

December 2, 2008

Section 363 Bankruptcy Sales

Bankruptcy-related M&A activity, through so-called "section 363 sales," is sure to increase significantly in the wake of the financial crisis that has deeply impacted the U.S. economy across numerous industries. For many companies, this will undoubtedly provide some unique buying opportunities. This client memo gives a brief overview of the section 363 sale process and related strategic considerations, which differ in many important respects from those faced in a typical sale process outside of bankruptcy.

Section 363 is the section of the Bankruptcy Code that governs sales of a debtor's property outside of the ordinary course of business in a bankruptcy proceeding. Bankruptcy sales in Chapter 11 cases, whether in connection with an operational or financial restructuring or an orderly liquidation, can provide significant advantages to buyers. First and foremost, purchasing assets from a debtor in bankruptcy provides buyers with the important protection of a final court order. A benefit of the court order is that all creditors and potential claimants who were notified of the asset sale will be precluded from later raising issues that were or could have been brought in connection with the section 363 sale.

Most asset-purchasers seek to take full advantage of this protection by requesting that the bankruptcy court make conclusive findings that the sale is "free and clear" of all liens, claims and encumbrances, and that the purchaser has acted in "good-faith." Moreover, asset-purchasers typically request

that the bankruptcy court make specific findings that can eliminate or significantly mitigate the risk of successor liability claims. In this respect, orders approving a section 363 sale may include an injunction prohibiting the debtor's creditors from suing the asset-purchaser with respect to the acquired assets.

Another key advantage of buying assets in bankruptcy is that anti-assignment provisions contained in debtor contracts are generally unenforceable. Therefore, with the exception of certain contracts (such as personal service contracts), a debtor may sell and assign its contracts in a section 363 sale to a purchaser without third-party consent.

It is important to note that a section 363 sale may be approved only after "notice and a hearing," thus affording creditors and other parties in interest the opportunity to object to the proposed transaction. To obtain approval of an asset sale, the debtor will have to demonstrate a business justification for the sale and must also establish, in the exercise of its business judgment, that the sale price represents the "highest and best" offer. In this regard, a debtor must show that it marketed the assets and that it considered and compared the sale price to other offers, if any. The easiest way for a debtor to satisfy this burden is to sell assets using a public auction mechanism, which courts generally favor.

Most section 363 asset sales conducted through an auction process involve two separate bankruptcy court orders: (i) an order approving bidding procedures, and (ii) an order approving the sale. In general, bidding procedures:

- establish the rules for interested parties to submit bids and participate in the auction process; and
- provide certain protections for a "stalking horse" bidder (if there is one), such as a "break-up" fee.

If there is a "stalking horse" bidder, the debtor and the stalking horse bidder will usually negotiate the terms of the initial bid and memorialize those terms in a signed asset purchase agreement (APA). The stalking horse bidder will also negotiate the terms of the overbid process, including any overbid requirements and payment of a break-up fee. The debtor will at that point seek court approval of the APA and the overbid process. The purpose of the overbid requirement and the break-up fee is to protect the stalking horse from subsequent bidders, recognizing that bankruptcy sales are subject to higher and better offers. Notwithstanding the availability of bid protections, the goal of a section 363 sale is to secure the highest and best bid, and therefore, a court will only approve proposed bid protections after concluding that they encourage, and do not deter, bidding.

Once the court approves the bidding procedures and form of the stalking horse bidder's APA, the debtor will usually serve notice of the APA and the deadlines for parties to submit overbids. The APA serves as the basis for subsequent bids and overbids are typically required to be on terms at least as favorable as those contained in the APA. The stalking horse stands in a better position than other bidders in that (i) it is entitled to the negotiated and court approved bid protections and (ii) its initial bid provides the basis against which other bids will be judged.

Bidding procedures, which are intended to attract those potential purchasers who are serious about purchasing the debtor's assets,

typically will require potential purchasers to do one or more of the following things:

- submit an irrevocable offer (that is greater than the price proposed by the stalking horse);
- submit a form purchase agreement or term sheet;
- submit evidence that the purchaser has committed financing or other ability to pay the purchase price; and
- pay a good faith deposit.

If a debtor receives more than one qualified bid, then an auction is usually scheduled to allow the qualified bidders to submit additional bids.

After an auction takes place, a debtor will typically confer with its advisors and a representative from a Creditors' Committee to determine which bid constitutes the highest and best offer. Once that determination is made, the debtor will ask the court at a hearing to approve the sale to the successful bidder.

* * * * *

Chadbourne's bankruptcy and M&A lawyers have a successful track record of working hand-in-hand to guide our clients through the section 363 sale process. If you have any questions about section 363 sales or any of the issues discussed in this client memo, please contact any of the individuals listed below. In addition, if you are interested in tracking potential section 363 sale opportunities in your industry, our bankruptcy group is equipped to implement a customized "watch" for you--please let us know if we can help you in this regard.

For Additional Information

Our client memos are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:

Bankruptcy

David M. LeMay
+1 (212) 408-5112
dlemay@chadbourne.com

Andrew Rosenblatt
+1 (212) 408-5559
arosenblatt@chadbourne.com

Howard Seife
+1 (212) 408-5369
hseife@chadbourne.com

Joseph H. Smolinsky
+1 (212) 408-5489
jsmolinsky@chadbourne.com

N. Theodore Zink, Jr.
+1 (212) 408-5356
tzink@chadbourne.com

Mergers & Acquisitions

Carlos T. Albarracín
+1 (212) 408-1081
calbarracin@chadbourne.com

Marc A. Alpert
+1 (212) 408-5491
malpert@chadbourne.com

A. Robert Colby
+1 (212) 408-5571
rcolby@chadbourne.com

William Greason
+1 (212) 408-5527
wgreason@chadbourne.com

Morton E. Grosz
+1 (212) 408-5592
mgrosz@chadbourne.com

Charles E. Hord, III
+1 (212) 408-5353
chord@chadbourne.com

Peter K. Ingerman
+1 (212) 408-5422
pingerman@chadbourne.com

Peter R. Kolyer
+1 (212) 408-5564
pkolyer@chadbourne.com

Sey-Hyo Lee
+1 (212) 408-5122
shlee@chadbourne.com

Jonathan M.A. Melmed
+1 (212) 408-1002
jmelmed@chadbourne.com

J. Allen Miller
+1 (212) 408-5454
amiller@chadbourne.com

Talbert I. Navia
+1 (212) 408-5316
tnavia@chadbourne.com

Marc M. Rossell
+1 (212) 408-1057
mrossell@chadbourne.com

Edward P. Smith
+1 (212) 408-5371
esmith@chadbourne.com

Kevin C. Smith
+1 (212) 408-1092
ksmith@chadbourne.com