The Seven Deadly Sins in §363 Sales

Written by:
Robert E. Steinberg[1]
Catalyst LLC; Manhattan Beach, Calif.
rs@ctlst.com

FEATURE ARTICLE

Asset sales under §363 of the Bankruptcy Code have become the preferred method of monetizing the assets of a debtor company. While the sales process has its advantages, it has many complexities that, if ignored, will undermine the process and greatly reduce the proceeds from the sale.

The §363 process ordinarily involves a chapter 11 debtor/seller and a prospective buyer presenting a fully negotiated asset purchase agreement (APA) to the bankruptcy court for approval. This purchase agreement then becomes the template against which other potential buyers bid in an auction, pursuant to a set of court-approved procedures. Once a winning bidder is selected, the transaction closes with the sale being free and clear of prior liens and most claims, including claims by creditors that have not been paid at the time of the sale.

The process often has the advantages of speed and the ability to maximize asset value through sale of the debtor company as a going concern. It is not unusual for a §363 sale to be completed within two to three months after a bankruptcy filing. The assets are cleansed in that they are sold, with certain limited exceptions, free and clear of liens, claims and liabilities. Also, a §363 sale can often yield the highest price for the assets because of the buyer's ability to select liabilities it will assume and to purchase a going-concern business.

From the seller's standpoint, the §363 process is advantageous because it can limit exposure of directors and officers of the seller for breaches of representations and warranties. In addition, a secured creditor can "credit bid" or take an ownership interest in the company by bidding a reduction in the debt the company owes, although, from a practical standpoint, there typically needs to be a cash outlay by the secured creditor to purchase the company in order to address the unsecured creditor constituency and cure certain claims.

Frequently, however, the §363 sale process fails to maximize value because debtor management is not able to lead the process properly or does not recognize, due to inexperience with the process, the many pitfalls and obstacles that must be avoided. Set out below are the seven most common mistakes made by debtor management during the §363 process.

1. Failing to Avoid Valuation Disputes. A §363 sale is typically an "as is, where is" sale. However, because the balance sheet of the company will change, for example, with respect to accounts receivable and inventory amounts from the period marketing first occurs to final sale, valuation disputes can stymie the process. Any delay due to a dispute over the value of inventory or collectability of receivables can radically devalue assets because time is the enemy of the seller in a §363 sale. Valuation issues, however, are avoidable through provisions in an APA that limit purchase price adjustments based on changes in inventory, accounts receivable and other assets of the estate that are quantifiable and not subject to debate.

> *While the §363 process has its challenges, a §363 sale, if handled properly, can result in a "win-win" for employees of the company and for its creditors.*

2. Glossing over Ownership Issues. In the rush to sell the assets, management may overlook liens on property preventing their sale or other legal restrictions on the assets. If ownership is wrongfully assumed to exist, then the buyer will typically obtain a dollar-for-dollar reduction for these assets, and the added profit on these assets resulting from the auction may be wiped out. Developing a solid fact base with respect to ownership of assets of the estate, as well as potential challenges to ownership rights, is an absolute necessity in the §363 process.

3. Failing to Address Employee Issues Properly. In addition to selling assets in a §363 sales, the company is also being sold as a going concern, and employee retention is key to the value of the enterprise. Employees can be the company's most important asset and also its largest liability, due to severance and other costs that may arise from the sale of the company. How an employee retention plan is structured can have an enormous impact on whether the §363 sale is successful. Is the retention plan structured so that employees who are hired by the buyer do not receive severance? How are stay bonuses set to ensure employees stay not only through the sale but also are available to provide a smooth transition to the buyer? Does the retention plan supersede prior severance plans of the company to minimize severance claims? Does the buyer assume other liabilities relating to retained employees such as accrued vacation liability? These are only a few of the many questions that must be answered with respect to retained employees for the §363 sale to maximize value. Furthermore, to allow a company to have sufficient funds to survive in bankruptcy and sell its assets, certain employees may need to be terminated. Excess employees are ordinarily terminated pre-petition to reduce liability to the company. Such terminations create tremendous instability, and retention programs need to be launched early in the bankruptcy process to offset the uncertainty and fear created by these terminations and other destabilizing factors.

4. Neglecting Post-sale Costs. Post-sale expenses can have a major impact on sale proceeds to the creditor constituencies. Through cooperation agreements, such expenses can be minimized. For example, the debtor company may need access to a huge number of documents. The right to access these documents, in lieu of moving and storing hundreds of crates of documents in an off-site facility, will help maximize the yield from the §363 sale. A pre-sale transition service agreement with the buyer also can help minimize costs to the debtor company post-sale.

5. Inadvertently Chilling §363 Bidding Through Selection of the Stalking Horse. Many §363 sales involve identification of an initial bidder, known as the stalking horse, that enters into an APA and is entitled to a variety of benefits for being the initial bidder, including a break-up fee, expense reimbursement up to a cap and minimum increments for overbids. The company/firm selected as the stalking horse and how they are selected will have a tremendous impact on subsequent bidding. Is it more beneficial for the stalking horse to be a financial buyer or a strategic buyer? Should managers allow the selection of the stalking horse to turn into a mini-auction? What is the appropriate level of break-up fees and overbid amounts? The answers to these questions, among many others, will determine whether a robust auction occurs that drives the purchase price to unexpectedly high levels.

6. Ignoring Special Issues. Tax and intellectual property issues, as well as certain legal claims, create special problems in a §363 sale. For example, §363 orders typically provide that transfer and sales taxes will not apply to the sale. Yet states may pursue such taxes, and the seller needs indemnification protection from expenses and costs arising from such claims. Licenses of intellectual property present special concerns regarding whether the right to use the asset is transferable and whether the right to royalties can be expunged. Another area fraught with hazards is potential claims, including employment and product-liability claims. While the company property is transferred free and clear of "interests" such as liens, mortgages and other interests, it is not clear that a claim is an "interest." Whether the debtor company remains responsible for claims depends, in part, on proper notice of the sale and notice to potential claimants. With respect to future product liability with yet-to-be-identified claimants, notice to potential claimants becomes more problematic. This issue has been addressed, in the asbestos context, through appointment of a representative for future claimants, an approach that may be adopted for other types of product-liability claims as well.

7. Not Addressing Existing Management's Inability to Maximize Value in a §363 Sale. A §363 sale can only maximize value with effective management. The process requires the coordination of numerous professionals, employees and other constituents of the company. Someone needs to lead the process who understands it and can coordinate the work of attorneys, financial advisors and employees of the company, as well as the attorneys and financial advisors for numerous creditor groups. If this leadership is not present, the process flounders.

This leadership is almost never present in the company. The pre-bankruptcy managers in the company are highly unlikely to understand the §363 process and its pitfalls. If existing management is not replaced or supplemented, management inexperience can create lost focus in company operations, as well as instability and departure of key employees, resulting in significant devaluation of the company. The managers may also have an interest in working for a particular company post-sale and can surreptitiously undermine the whole bidding process. At a minimum, the existing managers will have been involved in a prolonged fight to keep the company out of bankruptcy and are likely to be "burned out." A top-notch interim manager who has managed through a chapter 11 and has led a §363 process is often the difference between success and failure in the sale of the company.

While the §363 process has its challenges, a §363 sale, if handled properly, can result in a "win-win" for employees of the company and for its creditors. However, the process is unlike other sales processes; it has its own obstacles and traps for the unwary. With proper planning, the §363 process can yield optimal results for the company and its constituencies in a quick and painless fashion.

Footnotes

[1] Rob Steinberg is a director of Catalyst LLC, a turnaround and interim management firm. Return to article

---

Back