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Bankruptcy Code Section 363 Sales: Review of "Free and Clear" Requirements & Successor Liability Issues

WEDNESDAY, MAY 26, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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BANKRUPTCY CODE SECTION 363 SALES:

REVIEW OF "FREE AND CLEAR" REQUIREMENTS & SUCCESSOR LIABILITY ISSUES

May 26, 2021

Presented By:

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Review of 363 Basics

COMMON TERMS

Section 363 Sale – Sale of all or a portion of the assets of a debtor outside the "ordinary course of business"	**Bid Protections** – Break-up fees, bidding increments, expense reimbursement, consent and review rights.
Credit Bid – Purchase price bid by secured creditors reduced by amount of secured creditors' claim	**Fraudulent Transfer** – Transfer of property of the debtor where the debtor either (i) intended to "hinder, delay, or defraud any entity to which the debtor was or became … indebted," or (ii) received less than "reasonably equivalent value" while insolvent
Stalking Horse Bidder – Bidder for a debtor's assets, typically selected by the debtor to provide the initial starting bid in either a Section 363 or Plan Sale	**Liquidation** – Complete sale of debtor's assets and distribution of proceeds to creditors and interested parties according to the priority scheme established by the Bankruptcy Code

363 SALE OVERVIEW

- Section 363(b) allows a chapter 11 debtor to sell all or a portion of its assets outside of the ordinary course of business “after notice and a hearing”
- Established process involves:
  - Execution of Asset Purchase Agreement with a “stalking horse” bidder
    - First lien creditors often present a stalking horse credit bid
  - Filing of a motion with the Bankruptcy Court seeking approval of (i) bidding procedures, which set forth the rules with respect to the solicitation of other bids, and (ii) the sale of assets to either the stalking horse bidder or other bidder that provides a higher *or* better bid
  - Extremely broad notice of proposed sale to stalking horse is provided, including to all creditors and relevant state and regulatory agencies

KEY PROCESS DIFFERENCE BETWEEN DISTRESSED AND HEALTHY SALES

- Court process creates a forum for each of the key stakeholders to participate and advance their own respective interests in connection with the sale; thus, negotiations involve multiple parties rather than just a buyer and a seller
- Timelines often driven by liquidity runways and milestones imposed by secured lenders in connection with “DIP Financing” and/or “Restructuring Support Agreement”
- Initial “stalking horse bid” is used as a floor to shop assets for a better price and non-binding on the chapter 11 debtor until the court approves the sale

Process Overview

Sale Process Overview

PROCESS PHASE	COMMENTS
Market Assets	■ Marketing process is similar to that for non-distressed companies, though time pressure may be greater ■ Limiting the initial buyer universe can accelerate the process, although fewer bidders may result in lower initial bids and raise objections regarding whether the marketing process was sufficiently robust ■ In some cases, there are relatively few easily identifiable potential acquirors ■ Prospective buyers may attempt to "cherry-pick" assets and liabilities ■ Coordination with investment bankers is necessary

Select Stalking Horse Bidder	■ Bids are solicited from parties showing the greatest interest and ability to move quickly
	■ Often, it is advantageous to sign up a "Stalking Horse" bid which represents the starting point for the auction process (required in most bankruptcy sales)
	  ■ Stalking Horse bidders often receive a break-up fee in the event their bid is topped
	  ■ Typically, Courts approve break-up fees of approximately 3%, plus the reimbursement of reasonable and documented expenses
	■ After parties conduct due diligence, the most attractive bid is selected, and an Asset Purchase Agreement is negotiated and signed
	■ An Asset Purchase Agreement is subject to Court approval

Establish Bidding Procedures & Approve Break-up Free	■ The Stalking Horse bid and procedures for the auction are submitted to the Court ■ The Stalking Horse bidder often influences the bidding procedure terms ■ The procedures lay out deadlines and the rules for bidding (such as the minimum bid above the Stalking Horse bid and the bidding increments) ■ They define what qualifies a bidder to participate in the auction process ■ Often, a bidder is required to prove financial ability to execute a purchase by disclosing sources of funding and paying a deposit
Auction	■ The auction takes place according to the bidding procedures established by the Court
Receive Bankruptcy Court Approval of Sale	■ During the auction, bids are evaluated and the best bid is determined ■ An Asset Purchase Agreement is signed and submitted to the Court for approval
Close Transaction	■ Following Court approval and fulfillment of closing conditions, the transaction closes

Chapter 11 petition may be filed in this window

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BIDDING PROCEDURES

- Objectives
  - Maximize consideration to seller and fairly protect stalking horse – criteria is “highest and best” (i.e., cash is great, but ability to close may be more important even if less consideration)
- Customary provisions
  - Criteria to be a “qualified bidder”
    - Execution of confidentiality agreement and evidence of financial wherewithal
    - Timely delivery of a qualified bid
  - Minimum requirements for a “qualified bid”
    - Cash deposit
    - Signed purchase agreement
    - No conditions beyond those in stalking horse agreement
    - No break-up fee
    - Satisfaction of initial minimum overbid requirement
  - Bidders may join forces
  - Bid deadline and proposed auction date
  - Minimum bidding increments at the auction

BID PROCEDURES ORDER (STEP 1 OF COURT PROCESS)

- In addition to approving Bidding Procedures, entry of a Bidding Procedures Order allows the following to progress:
  - HSR Filings: potential stalking horse bidder and debtor can trigger start of 15-day HSR waiting period; other bidders may use bids to file for HSR approval as well
  - Contract Assumption/Assignment Process:
    - Section 365 of the Bankruptcy Code invalidates most assignment consent rights in executory contracts and allows debtors to “assume” an executory contract and “assign” contract to buyer
    - Note: need to identify vital intellectual property licenses, government contracts and other agreements where the general invalidation of anti-assignment provisions may not apply
    - Must cure monetary defaults (generally unpaid amounts from prior to the bankruptcy case) to assume/assign contracts and important for drafting to address who is responsible for making these “cure” payments

THE SALE HEARING AND SALE ORDER (STEP 2 OF COURT PROCESS)

- Generally the debtor's management is entitled to deference in its decision to sell assets
  - Creditors (including the creditors' committee and other major creditors or creditor groups) and their views are given significant weight by the Bankruptcy Court
- The form of Sale Order typically includes findings and provisions that offer significant buyer protections, including that:
  - The consideration is adequate and represents "fair value" (thereby protecting the buyer from a subsequent fraudulent transfer allegation)
  - Making the sale free and clear of liens and interests
  - Insulating the transaction from collateral attack by finding that the buyer acted in "good faith"
  - Prohibiting successor liability, as discussed in detail later

THE SALE HEARING AND SALE ORDER (CONT'D)

- The purchase agreement sometimes requires entry of a "final" sale order as a condition precedent; the order remains subject to appeal for 14 days
- The parties often choose to waive the requirement that the sale order become final and close immediately after entry of the order; closing often moots a subsequent appeal, but recent case law indicates a trend against categorical dismissals on the basis of mootness
- Notwithstanding the mootness of an appeal, under §363(m), reversal or modification of a 363 sale order "does not affect the validity of a sale … to an entity that purchased … in good faith"

Free and Clear Requirements

SECTION 363(f)

- Bankruptcy Code Section 363(f) allows for a debtor to sell assets “free and clear of any interest in such property of an entity other than the estate” in five scenarios:

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

- Statute focuses on the interests, not the assets

- Large and complex sales often require the use of a “waterfall” of 363(f) justifications to cleanse all interests from all assets

WHAT ARE "INTERESTS"

- 363(f)(3) strongly suggests "interests" means more than "liens"
- Easy: *In rem*
  - Liens, leases, easements
- Less obvious but accepted by majority
  - Successor liability & certain environmental claims
  - "Some courts have narrowly interpreted interests in property to mean *in rem* interests in property, such as liens. . . . [T]he trend seems to be toward a more expansive reading of 'interests in property' which 'encompasses other obligations that may flow from ownership of the property.'" In re Trans World Airlines, Inc., 322 F.3d 282, 288-89 (3d Cir. 2003) (quoting 3 Collier on Bankruptcy ¶ 363.06[1]).

363(f)(2) – CONSENT

- The ideal and most straightforward way
- Failure to object after receipt of due notice can equate to consent in almost all jurisdictions
- What constitutes "consent" in the context of a syndicate of lenders typically means consent from some majority of lenders, but not necessarily unanimous consent
  - Pre-filing review of secured loan documents is critical

363(f)(1) & (5) – APPLICABLE NONBANKRUPTCY LAW AND COMPELLED MONETARY SATISFACTION

- Sections 363(f)(1) and (5) arguably cover similar ground
  - Many nonbankruptcy laws that allow for a sale free and clear of liens also force lienholders to accept monetary satisfaction
- In the aggregate, the sections are useful for clearing out “junior liens” that do not consent
  - a sale may potentially proceed under (f)(1) or (5) over the objection of a second lienholder because its interest could be extinguished in a nonbankruptcy foreclosure proceeding or UCC sale
- Settled law that the 363(f)(5) phrase "could be compelled” contemplates a "hypothetical" proceeding in which a secured creditor could be compelled to accept a monetary satisfaction of its interest, and does not require the sale proceeding itself to provide for actual satisfaction
- Some courts have held that a cramdown proceeding is a "legal or equitable" proceeding for purposes of section 363(f)(5)

EQUITABLE INTERESTS AND SECTION 363(f)(5)

- Under section 363(f)(5), a sale may be free and clear if the party "could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest"
  - In Gouveia v. Tazbir, 37 F.3d 295 (7th Cir. 1994), the court held that if money damages are available upon the consent of those who hold a restrictive covenant, then such persons are not compelled to accept money, and thus § 363(f)(5) does not apply.
  - In In re Trans World, 322 F.2d 283, the court found that a travel voucher and EEOC claims were "subject to monetary valuation," satisfying section 363(f)(5) even though equitable relief was available

363(f)(4) – BONA FIDE DISPUTE

- "Bona fide dispute" is not defined by the Bankruptcy Code
- Entails some sort of meritorious, existing conflict where there is an objective basis for either a factual or legal dispute as to the validity of the asserted interest
  - Ongoing litigation is neither sufficient nor required. See, e.g., In re Revel AC, Inc., 802 F.3d 558, 573 (3d Cir. 2015) (meeting Article III's "case or controversy" requirement does not create a bona fide dispute as it only ensures that plaintiff has standing and a redressable injury).
- Courts have stated that the standard does not require that the court resolve the underlying dispute or determine the probable outcome but merely whether a dispute exists

363(f)(3) – PRICE

- Section 363(f)(3) allows sale free and clear of an interest if "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"
- Camp I: section 363(f)(3) requires the purchase price to exceed the face amount of all secured claims against the subject property
  - E.g., In re Terrace Chalet Apartments, Ltd., 159 B.R. 821, 826 (N.D. Ill. 1993) (alteration in source) (quoting the Seventh Circuit, stating in dicta, "[a]s a general rule, the bankruptcy court should not order property sold 'free and clear of' liens unless the court is satisfied that the sale proceeds *will fully compensate secured lienholders and produce some equity for the benefit of the bankrupt's estate.*")
- Camp II: 363(f)(3)'s mandate means that the purchase price must exceed the "economic value" of the liens encumbering the sale property
  - E.g., In re Beker Indus. Corp., 63 B.R. 474, 476 (Bankr. S.D.N.Y. 1986) (holding that "the term 'value', as used in § 506(a) with respect to the interest of a secured creditor, means its actual value as determined by the Court, as distinguished from the amount of the lien" and applying that meaning to section 363(f)(3))

MODEL 363(f) LANGUAGE

- **Finding of Fact**: The Debtors may sell and assign the Assets free and clear of all Liens, because, with respect to each creditor asserting a Lien, one or more of the standards set forth in Bankruptcy Code sections 363(f)(1)-(5) has been satisfied. Those holders of Liens who did not object or who withdrew their objections to the Sale Transaction are deemed to have consented to the Sale Motion and sale and assignment of the Assets to the Buyer pursuant to Bankruptcy Code section 363(f)(2). Those holders of liens who did object fall within one or more of the other subsections of Bankruptcy Code section 363(f) and are adequately protected by having their Liens, if any, attach to the net proceeds of the Sale Transaction ultimately attributable to the Assets in which such holders allege a Lien, in the same order of priority, with the same validity, force and effect that such holder had prior to the Sale Transaction, and subject to any claims and defenses the Debtors and their estates may possess with respect thereto.

MODEL 363(f) LANGUAGE (CONT'D)

- **Holding**: Effective as of the Closing, the sale and assignment of the Assets by the Debtors to the Buyer shall constitute a legal, valid and effective transfer of the Assets and the Assigned Contracts notwithstanding any requirement for approval or consent by any person, and will vest the Buyer with all right, title and interest of the Debtors in and to the Assets, free and clear of all Liens, pursuant to section 363(f) of the Bankruptcy Code.
- **Definition of Liens**: means any lien, encumbrance, pledge, mortgage, deed of trust, security interest, claim, lease, sublease, charge, option, right of first offer or first refusal, right of use or possession, restriction, easement, servitude, restrictive covenant, encroachment or any other similar encumbrance or restriction in respect of an asset of such the Debtor, whether imposed by law, contract or otherwise.

Successor Liability

SUCCESSOR LIABILITY

- Generally, when a corporation purchases the principal assets of another corporation it does not assume that corporation's liabilities unless it agrees to do so
- State level precedent has provided equitable exceptions to the general rule in various scenarios, including:
  - Transaction amounts to a consolidation or merger
  - Purchaser is a mere continuation of seller
  - Sale has fraudulent purpose of escaping liability
  - Certain product liability scenarios

GENERAL MOTORS, 829 F.3d 135 (2d Cir. 2016)

- Second Circuit adopted majority view that assets could be sold free and clear of successor liability claims but also held that two out of four categories of litigated claims were claims against New GM rather than claims against Old GM that New GM could be liable for under a theory of successor liability

Could Be Sold "Free and Clear"	New GM Potentially Liable
Pre-closing accident claims	Independent claims against New GM
Contingent economic loss claims arising from pre-closing defects	Claims held by post-closing purchasers of used Old GM cars.

- To protect a purchaser from a seller's liability, the "claim must arise from a (1) right to payment (2) that arose before the filing of the petition or resulted from pre-petition conduct fairly giving rise to the claim"
- Analogous to standard utilized in environmental context

GENERAL MOTORS (CONT'D)

- Second Circuit held that the assets of Old GM could have been sold free and clear of pre-closing accident claims and pre-closing contingent economic loss claims, but the holders of such claims were not provided with sufficient notice of the sale
- New GM argued that publication notice was sufficient
- Bankruptcy Court disagreed based on the facts, but enjoined holders of these claims from bringing actions against New GM due to lack of prejudice
- Second Circuit agreed that notice was insufficient, but disagreed with Bankruptcy Court by finding that the claimants were prejudiced by not being at the negotiating table
- Perspective: Subsequent case law reminds us that successor liability is a state law equitable cause of action that is challenging to prove

MODEL LANGUAGE

- **Finding of Fact**: By consummating the Sale Transaction pursuant to the Asset Purchase Agreement, the Buyer is not a mere continuation of any of the Debtors or any Debtor's estate, and there is no continuity of enterprise or otherwise or common identity between the Buyer and any Debtor. The Buyer is not holding itself out as a continuation of any Debtor. The Buyer is not a successor to any Debtor or any Debtor's estate by reason of any theory of law or equity, and the Sale Transaction does not amount to a consolidation, merger or de facto merger of the Buyer and the Debtors or any of their estates. Neither the Buyer nor any of its affiliates or their respective successors, assigns, members, partners, principals or shareholders (or the equivalent thereof) shall assume or in any way be responsible for any obligation or liability of any Debtor (or any affiliate of any Debtor) or any Debtor's estate, except as expressly provided in the Asset Purchase Agreement. The sale and transfer of the Acquired Assets to the Buyer will not subject the Buyer to any liability with respect to the operation of the Debtors' businesses prior to the Closing or by reason of such transfer, except that, upon the Closing, the Buyer shall remain liable for the applicable Assumed Liabilities (as defined in the Asset Purchase Agreement).

MODEL LANGUAGE (CONT'D)

- **Holding**: The Buyer and its affiliates and their respective predecessors, successors, assigns, members, partners, officers, directors, principals and shareholders (or equivalent) are not and shall not be (a) deemed a "successor" in any respect to the Debtors or their estates as a result of the consummation of the Sale Transaction contemplated by the Asset Purchase Agreement or any other event occurring in the chapter 11 cases under any theory of law or equity, (b) deemed to have, de facto or otherwise, merged or consolidated with or into the Debtors or their estates, (c) deemed to have a common identity with the Debtors, (d) deemed to have a continuity of enterprise with the Debtors or (e) deemed to be a continuation or substantial continuation of the Debtors or any enterprise of the Debtors.


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