

A Road Map for Potential Buyers of Distressed Businesses in Section 363 Bankruptcy Sales

The current COVID-19 market environment presents unique circumstances to companies and investors who may, as a result of the tumultuous markets and the financial and personal effects of COVID-19, have opportunities to acquire distressed businesses at potentially depressed prices. Particularly in this market environment, though, one or more of the following scenarios may apply:

- The target needs to consummate a sale quickly because the target's cash resources are dwindling. The buyer wonders whether the distressed sale and "melting ice cube" asset valuation increase its exposure to claims from the target's creditors that the buyer underpaid for the asset.
- The target has a history of litigation claims or other types of latent claims (potential or actual), which it may not be able to satisfy. Even with diligence and proper structuring, the buyer may not be able to get comfortable that an asset sale or indemnification covenants will thoroughly protect it against successor liability claims.
- The target's affiliates or other related parties have declared or are rumored to be considering bankruptcy, and it might be difficult to conduct diligence on the target's receivables and payables histories, recent profits and loss statements, and related financial matters to confirm the solvency of the target. Moreover, the target itself could get swept into its affiliates' or other related parties' bankruptcy processes, especially if the target is a guarantor of any affiliate's funded debt.

In each case, the risks related to acquiring a distressed business can become murky. The current COVID-19 market environment only clouds these issues further. Essentially, the buyer has three options for effecting the acquisition of a distressed business:

1. Complete the transaction after ensuring that the target conducted an active marketing process, the buyer has conducted comprehensive financial and operational due diligence, and the buyer has confidence that the target's sale process and the structure protect the buyer against claims by the target's creditors. The time and resources required to conduct a robust sale process may not align with the target's needs to consummate a sale quickly.
2. If the target is on the brink of bankruptcy, wait until the target files for bankruptcy and subsequently emerges. Depending upon the complexity of the target's business, the buyer may be waiting a long time, and the new owners (which could be the creditors) may not be willing to sell.
3. Seek to acquire the target or its assets through the bankruptcy process.

This article outlines the major features of a section 363 sale, the fastest and most common way to acquire a target's assets in a US bankruptcy case. It also identifies why such a transaction can be a worthwhile consideration for buyers, highlights similarities between the US and Canadian bankruptcy regimes with respect to asset sales, and briefly provides a comparison point to an acquisition conducted through a confirmed chapter 11 plan.

A section 363 sale (named after the section of the US Bankruptcy Code that authorizes a debtor to sell its assets) is a court-sanctioned sale process for a company in a US bankruptcy case. In its simplest and most common form, a section 363 sale is a cash purchase of assets, although the buyer may agree to assume some operational liabilities. The sale is consummated after a marketing and due diligence period (typically after the target's bankruptcy filing) and culminates in an auction, followed by bankruptcy court approval of the sale. Section 363 sales are typically on an "as-is, where-is" basis with limited representations and warranties, indemnity rights or other post-closing recourse for buyers, although synthetic coverage for representations is available through the representations and warranty insurance market.

A section 363 sale can protect the successful bidder in a number of ways:

- The bankruptcy court will approve the sale process and approve the winning bidder. This allows a finding by the bankruptcy court that the sale was "fair and reasonable," which is generally sufficient to insulate a buyer from fraudulent transfer risks asserted by creditors.
- As an asset transaction, the buyer can select the assets it wants to purchase and specifically delineate the liabilities it will assume. Because the bankruptcy court's order will provide that the sale is free and clear of all other claims and liabilities (including successor liability claims), the buyer will be able to insulate itself against the risk of legacy liabilities (other than those that travel with the assets as a matter of law such as certain environmental liabilities). It is unusual for a buyer to assume substantial liabilities as part of a section 363 sale.
- The assets acquired generally will be free and clear of all liens, the bankruptcy court's order will be sufficient to release the purchased assets from such liens, and the buyer generally does not need to worry about negotiating with secured creditors about satisfaction of their claims.
- Once in bankruptcy, the debtor seller does not need shareholder approval, even if it is selling substantially all of its assets.
- Because the sale and sale process are approved by the bankruptcy court, officers and directors of the debtor seller are generally protected from shareholders and creditors attacking the sale price or fairness of the transaction. These parties have the right and opportunity to come in and raise any concerns with the transaction before the bankruptcy court approves the sale.
- Executory contracts and unexpired leases generally can be assigned to the buyer notwithstanding any anti-assignment language in such contracts or leases so long as outstanding defaults are cured. Defaults triggered by the bankruptcy filing or the financial condition of the debtor, however, need not be cured. Whether the buyer or the debtor pays cure costs is typically a point of negotiation.
- The bankruptcy court's order should contain a finding that the buyer is a good faith purchaser. The effect of such a finding is that, even if a party successfully challenges the sale on appeal, a completed sale cannot be reversed. Typically, in the absence of collusive bidding, compliance with the procedures approved by the court, as evidenced by the testimony of the investment banker who ran the sale process, is sufficient to demonstrate a buyer's good faith.

Section 363 sales can move quite quickly from the commencement of the bankruptcy case to completion, particularly when the debtor has identified a "stalking horse" bidder before the filing. In many cases, a sale can be consummated within 60 days after the filing. The price and terms of the asset purchase agreement in a section 363 sale will always be public. Although generally fast moving transactions, section 363 sales are still subject to certain regulatory approvals prior to closing. For example, the HSR Act still applies to reportable section 363 sale transactions, but the post-filing waiting period has been shortened to 15 days (as opposed to 30 days ordinarily). A filing with the Committee on Foreign Investment in the United States (CFIUS) may also be required, depending upon the nature of the assets being sold, if the buyer is a non-U.S. person.

Often, the section 363 sales process starts prior to the commencement of the target's bankruptcy case. The target often will market its assets to potential purchasers outside of the bankruptcy process and then select the highest and best bid to serve as the "stalking horse" bid. It then negotiates with the stalking horse bidder an asset purchase agreement (the "Stalking Horse APA")

and bid procedures. The stalking horse bidder's purchase price sets the "floor" for the subsequent auction that will occur in the bankruptcy case, and the Stalking Horse APA typically becomes the form that all competing bids must use as a baseline. In most cases, the Stalking Horse APA will contain no (or a very limited) due diligence out and will contain no financing contingency. Competing bidders will have to submit bids that do not impose greater conditions than those included in the Stalking Horse APA.

No matter how the Stalking Horse APA is structured, the sale of all or a significant portion of a debtor's assets will require notice to interested parties, consideration of higher and better offers, and bankruptcy court approval.

Once the debtor and the stalking horse bidder reach an agreement on the Stalking Horse APA and bid procedures, the debtor files a motion with the bankruptcy court asking the court to approve the Stalking Horse APA and the bid procedures. If the debtor has selected a stalking horse bidder prior to the commencement of its bankruptcy case, the debtor may very well file the motion within the first several days of its case. In most instances, the motion is approved in two parts — approval of the bid procedures and bid protections at the outset of the process and then approval of the sale to one or more successful bidders at the conclusion of the process.

Approval of the Bid Procedures and Bid Protections

Before the formal bankruptcy marketing process begins, the bid procedures (including notice procedures for contract counterparties) and bid protections for the stalking horse bidder will be brought before the bankruptcy court for approval. Indeed, the stalking horse bidder often will require court approval of the bid procedures and bid protections as soon as possible, because the bid protections are not binding on the debtor until and unless approved by the court. Although stalking horse bidders will request that the debtor seek approval of the bid procedures and bid protections on an expedited basis, some jurisdictions require a minimum notice period unless circumstances warrant consideration on an emergency basis.

- In most cases, a stalking horse bidder will negotiate for bid protections in the form of a break-up fee and due diligence expense reimbursement if the stalking horse bidder is not selected as the winning bidder in the auction. Once approved by the bankruptcy court, the bid protections are administrative expenses, which means that they have priority in payment over prepetition unsecured claims against the debtor. It is typical for the bid procedures to require that any break-up fee or expense reimbursement be payable to a bidder at the closing and directly out of the sales proceeds. Combined break-up fees and expense reimbursements are typically limited to 3-4% of the purchase price.
- The bid procedures will specify the mechanism and requirements for other bidders to access the data room and the criteria for submitting bids that will qualify to participate in the auction. One of the most important criteria is the minimum purchase price for a competing bid. This initial "topping bid" usually is equal to the amount of consideration in the Stalking Horse APA *plus* the amount of the bid protections payable to the stalking horse *plus* an overbid amount. The bid procedures also will set forth the amount of the deposit that a competing purchaser must submit (often 10% of the purchase price) and whether the bids will be shared with the stalking horse bidder. The court's order approving the bid procedures will set the dates for submitting bids, conducting the auction, and approving the successful bidder. If any of the debtor's funded debt has a lien on the debtor's assets, the bid procedures also will recognize the secured lenders' right to "credit bid" and may establish slightly different requirements if the secured lenders exercise that right.

The Pre-Auction Process

After the bid procedures are approved, the debtor or its investment banker will notify any parties that it believes may be interested in the assets (often the same parties that the debtor identified during its pre-bankruptcy marketing efforts) of both the opportunity to bid on the assets and the relevant deadlines. At this point, competing bidders likely will have a short window to complete any due diligence and mark up the Stalking Horse APA — often, only 20 to 30 days after the bankruptcy court approves the bid procedures.

The bid procedures may require potential bidders to "pre-qualify" by providing to the debtor and its investment banker information about the bidder's ability to close in advance of the bid deadline. It is always important to keep this interim deadline in mind. By the bid deadline, other prospective

bidders may submit bids. Any bidders that submitted qualified bids (*i.e.*, bids that meet the standards set forth in the bid procedures) are entitled to participate in the auction. The bidding procedures typically provide for the cancellation of the auction if no other bidders submit qualified competing bids for the assets.

The Auction and Approval of the Successful Bidder(s)

Before the auction begins, the debtor (sometimes after consultation with its secured creditors or the unsecured creditors' committee) will announce which bid is the leading bid. The debtor will then describe how the bidding at the auction will take place. The debtor's investment banker usually determines the precise method, which can be influenced by the number of competing bids received, the types of assets being sold, and whether the debtor will be entertaining partial bids (*i.e.*, bids for fewer than all the assets being sold). Many jurisdictions, such as Delaware, have specific requirements for how auctions will be conducted, including requiring that each participating bidder confirm that it has not engaged in any collusion with respect to the bidding or the sale, the auction be conducted openly with all creditors permitted to attend, and that bidding at the auction be transcribed or videotaped.

Following the conclusion of the auction, the debtor will select the highest and best offer. Although unusual, a lower offer may still be the best offer if it is more certain or can be consummated more quickly. This may be the case, for example, if transactions with some bidders require regulatory approval or would pose greater regulatory clearance obstacles.

Usually within a few days after the auction (or after the bid deadline if no qualified competing bids are received), the bankruptcy court will hold a hearing to approve the sale of assets to the successful bidder. A disgruntled bidder (unless it also is a creditor of the debtor) *does not* have the right to challenge the sale. Following entry of the bankruptcy court's order approving the sale to one or more successful bidders and subject to any further conditions to closing, the closing of the section 363 sale will occur. Bankruptcy courts often waive the 14-day stay imposed on sales by the Bankruptcy Rules, and sales often close within a day or so after obtaining bankruptcy court approval.

The Role of the "Stalking Horse" Bidder

Potential buyers are sometimes reluctant to serve as the stalking horse bidder in a section 363 sale because they often they do not want to devote significant resources to perform due diligence and negotiate definitive agreements, only to have their initial bid "shopped around" to others in an auction. That is a construct that ordinarily does not exist in a sale outside the context of a section 363 sale. Serving as the stalking horse bidder in a section 363 sale, however, may afford the stalking horse bidder a competitive advantage in the bidding process. Indeed, a stalking horse bidder is more often than not the successful bidder at the end of the section 363 sale process. Of course, acting as the stalking horse bidder also poses some risks and challenges. These advantages and potential risks are discussed below.

Benefits of the Stalking Horse Bidder Role

- **Bid Procedures.** Subject to bankruptcy court approval, the stalking horse bidder can heavily influence the procedures for the auction, can set milestones for the key dates in the bidding process, and can condition its obligation to close on a specific form of bid procedures being approved by the bankruptcy court.
- **Bid Protections.** As noted above, the stalking horse bidder can also negotiate for a break-up fee and due diligence expense reimbursement if the stalking horse bidder is not selected as the winning bidder in the auction. In most cases, the stalking horse bidder will structure the bid procedures so that the amount of its break-up fee/expense reimbursement is always "credited" to the stalking horse bidder in evaluating bid amounts.
- **Purchase Agreement.** As discussed above, the stalking horse bidder dictates the terms of the initial asset purchase agreement. Any other bidders must mark up the Stalking Horse APA to reflect any changes they require, and the bid procedures typically will require that qualified competing bids cannot impose conditions or terms that are materially less favorable to the debtor than those contained in the Stalking Horse APA. The stalking horse bidder, therefore, sets the base case against which all other bids are compared and, from a

practical standpoint, limits the ability of other bidders to submit a purchase agreement that deviates substantially from the stalking horse bidder's form.

- **Sale Order.** Similarly, the stalking horse bidder will draft and negotiate the form of order approving the sale. Orders approving section 363 sales can be quite extensive and will contain a number of findings and provisions designed to protect the successful bidder. It is difficult for a competing bidder to require more provisions and protections than the stalking horse bidder negotiated.
- **Diligence.** The stalking horse bidder can get a head start and significantly more time to conduct diligence as compared with the other bidders, who are subject to the court-mandated deadline for completing diligence and submitting bids (usually 20 to 30 days after the bid procedures are confirmed). Because most Stalking Horse APAs do not contain any due diligence out, this shorter time period often acts as a deterrent to bidders that cannot conduct their due diligence in this period. Moreover, if the stalking horse bidder's diligence is commenced prior to the start of the debtor's bankruptcy case (as it customarily is), the stalking horse bidder can avail itself of the debtor's management and key employees in its diligence efforts before the debtor's attention is diverted by the bankruptcy case itself.
- **Financing:** Generally, a Stalking Horse APA does not contain any financing contingency. A stalking horse bidder, therefore, likely will have confidence in its financing sources before signing the Stalking Horse APA. Potential bidders who only start the process after the debtor selects the stalking horse bidder and announces the bid procedures may scramble to line up financing and complete their due diligence within the timeframe set by the bankruptcy court.
- **Exclusivity.** In certain circumstances, the stalking horse bidder may be able to negotiate for exclusivity with the debtor during negotiations with the debtor on the Stalking Horse APA and bid procedures, which typically occur before the commencement of the bankruptcy. Any "no shop" agreement with the stalking horse bidder will naturally terminate when the competitive auction process begins following the court's approval of the bid procedures. (Note, though, that the existence of a no shop provision may have the effect of lengthening the time that other potential bidders have to conduct due diligence.)

Risks of the Stalking Horse Bidder Role

- **Bankruptcy Court Approval Risk.** A bankruptcy court may not approve the bid protections and bid procedures that the stalking horse bidder and the debtor have negotiated. This often happens only when another party objects or another bidder challenges the stalking horse's bid protections (see below), and, even when that happens, the typical response of the bankruptcy court is to encourage the stalking horse bidder and the debtor to modify the bid procedures and the bid protections to address any concerns. Stalking horse bidders routinely condition their willingness to close on the bankruptcy court's approval of the bid procedures and bid protections within a specified time period, but a stalking horse bidder always can waive this requirement if it chooses to do so.
- **Third Party Objection Risk.** In connection with bankruptcy court approval, creditors and other parties in interest have an opportunity to object to the designation of the stalking horse and any proposed bid protections and bid procedures; however, the approval of such parties is not required *per se* so long as the court determines that approval of the stalking horse and related bid protections satisfies the debtor's business judgment or is in the best interest of the debtor's estate. Courts vary as to which test they apply, but the practical reality is that the stalking horse bidder often finds itself negotiating with the creditors' committee to attempt to address its concerns.
- **Bid Protection Risk.** The debtor's ability to enter into a purchase agreement and provide negotiated bid protections to the stalking horse is subject to bankruptcy court approval. Therefore, until court approval is obtained, it is possible for another bidder to come forward with another offer that the debtor finds more attractive to serve as a stalking horse bid and be entitled to bid protections. The stalking horse can mitigate this risk, to some extent, by conditioning the offer for the debtor's assets on the debtor's satisfaction of certain milestones, including a deadline by which court approval for the stalking horse and any bid protections must be obtained (with 18-21 days being standard). The creditors' committee may seek to reduce the amount of the break-up fee or expense reimbursement. In some

rare cases, creditors may object to paying a stalking horse bidder *any* break-up fee or expense reimbursement. The argument in these cases (likely not an issue in the current environment) is that the market for the debtor's assets is so robust that bid protections are not needed to facilitate a robust auction.

- **Topping Bid Risk.** Given that a stalking horse bid is subject to an auction process, the stalking horse always runs the risk that it will have incurred substantial fees in taking the lead in the sales process (which may or may not be fully reimbursed by the bid protections) only to be outbid at the auction. Indeed, some bidders decide that they would rather let another bidder spend the time and money conducting due diligence and negotiating the Stalking Horse APA and then set the price floor (which may be lower than the price to which they would have agreed). The other bidders can then draft off of the stalking horse bidder's efforts.
- **Decline in Value During Action.** By serving as a backstop for the auction, the stalking bidder assumes the risk that the assets continue to decline in value (though this can be mitigated to some extent by careful drafting in the Stalking Horse APA).

Canada Cross Border Considerations

A similar process to the section 363 sale process exists in Canada. Similar to a section 363 sale, Canadian courts will approve pre-plan sales and make orders conveying title to the purchased assets free and clear of all liens and encumbrances. A notable distinction in the Canadian insolvency regime compared to the US is that stalking horse bids, break-up fees, and auctions are not required, and, while they are sometimes used, the structured sales procedures in a typical section 363 sale are less common in Canada. In deciding whether to grant approval of the sale transaction, a Canadian court will look at a proposed transaction as a whole to determine if it is appropriate, fair and reasonable and will generally accept a proposed sale process when it has been recommended by the supervising insolvency professional and is supported by the debtor's major creditors. Prospective buyers should also be aware that a Canadian court will only approve a sale of assets so long as it is satisfied that any required payments to employees, former employees and their pension plans can be met. For a US debtor with assets in Canada, Canadian courts have statutory authority to make orders and grant relief to approve or implement arrangements from a chapter 11 proceeding, including a section 363 sale.

Sale Under a Plan of Reorganization or Liquidation

Although the primary focus of this article covers section 363 sales, it is worth noting that a party interested in acquiring the assets or stock of a debtor in bankruptcy can also acquire such assets or stock pursuant to a chapter 11 plan instead of separately through section 363 of the Bankruptcy Code. The biggest drawback of acquiring assets or stock through a plan (and what makes sales under a plan far less common than section 363 sales) is the time and expense associated with doing so. With certain exceptions, it often takes at least 120 days (and often longer) for the sale to receive bankruptcy court approval, because the sale must be approved as part of the chapter 11 plan of reorganization or liquidation and thus is subject to all of the various plan confirmation requirements, including the requisite creditor acceptance — and creditors may oppose the plan even if they are unopposed to the sale. Also, unlike in the section 363 sale context for stalking horses, break-up fees are not customary in the context of a sale under a plan. On the other hand, a buyer who wishes to acquire the equity of the debtor (usually the equity in the reorganized debtor) often prefers to do so under a plan instead of a section 363 sale. Other advantages of a sale under a plan include (i) the possible avoidance of an auction process, (ii) the ability to issue securities exempt from SEC registration requirements, (iii) in certain circumstances, the ability to provide non-cash consideration, (iv) greater flexibility in terms of financing or structuring the sale (including by merger, stock, or asset acquisition), and (v) preserving valuable tax attributes. Generally speaking, the benefits of a sale pursuant to a plan vs. a stand-alone asset sale are the same in Canada as in the US.

Thinking Ahead

In today's highly volatile global markets, with businesses of all sizes reeling from the effects of COVID-19, we may see a rise in section 363 sale transactions. While each transaction needs to be evaluated on an individual basis, the overall regime of section 363 sales as an alternative to an

out-of-court distressed sale is worth consideration earlier rather than later. Given the rapid timelines of some distressed M&A and limited due diligence periods, it can be helpful to learn the rules of the game prior to starting to play and possibly to be in a position to act as a stalking horse.

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