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Buying Assets from a Company in Chapter 11

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Buying assets or an on-going business from a company while it is in bankruptcy can be an excellent means of acquiring valuable assets free and clear of liens, claims, encumbrances, and other interests. Indeed, many Chapter 11 proceedings are commenced primarily, if not exclusively, to facilitate sale of the debtor's assets or on-going business. As a result, there are many opportunities to obtain assets at bargain prices. There are risks that accompany these acquisitions, however, risks that potential buyers need to understand. Here we outline the process for buying the assets of a debtor in a Chapter 11 case under § 363 of the Bankruptcy Code, which controls sales during the course of the case or, instead, pursuant to a confirmed plan of reorganization. We also highlight the critical risk—successor liability—faced by buyers and suggest ways to mitigate that risk.

Buying Assets Out of Bankruptcy

During a Chapter 11 case, the debtor may seek to sell certain or substantially all of its assets. These sales are governed by § 363 of the Bankruptcy Code and, therefore, are commonly referred to as 363 sales.

Section 363 Requires Court Approval of Non-Ordinary Course Transactions, Including Asset Sales

A debtor may continue to use, sell, or lease its property in the "ordinary course of business" after it files for bankruptcy without the need for notice to creditors or a hearing before the bankruptcy court. So the stereotypical widget producer can sell widgets after filing for bankruptcy just as it did before filing.[1] When a transaction is outside of the ordinary course of a debtor's business, however, the debtor may not use, sell, or lease its property without providing creditors with notice and an opportunity to request a hearing if they object.[2] In this article, we discuss sales outside the ordinary course of business and subject to § 363. "Section 363 is designed to strike a balance, allowing a business to continue its daily operations without excessive court or creditor oversight and protecting secured creditors and others from dissipation of the estate's assets."[3]

Section 363 Invalidates *Ipso Facto* Clauses

A debtor's right to use, sell, or lease its property is not affected by a provision in a contract, lease, or applicable law that would prohibit that use, sale, or lease due to the insolvency or financial condition of the debtor or the filing of a bankruptcy petition by or against the debtor, although other restrictions on assignment or transfer may be enforceable.[4] For example, a creditor with a security interest in a debtor's assets could not prohibit a debtor from selling those assets due to a provision in the parties' security agreement prohibiting any sale of assets upon the debtor's insolvency.

"Substantially All" or "A Portion" of the Debtor's Assets Can Be Sold Outside the Ordinary Course of Business

A debtor might want to sell only a portion of its assets outside the ordinary course of business. This could be specific property, such as equipment, or a specific operating unit, such as a division or subsidiary. For example, the debtor might seek to dispose of its assets in several separate sales because no single buyer has stepped forward to buy substantially all of the assets. A debtor also may pursue a sale of substantially all of its assets in bankruptcy, with the buyer to operate the business prospectively. A sale of substantially all of a debtor's assets may occur either inside or outside of a plan of reorganization. A sale of substantially all of a debtor's assets means a sale of assets such as real estate,

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inventory, equipment, trademarks, and other assets typically sold in an out-of-court asset sale. While this type of sale does not occur in every case, it is a very common method of realizing value in medium- to large-sized Chapter 11 cases.

Section 363 Sales Require Notice and Court Approval

Court Approval After Notice and Hearing Is Required

The bankruptcy court may approve a sale outside of the ordinary course of business only "after notice and a hearing."[5] This means that the debtor must give appropriate notice with an opportunity for parties-in-interest to request a hearing.[6] If no parties in interest request a hearing, then the bankruptcy court may authorize the sale without actually conducting a hearing.

Notice to Creditors of Proposed Sale Is Required

Under Bankruptcy Rules 2002(a)(2) and 2002(k), the debtor must give all creditors, indenture trustees, and the US Trustee 20 days notice of any proposed sale of assets, although the bankruptcy court may shorten the notice period for cause and may order the debtor to provide notice to the creditors' committee (rather than to all creditors) in order to reduce costs.[7] The content of the notice must state the time and place of any public sale, the terms and conditions of any private sale, and the time fixed for filing objections.[8] Objections to the sale normally must be filed at least five days before the sale unless the court orders otherwise.[9] If a party-in-interest files an objection, then the court must hold a contested hearing under Bankruptcy Rule 9014.

Standard for Approving Asset Sale Is Deferential

The bankruptcy court will approve a sale of substantially all or a portion of a debtor's assets "if all provisions of section 363 are followed, the bid is fair, and the sale is in the best interests of the estate and its creditors."[10] This is a deferential standard. The key to the transaction is that creditors must receive a notice accurately describing the terms of the proposed sale.

Assets Can Be Sold Outside Plan of Reorganization

The required procedures for notice and a hearing are the same whether a debtor sells some or substantially all of its assets. The debtor must provide 20 days notice[11] to parties-in-interest and must comply with the other procedures outlined above. Further, if a debtor proposes to sell substantially all of its assets, the debtor must comply with additional procedures and norms that are typically observed by debtors in such cases.[12] These procedures are designed to maximize the value obtained for the debtor's assets by testing whether a bid for the assets is the "highest and best bid."

Investment Banker or Other Valuation Professional Needed

A usual first step in the sale process is for the debtor to retain an investment bank or other representative to market the debtor's assets to potential buyers.

"Stalking Horse" Bid

After completing the preliminary marketing process, the debtor may enter into an agreement, subject to higher or better bids and subsequent bankruptcy court approval, to sell substantially all of its assets to a particular buyer, known as a stalking horse bidder. The stalking horse bidder's offer establishes a floor price for the debtor's assets, with that offer to be tested by the market through an auction process.

Bidding Procedures to Be Followed

After entering into an agreement with the stalking horse bidder, the debtor will file a motion to approve bidding procedures in connection with the sale of its assets (the bidding procedures motion). The purpose of the bidding procedures motion is to establish parameters for the process of bidding on the debtor's assets. A potential bidder typically must provide a substantial deposit along with its bid, as well as financial information demonstrating its ability to close the transaction if it is selected as the winning bidder. The bidding procedures motion also states the time and place for the auction, the deadline for submitting bids, the increments in which bidding will occur at the auction (for example, each bid might be required to exceed the next previous bid by $500,000), and the method for determining which bid is the highest and best bid.

Break-Up Fees and Other Bid Protections Used

The bidding procedures motion also will often seek approval of a break-up fee and other bidding protections for the stalking horse bidder. A break-up fee serves the same purpose inside bankruptcy that it serves outside bankruptcy: This fee is paid by the seller to the stalking horse bidder in the event that someone else outbids the stalking horse for the assets and the stalking horse is not the ultimate acquirer. The stalking horse bidder, in negotiations, will typically request a break-up fee and an agreement providing that it will be reimbursed for its due diligence expenses in the event that it is not selected as the winning bidder at the auction. The stalking horse bidder will insist upon these bidding protections because it is the stalking horse bidder's commitment that assures an acceptable sale, and as it will have spent a lot of time and money in conducting a due diligence investigation and negotiations, it must be compensated for its time, expense, and acceptance of risk.

The bankruptcy court must approve any break-up fee and other bidding protections.

Standards for Approval Vary by Court

Some courts have analyzed whether to approve a break-up fee under the deferential business judgment test, deferring to the debtor's decision to grant the break-up fee absent self-dealing or an unreasonable business decision.[13] Other courts conduct a more in-depth inquiry in determining whether to approve a break-up fee in a particular case.[14]

Court to Approve of Sale

When the auction is done, the debtor will ask the bankruptcy court to approve its proposed sale of assets to the winning bidder. To obtain approval of a sale of substantially all of the debtor's assets outside of a Chapter 11 plan, some older cases required the debtor to establish the existence of an emergency, reasoning that a sale of substantially all of a debtor's assets is like a plan without the protections for creditors contained in § 1129 of the Bankruptcy Code.[15] The modern rule followed by a strong majority of courts, however, is that a debtor need not establish an emergency to sell substantially all of its assets outside of a plan. Rather, the debtor merely must establish a "good business reason" for the sale.[16]

Sale Free-and-Clear of Liens, Claims, and Encumbrances

Some or all of a debtor's assets may be subject to liens or interests held by secured lenders, taxing authorities, or other creditors asserting a security interest in the debtor's assets. The presumptive rule in bankruptcy is that any sale of a debtor's property is subject to the liens and interests of other parties. A buyer of assets, however, typically will buy assets in bankruptcy only if the purchase is free-and-clear of liens, claims, and encumbrances.

Requirements for Approving Sale Free and Clear of Liens

Section 363(f) of the Bankruptcy Code resolves this issue by allowing a sale of assets free-and-clear of liens, claims, and encumbrances in any of the following circumstances:

- A free and clear sale would be permitted under applicable non-bankruptcy law;
- The secured party consents to the sale;
- The other interest is a lien, and the selling price is higher than the aggregate value of all liens on the property;
- The lien or interest is in *bona fide* dispute; or
- The secured party could be compelled to accept a monetary satisfaction of its interest in a legal or equitable proceeding.

Security Interests Attach to Sale Proceeds

Upon a sale free-and-clear of liens, the buyer takes the property free from any interest of the lienholders. The interests of the lienholders attach to the proceeds of the sale in the same priority as they attached to the assets prior to the sale.

Right to Credit Bid Affects Debtors' Ability to Sell Assets Free-and-Clear Under § 363

Section 363(k) of the Bankruptcy Code allows a secured creditor to credit-bid the amount of its secured claim to purchase the property in which it holds a lien. This creates a possible obstacle to potential purchasers in that the credit bid might price them out of the process. Also, a recent judicial decision potentially affects the ability of a debtor to sell its assets free-and-clear of out-of-the-money liens under § 363(f) of the Bankruptcy Code. In *Clear Channel Outdoor, Inc. v. Knupfer*, 391 B.R. 25 (B.A.P. 9th Cir. 2008), the court held that a debtor could not sell its property to a senior lienholder pursuant to a credit bid free and clear of the lien of a junior lienholder. Although this decision was made in the context of a credit bid, the court's reasoning could apply to prevent the sale of property free and clear of a junior lien in any case when the sale price is less than the amount of the junior lienholder's claim in the property. The decision could have a significant impact on 363 sales if it is adopted by other courts. In many cases, especially small- to medium-sized cases, an expeditious 363 sale for less than the value of all liens on the property is the only viable exit strategy. If parties cannot rely on § 363(f) to sell assets free and clear of junior liens outside of a plan, then bidders might consider reducing their bids or might demand reserve funds. Both of these possibilities are discussed in some detail below as protections against successor liability.

Representations and Warranties in Bankruptcy

The representations and warranties that a purchaser might typically expect from a seller will not survive the closing in bankruptcy. A purchaser will purchase the assets "as is and where is" to protect the debtor and its estate from lingering obligations such as administrative claims and challenges to the purchase price. While this may increase the intensity of the due diligence required by a purchaser, it helps establish the bargain price that can be realized in bankruptcy.

Sale of Assets Pursuant to Plan

A debtor may also sell substantially all of its assets pursuant to a Chapter 11 plan of liquidation.[17] If the debtor sells its assets under a plan, then it must comply with all of the applicable plan confirmation requirements. A debtor that sells substantially all of its assets pursuant to a plan also will typically have to go through the steps for selling assets outlined in the plan, which typically are similar to those described in the previous sections of this article, such as marketing the property, signing an agreement with a stalking horse bidder, and conducting an auction to obtain the highest and best bid. The major difference between a sale inside and outside of a plan is that the bankruptcy court evaluates a sale pursuant to a plan as part of the plan confirmation process. The sale thus can be validated by creditor votes in favor of the plan. Conversely, a 363 sale outside a plan is not subject to the votes of creditors, inviting the bankruptcy court to scrutinize the proposed sale more closely. Another potential advantage of a sale pursuant to a plan is that the buyer can avoid transfer taxes, which is not the case in a 363 sale.

The Successor Liability Risk

Successor Liability Can Be Claimed

Section 363(f) of the Bankruptcy Code recognizes the need for finality of the sales conducted by bankruptcy courts and certainty as to the expectations of parties relative to future liabilities associated with the purchased assets. Still, there is tension between legal principles of successor liability and the goals of the 363 sale process.

Generally, "a corporation which acquires another corporate entity's assets does not assume the seller's liabilities unless (1) the buyer expressly assumes those liabilities; (2) the transaction constitutes a merger or consolidation; (3) the buyer is a mere extension of the seller; or (4) the transaction amounts to a fraudulent or collusive attempt to avoid the seller's liabilities."[18]

The free-and-clear language of § 363(f) has proven to be troublesome in the area of successor liability. While there is no successor liability for secured claims or unsecured claims of vendors, there is risk of successor liability for certain product liability, ERISA, tax, environmental, and other claims of favored classes of creditors. Judges' holdings have been inconsistent. Some have held that no successor liability can ever be imposed because that would reduce the prices that debtors would receive for their assets. Others have held that successor liability claims can never be extinguished by a 363 sale. The result has been confusion because a free-and-clear finding does not act as an absolute bar against the imposition of future successor liability. While courts have developed several tests to determine whether a claim can be asserted against a successor in interest, a potential buyer can use one or more tactics, explained below, to cope with potential claims.

Potential Successor Liability Can Be Managed

Build Protections into Purchase Agreement and Sale Order

The buyer's best protection against successor liability is to craft the purchase agreement to minimize this liability and to insist that the sale order contain provisions designed to insulate the buyer from liability. For example, a buyer will generally request that the purchase agreement and proposed sale order unambiguously state that the sale is free and clear of all claims against the debtor, whether known or unknown, liquidated or unliquidated, and that they release or discharge the buyer from any successor liability. Similarly, the purchase agreement and the proposed sale order might include broad releases and provisions unambiguously enjoining creditors and others from bringing actions and claims against the buyer arising before the buyer's acquisition of the debtor's assets or business.

Also, the buyer should request that the purchase agreement, the sale order, and the bankruptcy court's findings of fact and conclusions of law state unequivocally that the buyer is not a successor in interest of the debtor for any purpose and thus is not answerable for any successor liability claims. Finally, to minimize confusion and possible disputes in the future, the purchase agreement should clearly identify all liabilities that the buyer expressly agrees to assume, with all other liabilities expressly rejected.

In addition to ensuring that the purchase agreement, sale order, and findings of fact and conclusions of law contain the appropriate devices to protect the buyer from successor liability, the buyer should do everything possible to assure that it does not appear to be a successor in interest to the debtor's business. For example, it is generally a good idea for a buyer not to assume employee obligations or retain employees under existing contracts. Similarly, it is generally preferable not to employ the debtor's directors, officers, or controlling shareholders unless absolutely necessary.

If the buyer intends to operate in a manner substantially similar to the debtor's business, then the buyer should consider halting operations for a while, operating from a different location and using a different business name, letterhead, and telephone numbers. The fewer connections that the buyer's business has with the debtor's business, the less likely it will be that the buyer will be held responsible for successor liability.

Reserve Fund Can Be Used to Satisfy Claims

If it is likely that substantial unknown claims exist, such as product liability or other tort claims, then the buyer may want additional protection by having the debtor set aside a reserve to pay unknown tort claimants. The amount of the reserve fund will be based upon historical assumptions about the company's business and actuarial calculations of damages, injuries, or deaths occurring in the same industry. For example, as part of the prospective buyer's due diligence investigation, it might engage an expert to estimate the number of injuries or even deaths that might be expected to result from the production, use, or sale of any given product manufactured or sold before the bankruptcy. Being informed by the expert's evaluation, the buyer can then negotiate for the debtor to set aside a reserve sufficient to pay these claims in full.

The reserve fund device has been widely used in mass tort cases when claimants often do not even know that they have claims against the debtor, or the debtor's successor-in-interest, for years after exposure. A reserve fund can be especially desirable if the acquired assets are located outside of the bankruptcy court's jurisdiction such that an injunction would not be enforceable.

Discount for Possible Claims

Frequently, a company that may have significant unknown claims against it may agree to discount the price of its assets in an amount sufficient to cover potential successor liability claims. Unfortunately, it is often difficult to determine an accurate discount, as any given year might be statistically atypical. A buyer might receive a windfall if fewer-than-expected successor liability claims (or less-severe-than-expected such claims) are asserted against it. Conversely, an asset buyer could be saddled with significant unanticipated obligations if greater-than-expected successor liability claims are brought. Accordingly, discounting should be used as only one of many successor liability management tools available to prospective buyers.

Conditional Offer Can Be Made

Finally, an offer to buy assets from a debtor or an insolvent company can be conditioned upon the bankruptcy court's approval of a purchase agreement eliminating all claims, including unknown or future tort claims (arising from prior conduct), from assets to be acquired by the buyer. In such a case, and assuming the enforcement of such a provision under applicable state law, claims asserted after the acquisition could be brought only against the debtor or other assets of the bankruptcy estate, including sale proceeds. If the debtor or insolvent company were not to obtain court approval of this condition, then the asset buyer would expect to be able to terminate the purchase agreement for cause.

Conclusion

The assets of a company in bankruptcy can often be acquired at bargain prices. There are risks associated with this, but the risks are manageable. The stalking horse bidder will want to negotiate a break-up fee as compensation for assuming the risk of being outbid in an auction after spending time and money on due diligence and negotiations.

There is also the risk of successor liability. The buyer can attempt to manage that risk by including protective provisions in the purchase agreement, by requiring the debtor to set aside a sufficient reserve to pay unknown or future claims, by obtaining a discount based upon estimated successor liability claims, by negotiating a release from such claims, or by adopting some combination of these tactics.

There are other risks and solutions that arise on a case-by-case basis in connection with asset purchases from debtors involved in bankruptcy proceedings. Experienced legal counsel can help would-be buyers identify and manage these risks.

Notes

1. 11 U.S.C. § 363(c)(1).
2. *See* 11 U.S.C. § 363(b)(1).
3. In re Roth American, 975 F.2d 949, 952 (3d Cir. 1992).
4. *See* 11 U.S.C. § 363(l).
5. 11 U.S.C. § 363(b)(1).
6. *See id*. § 102(1).
7. *See* Fed. R. Bankr. P. 2002(a)(2), (i).
8. *See* Fed. R. Bankr. P. 2002(c)(1).
9. *See* Fed. R. Bankr. P. 6004(b).
10. In re Quality Stores, Inc, 272 B.R. 643, 647 (Bankr. W.D. Mich. 2002); *see also* In re Montgomery Ward Holding Corp., 242 B.R. 147, 153 (D. Del. 1999) (courts evaluate a variety of factors constituting a "business judgment test" in deciding whether to approve a sale under § 363 of the Bankruptcy Code).
11. Although only 20 days notice is required, sales usually take much longer than that to be approved. The debtor's investment bank needs to be given sufficient time to market the assets thoroughly.
12. These procedures can be followed in the sale of any assets of the debtor but are typical when selling substantially all of a debtor's assets.
13. *See, e.g.,* Official Committee of Subordinated Bondholders v. Integrated Resources, Inc., 147 B.R. 650, 657 (S.D.N.Y. 1992).
14. *See, e.g.,* In re America West Airlines, Inc., 166 B.R. 908, 912 (Bankr. D. Ariz. 1994) (the test "is not whether a break-up fee is within the business judgment of the debtor, but whether the transaction will further the diverse interests of the debtor, creditors and equity holders, alike"); In re Hupp Indus., Inc., 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992) (the "[s]ignificant factors" in deciding whether to approve a break-up fee include, among other things, "[w]hether the fee requested correlates with a maximization of value to the debtor's estate" and "[w]hether the dollar amount of the break-up fee is so substantial that it provides a 'chilling effect' on other potential bidders").
15. *See, e.g.,* In re White Motor Credit Corp., 14 B.R. 584, 590 (Bankr. N.D. Ohio 1981).
16. *See, e.g.,* In re Lionel Corp., 722 F.2d 1063, 1070 (2d Cir. 1987); Stephens Indus., Inc. v. McClung, 789 F.2d 386, 389-390 (6th Cir. 1986); In re Ancor Exploration Co., 30 B.R. 802, 808 (N.D. Okla. 1983).
17. *See* 11 U.S.C. §§ 1123(a)(5)(D), 1123(b)(4).
18. In re Savage Indus., Inc., 43 F.3d 714, 717 n.4 (1st Cir. 1994) (citing Conway v. White Trucks, 885 F.2d 90, 93 (3d Cir. 1989) (other citations omitted)).