

WHAT BUYER'S COUNSEL NEEDS TO KNOW ABOUT BANKRUPTCY SALES

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Overview of the Sale Provisions of the Bankruptcy Code

Among other things, Section 363¹ of the Bankruptcy Code authorizes a bankruptcy trustee, or a Chapter 11 debtor-in-possession, to sell bankruptcy estate assets outside of the ordinary course of business free and clear of all liens, claims and encumbrances.

Section 363(f)² sets out the requirements for a sale free and clear of liens, claims

¹ Section 363(b) provides that:

(b) (1) The trustee [or debtor-in-possession], after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate, except that if the debtor in connection with offering a product or a service discloses to an individual a policy prohibiting the transfer of personally identifiable information about individuals to persons that are not affiliated with the debtor and if such policy is in effect on the date of the commencement of the case, then the trustee may not sell or lease personally identifiable information to any person unless—

(A) such sale or such lease is consistent with such policy; or

(B) after appointment of a consumer privacy ombudsman in accordance with section 332, and after notice and a hearing, the court approves such sale or such lease—

(i) giving due consideration to the facts, circumstances, and conditions of such sale or such lease; and

(ii) finding that no showing was made that such sale or such lease would violate applicable nonbankruptcy law.

² Section 363(f) provides that:

(f) The trustee may sell property under subsection (b) or (c)

and encumbrances. A discussion regarding the satisfaction of these requirements is beyond the scope of this seminar.

Notably, there is nothing in Section 363 that requires a bankruptcy sale to be by public sale with competitive bidding. Rather, Bankruptcy Rule 6004(f)(1) specifically provides that “all sales not in the ordinary course of business may be by private sale or by public auction.”

Similarly, there is nothing in the Bankruptcy Code or the Bankruptcy Rules that discuss sale procedures, bidder protections, higher and better bids, back-up bids or other matters that routinely arise in bankruptcy sales. Rather, all of these matters have developed over the years through practical experience by practitioners and courts.

Advantages of Buying Assets from a Bankruptcy Estate

From a buyer’s perspective, there are several significant advantages of buying assets from a bankruptcy estate through a Section 363 sale.

For example:

- A purchaser will take title to the assets free and clear of any “interests” of a third party in the assets (*e.g.*, liens, claims, and encumbrances) pursuant to a federal court order.
- Generally, a buyer of assets under § 363 can avoid the potential risks of assuming a seller’s liabilities that a purchaser of assets may be subject to, outside of bankruptcy, under theories such as the “mere continuity doctrine,” “substantial continuity doctrine,” “successor liability doctrine,” “de facto merger doctrine,” and the Bulk Sale Act that purchasers of substantially all

of this section free and clear of any interest in such property of an entity other than the estate, only if—

- (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
- (2) such entity consents;
- (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
- (4) such interest is in bona fide dispute; or
- (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

of an insolvent business's assets will inherit some or all of the business's liabilities.

- A bankruptcy order approving a sale can bind non-consenting constituents and other parties that may have an interest in the property. For example:
 - Some corporate bylaws require the approval of a majority of shareholders in order to sell substantially all of the assets of a company. In bankruptcy, such provisions generally will not prevent the sale of assets free and clear of those requirements.
 - Section 363(h)³ allows for the sale of a non-debtor co-owner's interest in estate property under certain circumstances.
- Pursuant to Section 365 of the Bankruptcy Code, a purchaser will be able to assume beneficial unexpired leases and executory contracts while cumbersome agreements can be rejected with no liability to the buyer.

Disadvantages of Buying Assets from Bankruptcy Estates

There are some disadvantages for a buyer in a Section 363 bankruptcy sale, as well. For example,

³ Section 363(h) provides that:

(h) Notwithstanding subsection (f) of this section, the trustee may sell both the estate's interest, under subsection (b) or (c) of this section, and the interest of any co-owner in property in which the debtor had, at the time of the commencement of the case, an undivided interest as a tenant in common, joint tenant, or tenant by the entirety, only if—

(1) partition in kind of such property among the estate and such co-owners is impracticable;

(2) sale of the estate's undivided interest in such property would realize significantly less for the estate than sale of such property free of the interests of such co-owners;

(3) the benefit to the estate of a sale of such property free of the interests of co-owners outweighs the detriment, if any, to such co-owners; and

(4) such property is not used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light, or power.

- The Court will usually require a public auction with competing bids.
- Because the sale must be noticed to interested parties, and almost always must be subject to pre-sale marketing efforts by the seller, the sale of assets will be publicly and widely known. Sometimes, this may engender negative publicity that could have a negative effect on the business operations.
- Because of the noticing requirements, competitive bidding process, potential objections to the sale by secured creditors and other constituents, and the sale procedures usually adopted by a bankruptcy court, Section 363 sales can often take a long time and cost more than a sale outside of bankruptcy.

Sale Procedures and Process

The primary goal for a bankruptcy seller in a bankruptcy sale is to maximize the recovery and benefits to the bankruptcy estate and the seller's creditors. This goal, of course, is not always aligned with the buyer's goal of getting the best deal possible for the assets. Therefore, the buyer and the seller frequently negotiate the processes and procedures for conducting the bankruptcy sale.

In this regard, because there are no general rules of procedure governing the process and procedures for conducting bankruptcy sales under Section 363—other than certain timing requirements--bankruptcy courts generally have considerable discretion in conducting sales.

Note that some local rules address bankruptcy sales that can vary widely from jurisdiction to jurisdiction. In Arizona, the local rules mainly address the filing and noticing processes and are silent on the procedures governing the auction process.

Stalking Horse Bidders, Bidder Protections and Stalking Horse Fees

While it is possible for a trustee or debtor in possession to seek authority to sell assets without an existing purchase offer, that is unusual.

Rather, a bankruptcy sale most often starts with an offer from an initial bidder—the “stalking horse” bidder. Below are some suggestions for what should be included in the LOI and, ultimately, the purchase and sale agreement.

The stalking horse bidder is important to the sale process because its opening offer is the catalyst for competing bids and the maximization of value to the estate and creditors.

Typically, the stalking horse bidder will incur costs and time engaging in due diligence, lining up financing, and negotiating a purchase agreement. In doing so, the

stalking horse bidder is risking that it will be the successful bidder at the public auction sale.

Therefore, to encourage a prospective buyer to be a stalking horse bidder and take those financial risks, a bankruptcy seller will frequently offer certain bidder protections to the opening bidder. These incentives and protections may include certain stalking horse fees, in addition to exclusivity rights, overbid requirements, etc. outlined below in the discussion regarding the LOI.

Stalking horse fees are designed to encourage the stalking horse bidder by compensating it in the event it is not the successful bidder at the auction sale. There are several types of stalking horse fees, such as:

Expense reimbursements are payments to the initial bidder to reimburse it for its out of pocket fees and expenses. Sometimes these fees are subject to a negotiated cap. These fees are usually not controversial and are routinely approved by courts as an incentive for stalking horse bids.

A break up fee is similar to an expense reimbursement. It is paid to a stalking horse bidder in the event that the contemplated transaction fails to be consummated and/or that certain criteria in the purchase agreement are not met. The most common condition giving rise to the payment of a break-up fee is the seller's acceptance of a subsequent bid at the auction sale. Break up fees are also sometimes payable if, for a reason outside of the stalking horse bidder's control, the Court fails or refuses to approve the sale (*e.g.*, the seller was unable to satisfy the conditions of a free and clear sale under Section 363(f)).

A topping fee is an amount payable to the initial bidder equal to a certain percentage of the amount by which a prevailing bid from a competing bidder exceeds the initial bidder's offer.

The tests for approving these fees vary from jurisdiction to jurisdiction, and even from court to court. Note also that the United States Trustee's Office will often weigh on the approval of stalking horse fees.

Some courts hold that the entitlement to stalking horse fees should be determined simply under the "business judgment rule," just as they would outside of bankruptcy.

Other courts have established certain tests for considering whether to approve stalking horse fees, such as: (1) whether the relationship between the parties was tainted with self dealing; (2) whether the break-up fee hampers, rather than encourages, bidding; and (3) whether the fee is unreasonable in relation to the proposed purchase price.

Other courts look to whether the fees serve the best interests of the bankruptcy

estate. In this regard, several factors are examined, such as whether: (1) the requested fee correlates with a maximization of value to the debtor's estate; (2) the terms were negotiated at arm's length; (3) the requested fees were supported by the secured and unsecured creditors of the estate; (4) the requested fees were reasonable and fair in relation to the proposed purchase price; (5) the break-up fee was so substantial that it would "chill" bidding; (6) safeguards beneficial to the debtor's estate existed; and (7) unsecured creditors would be adversely impacted by objecting to requested fees.

In Arizona, the seminal case on break-up fees is *In re America West Airlines*, 166 B.R. 908, 912 (Bankr. D. Ariz. 1994), which found that:

the Court must take into consideration what is in the best interests of the estate. *In re Wilde Horse Enterprises, Inc.*, 136 B.R. 830, 841 (Bankr.C.D.Cal.1991). As stated, the standard 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 Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir.1983). The proposed break-up fee must be carefully scrutinized to insure that the Debtor's estate is not unduly burdened and that the relative rights of the parties in interest are protected. *In re Hupp Industries, Inc.*, 140 B.R. 191, 196 (Bankr.N.D.Ohio 1992). The analysis conducted by the Court must therefore include a determination that *all* aspects of the transaction are in the best interests of all concerned.

It is prudent for the stalking horse bidder to require that any stalking horse fees approved by the Court and that are ultimately payable to the stalking horse bidder be (a) paid from the sale proceeds and/or (b) be allowed as administrative claims against the bankruptcy estate, so that they are paid with priority over other claimants.

The seller and the buyer should (a) include these bidder protections in the purchase and sale agreement that is to be approved by the bankruptcy court and (b) specifically request in the sale motion, discussed below, that the court approve the protections prior the sale.

What to Include in a Letter of Intent and PSA as a Stalking Horse Bidder

The following bankruptcy related provisions are samples of what should, or may be, included in an LOI, and a PSA, when purchasing assets from a bankruptcy estate:

- **Bankruptcy Court Approval.** "Buyer's purchase of the Property shall be subject to approval by the United States Bankruptcy Court for the District of _____ ('Court') in the Seller's Chapter ___ bankruptcy case, Case No. _____ ('Bankruptcy Case')."

- **Bankruptcy Court Auction:** “Buyer acknowledges that the sale of the Property shall be pursuant to Section 363 of the United States Bankruptcy Code (‘Bankruptcy Code’); that the sale may be subject to a public auction (‘Auction’) to be held by the Court in the Bankruptcy Case; and that the Court will establish certain procedures (‘Auction Procedures’) for the conduct of the Auction. The Auction Procedures shall be acceptable to Buyer. Seller shall, promptly following the execution of this LOI, seek approval of the Auction Procedures and the sale of the Property by Auction, with Buyer identified as the ‘stalking horse bidder’ pursuant to the terms of this LOI and subject to the Auction and the entry of the Sale Order (defined below).”

- **Stalking Horse Bidder Protections:** “The Auction Procedures to be approved by the Court shall include the following bidder protections for the Buyer as the ‘stalking horse bidder’:
 - a. **Expense Reimbursement:** Buyer shall be entitled to be paid the sum of \$_____ (the ‘Expense Reimbursement’) from the proceeds of any sale of the Property in the event that a bidder other than Buyer is the successful bidder for the purchase of the Property at the Auction and such higher bidder closes the purchase of the Property.

 - b. **Other stalking horse fees.** Discussed above.

 - c. **Competing Qualified Bids:** In order to be a qualified overbid, any other bid (‘Qualified Bid’) for the purchase of the Property must be (a) submitted to the Seller within ten (10) business days prior to the Auction, (b) be accompanied by a form of asset purchase agreement in substantially the form approved by the Court pursuant to the Auction Procedures (‘PSA Form’) and marked to show any differences with the PSA Form, (c) be accompanied by an earnest money deposit in the amount of \$_____ to be deposited with the Escrow Holder and which shall be refundable if the bidder is not the successful bidder at the Auction, and (d) in an amount equal to or greater than the sum of (i) the Buyer’s opening bid of \$_____, (ii) the Expense Reimbursement, and (iii) \$_____ (the ‘Initial Overbid Amount’).

 - d. **Overbids at Auction:** “Overbids at the Auction shall be in increments of \$_____ over the Initial Overbid Amount.”

- **Sale Order:** “The sale of the Property to the Buyer shall be free and clear of all liens and encumbrances pursuant to an order of the Court (the “Sale Order”) pursuant to Section 363 of the Bankruptcy Code the form of which

shall be subject to Buyer's approval."

- **Execution of PSA:** "Buyer and Seller shall execute a binding purchase and sale agreement ('PSA'), with no contingencies other than Court approval as stated herein, on or before _____ ('Execution Date')."
- **Due Diligence Period.** "Seller shall complete its due diligence with respect its purchase of the Property on or before _____."
- **Exclusivity:** "Following execution of this LOI and ending upon the Execution Date if, but only if, Buyer has not executed the PSA, Seller shall not actively seek or solicit alternative bids for the sale of the Property and shall not enter into any agreements for the sale of the Property to any other potential buyer unless or until Buyer terminates or defaults under the PSA pursuant to its terms. Nothing herein, however, shall preclude, prevent or limit Seller from responding to inquiries regarding the sale of the Property and providing due diligence information and access to the Property as requested by other potential bidders."
- **Brokerage Commission.** "Subject to Bankruptcy Court approval as part of the Auction Procedures, and if Buyer is the successful bidder at the Auction, Seller agrees to pay [broker commission]."

Approval of the Sale Procedures, Bidder Protections, and Sale

Once the parties negotiate the LOI, then the seller's counsel will file a motion requesting that Court (a) approve bidding and auction procedures for the sale, including the approval of any bidder protections, as discussed above, (b) authorize the sale, and the assignment of contracts and lease, if any, pursuant to the terms of the LOI (sometimes the purchase and sale agreement will have been negotiated and drafted by this time, also), (c) set dates and times for objections to the sale and (d) set a date and time for the auction sale.

Importantly, the sale motion should be noticed to all interested parties in the bankruptcy case, including creditors, other parties to contracts and leases, and any interest holders. These parties need to have notice of the sale in order to be bound by the ultimate sale order.

Public Auction, Competing Bids, Highest and Best Bid, and Back-Up Bids

Although there are rare exceptions, Section 363 sales are typically conducted as public auctions. Again, this is designed to ensure that the assets are properly exposed to the market and to maximize the recovery to the estate and creditors.

In Arizona, the bankruptcy sale auction is most commonly conducted before the court, with the bankruptcy judge acting as auctioneer. However, the auction may be conducted on site by an auctioneer, by an investment banker at its office, or in any other public venue.

Oftentimes, the sale procedures approved by the court will require that competing bidders be pre-qualified to bid at the auction sale. This is designed to ensure that only real and capable bidders bid at the auction. The pre-qualification requirements may include, for example, proof of the financial ability to pay the purchase price, the execution of a purchase and sale agreement similar to the stalking horse bidder's agreement, an earnest money deposit that is refundable if the bidder is not the successful bidder, etc.

Ordinarily, the sale procedures will require a specific "over bid" to start the bidding process. This initial over bid will be at least the amount of the stalking horse bid plus the amount of any approved stalking horse fee plus an established minimum bid increment. This will ensure that the bankruptcy estate will recover more from the initial bid than from the stalking horse bid. Subsequent bids should also be subject to a minimum bid increment.

Once bidding has concluded, the seller will inform the Court of its determination of the highest and best bid and will request that the Court approve the sale to that bidder.

Sometimes the highest and best bid is not the highest amount of money offered. For example, if there are contingencies in a competing bidder's bid (due diligence, financing, licensing approval by third parties, etc.) or if the bid is payable over time rather than immediately upon closing, then the seller may choose a lower priced bid as the highest and best bid.

The Court will typically ask unsuccessful bidders if they would like to have their last bid be a back-up bid in case the successful bidder fails to close the transaction for any reason. The seller and the court should only approve the back-up bidders' last bid as a back-up bid. It would be foolish to allow a back-up bidder to revert to any of its prior bids.

Sale Free and Clear of Liens, Claims and Encumbrances

Section 363(f) provides that, so long as certain conditions are satisfied, a bankruptcy sale will be "free and clear of any interest in such property of an entity other than the estate." Consequently, if a sale is approved, then the buyer will take the property free and clear of any liens, claims and encumbrances and all such liens, claims and encumbrances will attach to the sale proceeds.

However, there are some potential claims against the seller's bankruptcy estate that may survive a Section 363 sale and may impact a buyer. A discussion of those types of

claims is beyond the scope of this presentation, but a buyer should be wary of third parties' "interests" that may not be included in Section 363(f) and that will follow the assets. For example, certain licensing requirements, environmental compliance requirements and claims, toxic tort claims, labor liabilities, etc. may not be "interests" that are eliminated by a Section 363 sale order.

A prudent buyer's lawyer will make sure that these issues are raised during the sale process and that the order approving the sale specifically addresses the issues.

Dealing With Title Companies

Some, but not all, title companies are familiar with Section 363 sales, and will close a transaction and issue a title policy to the buyer based upon the bankruptcy court's order that approves the sale and provides that the sale is free and clear of liens, claims and encumbrances.

Nevertheless, it is prudent and a best practice that the buyer get the title company involved early in the sale process and to have the title company approve the form of order authorizing the sale before it is submitted to the court.

Assumption and Rejection of Contracts and Leases

Among other things, Section 365(f)⁴ of the Bankruptcy Code authorizes a trustee or a debtor in possession to assign unexpired leases and executory contracts to third parties, even if those agreements contain provisions limiting or prohibiting the assignability of the agreement.

Section 365 also allows a debtor to reject unexpired leases and executory contracts

⁴ Section 365(f) provides as follows

(f)(1) Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.

(2) The trustee may assign an executory contract or unexpired lease of the debtor only if—

(A) the trustee assumes such contract or lease in accordance with the provisions of this section; and

(B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

that are burdensome to the debtor's estate. If the debtor rejects an agreement, then the bankruptcy estate, not the buyer, will be responsible for any damages arising out of the rejection.

These provisions of Section 365 can be very beneficial to a buyer because it will be able to assume beneficial agreements and avoid the burdens of any undesirable agreements.

In order to assign an agreement to a buyer, (a) the trustee or debtor must first "assume" the agreement pursuant to Section 365(b)⁵ by **curing prior defaults under the agreement** and (b) the assignee/buyer must provide "adequate assurance" of the assignee's future performance under the agreement.

⁵ Section 365(b) provides as follows:

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.

Note that Section 365(c)⁶ provides that certain executory contracts and unexpired leases cannot be assigned, but those exclusions are relatively limited.

It is important that (a) the purchase and sale agreement specifically identify which agreements will be assumed by the buyer, (b) the sale motion specifically identify the agreements that will be assumed and those that will be rejected, and (c) that all parties to the agreements, whether assumed or rejected, be provided with notice of the assumption and assignment or rejection.

Good Faith Purchaser Protections under § 363(m)

Section 363(m)⁷ provides that a “good faith” buyer is protected in the event that a

⁶ Section 365(c) provides:

(c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(1) (A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment; or

(2) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor; or

(3) such lease is of nonresidential real property and has been terminated under applicable nonbankruptcy law prior to the order for relief.

⁷ Section 363(m) provides that:

(m) The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale

Section 363 sale order is reversed on appeal.

Section 363(m) is designed to ensure finality of bankruptcy sales for the benefit of both buyers and the debtor's bankruptcy estate.

In order for the protection to be enforced, the sale motion and any accompanying declarations, as well as the final sale order, should include provisions demonstrating that the buyer is, in fact, a "good faith" buyer.

For example, the sale motion should include facts demonstrating, and the sale order should make specific findings, that the purchase and sale agreement between the seller and buyer was negotiated at arms-length and that the buyer is unrelated to the debtor.

The Sale Order

Importantly, the following terms should be included in the order approving the sale of assets:

- It must authorize the trustee or debtor-in-possession to sell the assets pursuant to the terms of the purchase and sale agreement and Sections 363 and 365 of the Bankruptcy Code.
- It must refer to and specifically incorporate the terms of the purchase and sale agreement and provide that the parties are bound by its terms.
- It must provide that the sale is free and clear of all liens, claims and encumbrances pursuant to Section 363 of the Bankruptcy Code.
- It must provide for the assumption and assignment of any executory contracts or unexpired leases pursuant to Section 365 of the Bankruptcy Code.
- It must provide that the sale of the assets to the buyer, and the buyer's purchase of the assets, are in good faith and that the buyer is entitled to the protections of Section 363(m) of the Bankruptcy Code.
- It should provide that the seller is authorized to execute any documents necessary to consummate the sale of the assets pursuant to the terms of the sale order and the purchase and sale agreement.
- It should provide that the consideration to be provided by the buyer pursuant to the sale (i) constitutes reasonably equivalent value and fair consideration for the assets transferred and (ii) is fair and reasonable and may not be avoided under Section 363(n) or any other provision of the Bankruptcy Code or otherwise.
- It should provide that the bankruptcy court retains exclusive jurisdiction to hear, determine and resolve any and all matters arising from the sale or the

or lease were stayed pending appeal.

sale order.