become the shareholders of the buyer;
- the management, personnel, physical location, assets and business operation of the seller continues under the control of the purchaser.[18]

Third, if the purchased business is a reorganized or restructured form of itself, the court is likely to impose successor liability.[19] Factors used to determine whether successor liability is appropriate include those mentioned above, as well as whether the successor holds itself out as the continuation of the previous business.[20]

Avoiding Successor Liability. Purchasers may limit successor liability in the following ways:

- investigate potential liabilities actions of the debtor prior to the purchase of its assets;
- obtain consents and waivers from potential claimants;
- notify all holders of contingent claims of the proposed sale;
- clearly identify those liabilities being assumed in the purchase documents;
- clearly identify excluded liabilities which are not being assumed in the purchase documents;
- avoid employing the same directors, managers and officers employed by the seller;
- avoid using the same name as the purchased entity;
- hold back some of the purchase price until the buyer is sure that successor liability claims will not be raised;
- if there is a solvent party who will give it, seek an indemnity;
- obtain a broad order from the Bankruptcy Court providing that the buyer is purchasing the assets free and clear of all creditor claims.[21]

Protections afforded to Bidders and Buyers in Bankruptcy

Break-up fees. The first bidder, often called the "stalking horse", generally conditions its offer to purchase the debtor's assets on reimbursement of its expenses and payment of a break-up fee if the proposed sale does not occur.[22] Break-up fees are often used to compensate the bidder for its time and expense in performing due diligence and arranging the sale, and to compensate it for lost opportunities. Courts generally acknowledge that a stalking horse bidder brings value to the estate with its initial offer, which often jump starts the bidding process. The availability of expense reimbursement and break-up fees may help to encourage the original bidder by reducing its fear of lost out-of-pocket and opportunity costs if its offer is ultimately not successful.

The availability of break-up fees to an initial bidder requires court approval, and courts around the country impose different standards to approve such fees. For instance, courts in the Third Circuit require that break-up fees: (i) promote bidding that maximizes the value of the debtor's estate, and (ii) be essential to the preservation of the estate.[23] This standard is similar to that used to approve administrative expenses under Section 503(b) of the Bankruptcy Code. A break-up fee is payable under this standard only if the purchaser can establish that the fee is an actual and necessary expense to the debtor's estate, or that the bidder made a substantial contribution to the debtor's estate.[24] The standard used by courts in the Seventh Circuit examines whether the initial bidder's due diligence has a maximizing effect on any subsequent bidding.[25] Courts in the Ninth Circuit examine the role of break-up fees in maximizing the purchase price of the debtor's assets, and whether such fees further the interests of creditors.[26] Second Circuit courts examine whether the break-up fee is reasonable in relation to the bids as well as the chilling effect of the fee on the bidding process.[27]

Purchaser in Good Faith. If the bankruptcy court finds that the sale is in good faith, the buyer will receive special protections pursuant to Section 363(m) of the Bankruptcy Code which provides:

> The reversal or modification on appeal of an authorization…of a sale or lease of property does not affect the validity of a sale or lease…to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.[28]

This provision requires a stay to be obtained by the objecting party in order to prevent the mootness of an appeal relating to the validity of a sale. The purpose of this provision is to protect the purchaser. As long as good faith is shown, many collateral attacks on the sale and the sale procedures involving the debtor's assets will be thwarted.[29] Factors used to determine a lack of good faith include:

fraud relating to the sale proceeding;
collusion between the purchaser and other bidders;
attempts to take grossly unfair advantage of other bidders;
an inadequate sales price.[30]

The Sale Order. The bankruptcy court's order approving the sale can also help to minimize collateral attacks on the sale or the purchased assets themselves. The court's sale order should contain the following factual findings:

the purchase is in good faith;
the terms of the sale were disclosed candidly
there is sufficient cause for the sale;
the sale is in the best interest of the estate;
the sale is free and clear of liens;
the sale is for fair market value;
sufficient notice of the sale was provided.

The court's finding of such facts may make it more difficult for unsuccessful bidders, or those initiating lawsuits related to the purchased assets, to undo the sale or encumber the purchase assets with liens. This is because the bankruptcy court's findings of fact may not be overturned unless they are found to be clearly erroneous.

Conclusion

It is beyond the scope of this article to discuss all of the nuances of the bankruptcy sales process and the techniques available to buyers, but readers should know that buying assets out of bankruptcy is a viable business strategy. Buyers should be sure to obtain the guidance of bankruptcy counsel early in the process who can provide advice about "market standard" terms, and the techniques and processes that are available to buyers to win the bid. For example, depending on the circumstances, a buyer may want to purchase claims in the bankruptcy case so that it will be treated as a party in interest and not just a prospective bidder. It my want to loan money to the debtor, pursuant to an appropriate bankruptcy court order, so that it holds a lien on the debtor's assets. The lien can become a vehicle to acquire those assets. It may want to negotiate a deal pre-bankruptcy to expedite the actual time in bankruptcy. The opportunities for buyers in today's market for assets of bankruptcy companies is limited only by the assets available and the creativity of the parties involved in the process.

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[1] *See* 11 U.S.C. § 363(b)(1) (2005).
[2] See Harvey R. Miller and Shai Y. Waisman, *Chapter 11: An Acquisition Opportunity for Financial and Strategic Buyers,* The Bankruptcy Strategist, Vol. XVII, No. 9 (July 2001).
[3] See *In re Bakalis*, 220 B.R. 525 (Bankr.E.D.N.Y. 1998).
[4] *See Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1071 (2d Cir. 1983).
[5] *See Stephens Indus., Inc. v. McClung*, 789 F.2d 386 (6th Cir. 1086); *Fulton State Bank v. Schipper (In re Schipper)*, 933 F.2d 513, 515 (7th Cir. 1991).
[6] *See* inf*ra* notes 22 through 27 below.
[7] *See* 11 U.S.C. §§ 1123(a)(4) and (a)(5).
[8] *See* Richard N. Tilton, *Bankruptcy Business Acquisition,* § 13.07[6] (2002).
[9] *See id*.
[10] *See* 11 U.S.C. § 363(f); *Citicorp Homeowners Services, Inc. v. Elliot (In re Elliot)*, 94 B.R. 343, 345 (E.D.Pa. 1988).
[11] *See infra* notes 28 through 30 below.
[12] *See In re Women First Healthcare, Inc*., 332 B.R. 115 (Bankr.D.Del. 2005).
[13] *See In re Chung King, Inc.*, 753 F.2d 547 (7th Cir. 1985).
[14] *See R.C.M. Executive Gallery Corp. v. Rols Capital Co.*, 901 F. Supp. 630, 635 (Bankr.S.D.N.Y. 1995).
[15] *See In re Lady H. Coal Co., Inc*., 199 B.R. 595 (S.D.W.Va. 1996), *aff'd,* 99 F.3d 573 (4th Cir. 1996).
[16] *See* Michael B. Solow and Harold D. Israel, *Buying Assets in Bankruptcy: A Guide to Purchasers,* 10 JOURNAL OF BANKRUPTCY LAW AND PRACTICE 87, 94 (Nov./Dec. 2000).
[17] *See id*.
[18] *See id*. at 95 (citing *Steel Co. v. Morgan Marshall Indus., Inc*., 662 N.E.2d 595 (Ill.App. 1996)).
[19] *See id*.
[20] *See id*.
[21] *See id*.
[22] *See id*. at 88.
[23] *See* Peter S. Clark II and Brook J. Hertzer, *Break-up Fees and Critical Vendor Payments in Bankruptcy: A Survey of the Circuits,* American Bar Association Commercial Law Newsletter (December 2002).
[24] *See* Solow and Israel, *supra* note 16, at 91.
[25] *See* Clark and Hertzer, *supra* note 23.
[26] *See id*.
[27] *See id*.
[28] *See* 11 U.S.C. § 363(m)
[29] *See* Tilton, *supra* note 8, at § 19.11.
[30] *See id*.