

**INDUSTRY
INSIGHTS**

WEBINAR

Buying Assets Out of Bankruptcy

HOSTED BY

Shearman

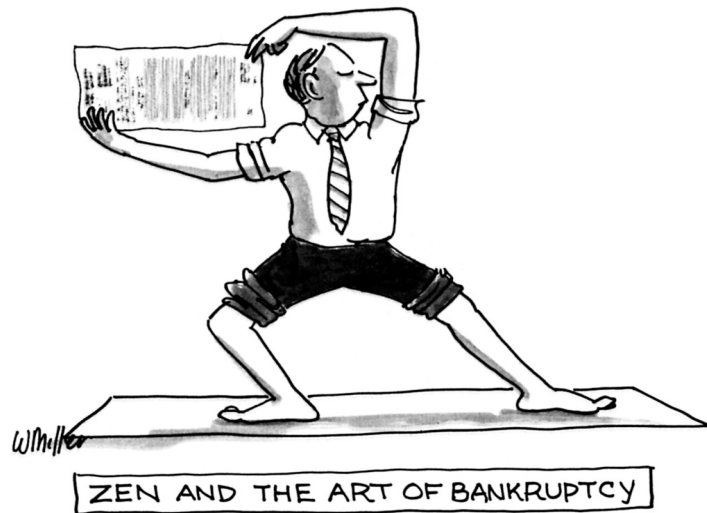
SHEARMAN & STERLING



BUYING ASSETS OUT OF BANKRUPTCY: WHAT YOU NEED TO KNOW

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" I DECIDED TO TAKE A CALCULATED RISK BUT HAYWARD DID THE CALCULATIONS. "

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THE PROBLEM: BUYING DISTRESSED ASSETS OUTSIDE OF BANKRUPTCY

- Risks are often disguised as opportunities outside of bankruptcy
 - Buy low, sell high....but do not buy too low
- If seller is insolvent, 4-10 year claw-back risk for fraudulent transfer
 - Not a simple unwinding...no money-back guarantees
- What is insolvency?
 - For fraudulent transfer – balance sheet test only*
- Mitigation Strategies to Prove REV
 - Solvency and valuation opinions...C-
 - Competitive sale process...B
 - Foreclosure sale...B+/A-
 - Bankruptcy acquisition....A+

THE SOLUTION: THE “363” SALE IN BANKRUPTCY

- 11 U.S.C. § 363 governs use, sale or lease of estate assets
 - Ordinary course – no court order needed, no special protections afforded
 - Outside ordinary course – court order needed, but special protections abound
- Debtor must establish a business justification for the sale
- Auctions....not an explicit requirement, but useful, common, and generally expected
- Purchase agreements in § 363 sales are not enforceable against the debtor until approved by Bankruptcy Court



“Are there several doctors in the house, so we can have a little managed competition?”

THE MAGIC BANKRUPTCY WAND: FREE AND CLEAR



"So how's everything going?"

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- 363 permits a sale “free and clear of any interest in such property” if ...
 - Non-bankruptcy law permits a free and clear sale
 - Consent of the party holding an interest in the asset
 - Purchase price exceeds total value of liens on the asset
 - The interest is a bona fide dispute under § 363(f)(4)
 - The interest can be reduced to a monetary claim under § 363(f)(5)

BUT WHAT'S AN INTEREST?

▪ The Basic Stuff:

- Equity
- Management options
- Contracts
- Liens
- Prepetition claims
- ROFOs & ROFRs / Pref Rights
- Creditor remedies (e.g., fraudulent transfer)

▪ The “We-Can-Do-That?” Stuff:

- State-assessed unemployment tax ¹
- Tort claims related to the property being sold ²
- Workers' compensation experience rating ³
- Successor liability ⁴
- Discrimination claims ⁵
- Unexpired leases that usually have priority over § 363 sales ⁶

⁽¹⁾ See *Massachusetts Dep't of Unemployment Assistance v. OPK Biotech, LLC (In re PBBPC, Inc.)*, 484 B.R. 860 (B.A.P. 1st Cir. 2013)

⁽²⁾ See *In re Christ Hosp.*, 502 B.R. 158, 172 (Bankr. D.N.J. 2013), *aff'd*, CIV.A. 14-472 ES, 2014 WL 4613316 (D.N.J. Sept. 12, 2014)

⁽³⁾ See *In re ARSN Liquidating Corp. Inc.*, 2017 WL 279472, at *4-6 (Bankr. D. N.H. Jan. 20, 2017).

⁽⁴⁾ See *In re Leckie Smokeless Coal Co.*, 99 F.3d 53 (4th Cir. 1996)

⁽⁵⁾ See *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3^d Cir. 2003)

⁽⁶⁾ *Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holdings II, LLC)*, 872 F.3d 892, 898-901 (9th Cir. 2017)

DEBTOR CAN EVEN COMPEL THE SALE OF NON-DEBTOR ASSETS

- § 363(h) permits sale of tenancy-in-common interests of a non-debtor if:
 - Partition impracticable;
 - Sale of undivided interest would realize significantly less value;
 - Balance of harm test; and
 - Special exception for the power lobby (production, transmission, or distribution of electricity or gas)
- § 363(i) gives the TIC a matching right

BUSINESS PARTNERS' VOWS



*"...in mergers and in acquisitions, in profit and in loss,
until receivership do you part..."*



"I'm not interested in minimum risk. I want long term gains without risk."

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STALKING HORSE ISSUES

- Public auctions often preceded by private stalking horse selection, concluding with fully executed PSA
- Game Theory: Stalking Horse vs. Spoiler/Sniper Role
- Advantages to being the stalking horse include:
 - Control:
 - structure of the transaction (e.g., which assets are being sold)
 - terms of its purchase agreement (e.g., walk rights, deposit terms, rep package)
 - auction procedures / timeline
 - Downside Protection:
 - Break-up fee (usually 3%)
 - Expense reimbursement (cap?)
 - Intangible Benefits
 - Prioritized due diligence requests
 - Management relationships
 - Statistical winner
- Disadvantages include:
 - Bid protections not guaranteed
 - Market volatility risk
 - Longer delay between signing & closing
 - Public company stock
 - Competition – attracts competing bids . . . Right?

POTENTIAL PITFALLS: NDA PROCESS

- NDAs
 - Commonly used, and necessary for due diligence
 - Some debtors restrict parties from participating in any other process for these assets
 - Bidders could choose to approach acquisition as hostile take-over
- Stalking Horse Protections Require Court Approval
 - Usually a GAP period of 7-14 days between signing and approval
 - Some debtors get advance authority, but case specific



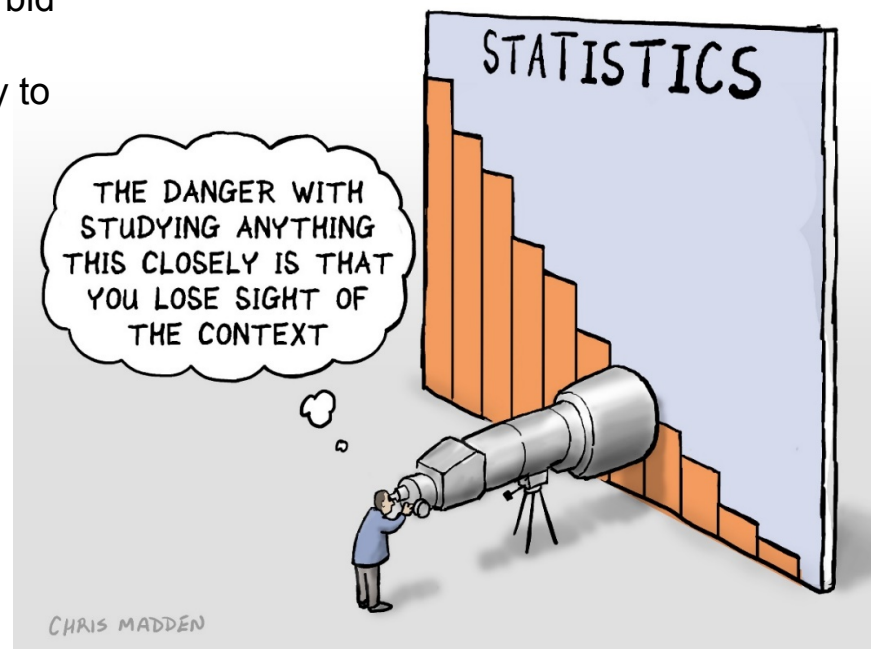
“There’s a lot of uncertainty out there these days. Or not. Who knows?”

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STALKING HORSE STATISTICS

- The stalking horse enjoys a statistical advantage
 - anecdotal evidence observed by restructuring lawyers and bankers; and
 - validated by case study of twenty-six cases where the stalking horse became the buyer in 85% of the cases (22 of 26).¹
- Stalking horse concepts welcomed in bankruptcy, but bid protections can have a chilling effect
- Debtor's investment bankers provide expert testimony to support challenged protections, including:
 - Break-up fees
 - Expense reimbursement
 - Initial over-bid
 - Bidding increments
 - Deposit amount/terms
 - Auction timing
 - Auction logistics
 - Backup bidder terms
 - Qualified Bidder requirements

⁽¹⁾ See Lynn M. LoPucki & Joseph W. Doherty, *Bankr. Fire Sales*, 106 Mich. L. Rev. 1, 35 (2007).



BACKUP BIDDER ISSUES

- Depending on the bid procedures the stalking horse or second highest bidder may be tied-up as a “back-up bidder”
- A back-up bidder is restricted, and deposit held, until the successful bidder completes the sale
- In the event the successful bidder does not complete the sale, the back-up bidder would be obligated to step in
- Downsides of being the back-up bidder include:
 - Your client just lost the auction, and is not in a good mood
 - Significant deposit held in escrow until conclusion of sale process
 - Delays an uncertainty in the sale process
- So what can you do?
 - Break the rules...seriously
 - Every sale order authorizes the debtor to modify the auction rules on the fly
 - Condition your subsequent bids in the auction on relief from the backup bidder role
 - Debtors will take your higher bid; cash is king

CREDIT BIDDING/RESERVE PRICE STRATEGIES

- Credit bidding allows a secured claim to be bid against the purchase price of a 363 sale.
 - Defensive Credit Bidding
 - Used by lenders to protect the value of their collateral
 - Useful when it is likely the collateral will be sold for less than actual value
 - Offensive Credit Bidding
 - Used by investors to acquire assets below market price
 - Purchase secured debt on the secondary market for a steep discount, use to credit bid on assets.
- Merits of negotiating a reserve price are in flux.
 - Reserve price encourages bidder interest, but...
 - May also encourage basement bidding
 - Current trend in oil and gas market
 - No reserve prices
 - Encourage parties that secured creditors support the sale process

DEPOSIT TRENDS

- Deposits serve multiple purposes
- Used to limit the auction to serious bidders and discourage breach.
 - Keeps the tire-kickers away
 - Also limits competition by moving up the deadline for formal approval
 - Teams diligence/chase assets
 - Serious bidding decisions, including deposit, requires additional credit committee approvals
- Usually 10% of the initial bid amount (not updated in real time)
- Typically a winning bidder who fails to close the sale will have deposit retained by the debtor.¹
 - PSA should address rational breach scenarios.
 - In addition to forfeiting its deposit, a winning bidder that fails to close the sale may also be liable for additional contract damages under certain circumstances.²
- The stalking horse may be exempt from making a deposit in some cases.³

⁽¹⁾ See *Brown Publ'g Co. Liquidating Trust v. Brown Media Corp. (In re Brown Publ'g Co.)*, 486 B.R. 46, 58-61 (Bankr. E.D.N.Y. 2013).

⁽²⁾ See *Berlin & Denmark Distribs., Inc. v. Goldstein Dev. Corp. (In re Berlin & Denmark Distribs., Inc.)*, 2014 WL 2178027, at *4-5 (Bankr. S.D.N.Y. May 23, 2014).

⁽³⁾ See *Order Approving Bid Procedures*, at ¶ 13, *In re Orchids Paper Products Company*, Case No. 19-10729 (Bankr. D. Del. May 20, 2019).



"Wait, those weren't lies. That was spin!"

INSIDER BIDDING IN BANKRUPTCY

- Insiders can—and often do—participate in bankruptcy sales, but process is key.
- Need independent board to guide the process, but ultimate decision-making is relatively risk-free
 - Auction required as practical point;
 - Initial decisions tend to be vetted/made by debtor professionals with input from UCC professionals and DIP lenders
 - Decision must still be approved by bankruptcy court after notice/hearing.
- Insider can even be the stalking horse
 - Stalking horse protections likely to face objection from UST, but not absolutely prohibited
- Full disclosure is paramount, and buyer is incentivized to play fairly
 - 363(m) – good faith moots appeals

KNOW THE RULES

- Collusion¹
 - Where “sale price was controlled by an agreement among potential bidders at such sale”
 - The court may avoid a sale, and even award actual and punitive damages
 - To be collusion, the bidders must intend to influence the sale price; incidentally affecting the sale price is not enough²
 - Every JV or partner bid should include consideration regarding collusion risks
 - Examples from prior cases: support agreements, timing

⁽¹⁾ 11 U.S.C. § 363(n)

⁽²⁾ See *In re N.Y. Trap Rock Corp.*, 42 F.3d 747, 752-53 (2d Cir. 1994) (noting that “[t]he influence on the sale price must be an intended objective of the agreement, and not merely an unintended consequence”)



“See? There. I think something bad happened right there.”

LINES YOU NEVER CROSS: TITLE 18

- Stay Out of Jail

- 18 U.S.C. § 157 – five-year prison term for false statements
- 18 U.S.C. § 152(6) – five-year prison term for [just about anything]
- 18 U.S.C. §154 – federal felony for trustee to purchase estate property
 - Courts have extended this to former trustees, auctioneers, and lawyers
 - Fraud not necessary; goal is to avoid any appearance of impropriety



"And then one day I decided that not taking risks was the greatest risk of all."



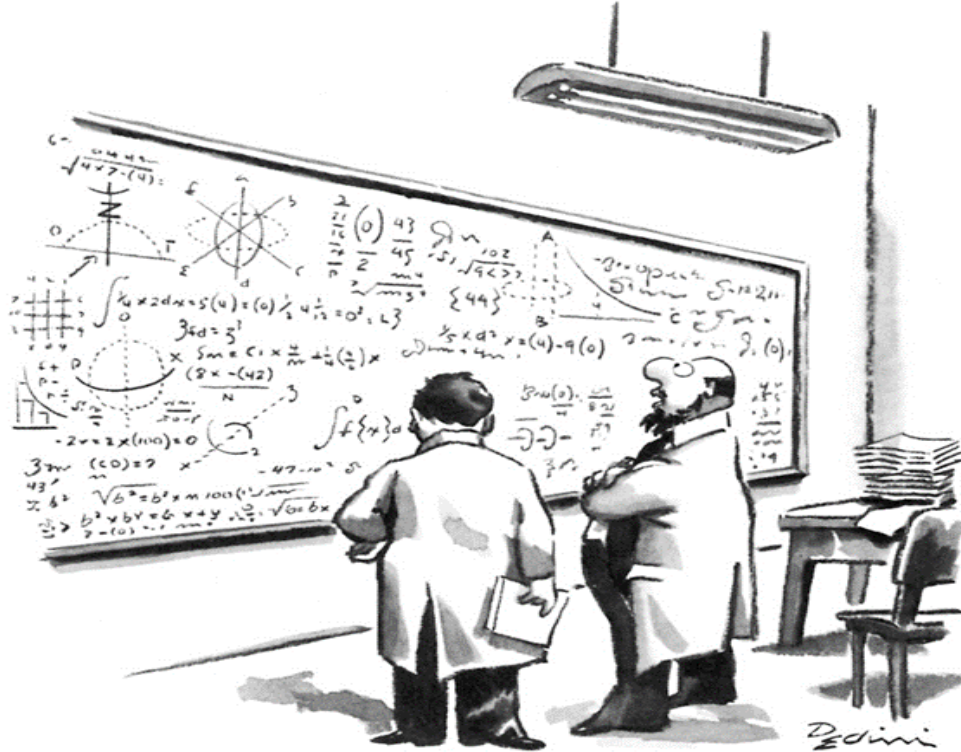
**“They presented us with an ironclad contract that we
were able to totally reinterpret.”**

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CONTRACT ASSIGNMENT ISSUES

- Buyer can cherry pick among contracts
- To assume/assign a contract, all defaults must be cured & buyer must provide “adequate assurance of future performance”
 - Fact specific test, often satisfied by:
 - testimony;
 - credit support; and/or
 - settlement.
- Anti-assignment provisions generally unenforceable
 - Exceptions for wedding singer & bank loans
- Buyer Considerations
 - Focus on contract issues earlier than you think necessary
 - Due process concerns need to be addressed; due process trumps bankruptcy powers
 - Credit support – how/when are you going to replace LCs and bonding
 - Fight for language ensuring a clean start – flush out hidden defaults
 - Consider strategic risk/benefits of paying cure costs – I recommend a ceiling

PLAN VS. 363 MOTION – WHICH IS BETTER?



"This is fine as far as it goes. From here on, it's who you know."

PLAN VS. 363 MOTION

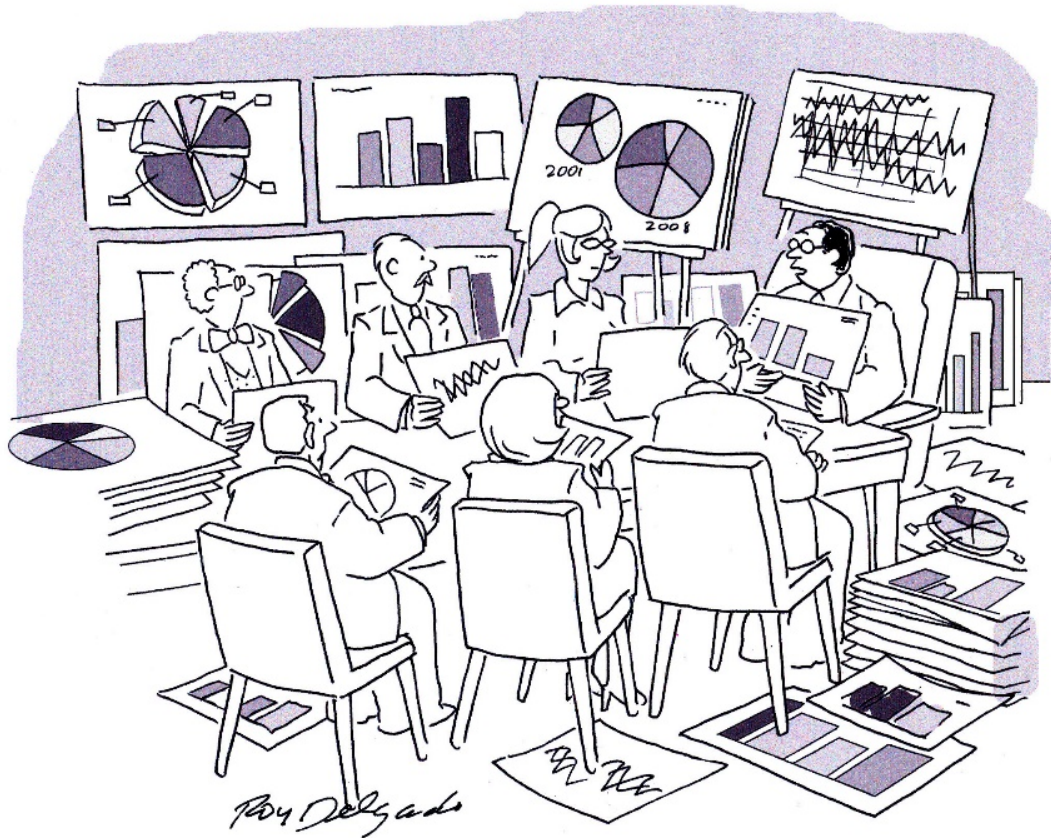
Sale Pursuant to a Plan of Reorganization

Advantages

- Easier to avoid an auction in plan than by sale motion
- Insiders/sponsors can negotiate their treatment before the case ever files
- Plan can force financing on secured creditors that may not be available on market terms
- § 1146 provides exemption for certain transfer taxes, but only in plan context
- Plan can give buyers broad releases, sometimes even from non-consenting third parties; sale orders are more limiting
- Additional appellate protections for plan sales

Disadvantages

- Plan usually takes longer, but timing can be case specific
- Plan sale requires consensus among key creditors
- Plan sale can be delayed or risked for creditor fights unrelated to sale
- Risk if seller loses exclusive right to file a plan
- Plan process costs more money than motion



" But then again ... we **could** be wrong. "

APPELLATE CONSIDERATIONS

- § 363(m): a sale to a good faith purchaser cannot be modified or overturned absent stay
 - The majority rule is that any appeal of a sale order is mooted if closing of the sale is not stayed.
 - “This mootness rule applies regardless of the merits of legal arguments raised against the bankruptcy court's order and functions to encourage participation in bankruptcy asset sales and increase the value of the property of the estate by protecting good faith purchasers from modification by an appeals court of the bargain struck with the [trustee].”
- **But** *Clear Channel Outdoor* limited mootness and re-instated junior lien¹
 - Senior lienholder credit bid its secured claim, and the sale was approved free and clear of all junior liens
 - A junior lienholder appealed, got no stay, and the sale closed while the appeal was pending
 - BAP held that good faith purchaser protections that normally prevent an appeal did not apply to the lien-stripping provisions of the code
- BAP decision is dying a slow death ²

⁽¹⁾ *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (B.A.P. 9th Cir. 2008);

⁽²⁾ See *In re Gardens Reg'l Hosp.*, 2018 WL 1229989, *5 (C.D. Cal. Jan. 19, 2018) (“BAP cases are not binding, and the Court is unpersuaded by the rationale of *Clear Channel*.”); *In re Wrangell Seafoods Inc.*, Memorandum Re: Sale, Case No. 09-00012, Docket No. 116 (Bankr. D. Alaska, March 9, 2009); *In re Jolan Inc.*, 403 B.R. 866 (Bankr. W.D. Wash. 2009)

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AN EXPERT IS ONE WHO KNOWS
TOMORROW WHY THE THINGS
HE SAID YESTERDAY
DIDN'T HAPPEN TODAY!



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