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Bankruptcy 101 for Investors: Acquiring a Debtor's Assets in a Bankruptcy Case

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The first article in this series discussed the immediate impact of a bankruptcy filing on investors and creditors, including the scope of the automatic stay and early case events. This article focuses upon the disposition of a debtor's assets and business as the result of a bankruptcy filing: how and when the assets or business may be sold, and what to do if you want to buy them.

This issue may arise if one of your portfolio companies runs out of cash or time, and has to seek bankruptcy protection but where you still like the patented technology or the long-term business prospects – if only you could get the assets out from under the company's debt load, into the hands of new management, or supported by a new business plan. Or perhaps you have had your eye on some promising technology or other assets held by another company, but you would be interested in investing – but only if the assets you want were separated from the current owner and management team, and only if you could acquire them without becoming liable for the company's debts and other obligations.

The following is a general overview of acquiring assets out of bankruptcy cases. This is a realm of special rules, obstacles and risks, so beware. On the other hand, the "second life" of many former chapter 11 debtors or their assets has sometimes been much more rewarding than the first.

I. Types of Buyers in Bankruptcy Sales

Most companies sell at least some assets during their bankruptcy cases. Many sell all of their assets, either as a going concern or piecemeal. Generally, three types of buyers pursue business assets that are tied up in bankruptcy cases.

- Insiders or other current investors or creditors who know the business and its assets better than anyone else and who still believe in their potential;
- Financial investors who see an opportunity for a significant future return on their investment, if they can buy the assets at a bargain price; or
- Strategic investors, including competitors or others already in the same business, who usually plan to use the assets in combination with their own on-going business.

Buying assets out of a bankruptcy case has one significant advantage: the buyer can obtain an order transferring title "free and clear" of any liens, claims or interests. A sale "free and clear" generally precludes successor liability, provided that the deal is properly structured.

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II. Possible asset dispositions in chapter 11 cases

The debtor's overall exit plan determines when and how assets come to market in chapter 11 cases.

You can usually learn whether the debtor intends to sell its assets immediately or try to reorganize as a standalone company from reading the "first day declaration" that is customarily filed with or soon after the bankruptcy petition. The declaration provides the evidence upon which the company relies in requesting court orders at the beginning of the case. Indeed, if the debtor plans on selling its assets immediately, the petition may be accompanied by a motion seeking approval of a sale of some or all of the debtor's assets within the first 60-90 days of the case.

Even if the debtor professes its intention to reorganize, the initial filings may indicate to a discerning reader that the debtor's chances of reorganizing are poor and that the case is likely to result in a sale out of necessity or in dismissal or conversion of the bankruptcy case due to the inability to confirm a reorganization or liquidation plan.

Different parties may control the sale decision – or be able to exercise significant leverage over the price on the seller's side and terms – depending upon which exit path is chosen by (or forced upon) the debtor company. Typically a chapter 11 business bankruptcy case will have one of six possible outcomes; three retention scenarios and three sale scenarios.

A. Debtor entity retains most assets at exit

- (1) *Reorganization*: The company emerges as a standalone, reorganized entity under a plan of reorganization, usually retaining most, if not all, of the debtor's assets and business operations – but usually with new ownership. An investor can acquire the business and entity (subject to the repayment obligations imposed by the plan), or the prepetition creditors' claims may be converted to equity in the reorganized debtor.

Debtor controls any sale process; both secured and unsecured creditors have significant say.

- (2) *Structured dismissal*: The case is dismissed by stipulation, usually because the specific problem that precipitated the bankruptcy has been resolved by settlement. The debtor exits as a standalone entity but without the time and cost of the plan process. Structured dismissals may either result in the debtor retaining most or all of its assets and business operations, or may

follow a sale of substantially all assets. The structured dismissal procedure is not universally accepted and has generated some controversy; its availability depends upon which bankruptcy court is involved.

Debtor controls any sale process; secured creditors may have significant say, but unsecured creditors do not.

- (3) *Straight dismissal*: Straight dismissal usually results either from (i) the debtor's failure to comply with the requirements of chapter 11 cases, or (ii) the recognition that a plan is impossible and no unencumbered assets exist to be administered by a chapter 7 trustee. Secured creditors then typically proceed to foreclose, so any asset sales will likely occur in the context of foreclosure sales.

Secured creditors control any foreclosure sale process, but debtor may seek a distress sale before foreclosure.

B. Debtor sheds assets during bankruptcy case

- (1) *Going-concern sale*: Substantially all assets are sold as a going-concern package to one or more buyers that will continue the business(es) under different ownership, corporate structure, and management.

Debtor technically controls the sale process, as only the company can file a motion to sell, but secured lenders usually exert significant influence over timing and terms of any sale.

- (2) *Liquidation sale*: The company entirely liquidates its assets during the chapter 11 case, selling them off in chunks, with no continuation of the business. The chapter 11 case typically concludes with a liquidation plan that provides for distributions to creditors, although some courts will permit a post-sale structured dismissal.

Debtor controls sale process, but secured creditors may effectively control the ultimate disposition of their collateral if the debtor lacks equity.

- (3) *Conversion*: The debtor's inability to confirm a plan may result in conversion to chapter 7. Conversion usually is only the result if the court finds that having a chapter 7 trustee oversee liquidation of assets and distributions is in the best interests of creditors.

The chapter 7 trustee controls the sale process. The trustee usually turns over collateral to secured creditors unless a meaningful return

from equity in the property can be achieved from sale for the benefit of unsecured creditors.

III. Strategies for buying chapter 11 assets on a “going-concern” basis

Most bankruptcy sales require that other bidders be provided a reasonable opportunity to overbid the initial bidder. This public sale requirement tends to maximize recoveries for the creditors. If you are interested in buying the assets of a chapter 11 debtor and continuing the business as a “going concern,” here are some options:

A. Buy the senior debt

Senior debt may be willing to sell for cash at a steep discount.

Holding the senior secured debt, you can make a “credit bid” based upon the outstanding debt, plus allowing debtor to retain some cash to satisfy transaction costs and pay something to the other creditors (i.e., more than they would receive in a liquidation or litigation war).

- (1) *Advantage:* If the senior debt can be purchased at sufficient discount, this can offer the highest return. Ideally, you might be able to buy the debt and make an offer to the company early enough that you could negotiate an out-of-court deal and avoid a bankruptcy filing and auction entirely.
- (2) *Disadvantage:* If you are unsuccessful in your acquisition attempt, the debtor may draw down a plan that stretches out payment of the senior debt you just purchased.

B. Act as “stalking horse” bidder

Either the senior secured debt or an outside buyer can negotiate with the debtor to become the opening bidder for an auction sale. Such sales are often conducted during the early months of a case to stem the hemorrhaging of the business (and under pressure from the senior lenders to avoid having to fund operating losses).

- (1) *Advantage:* As the stalking horse bidder, you can negotiate the documents and set the terms. Other interested bidders usually have to accept the structure of the deal and must outbid you with respect to the value to the debtor at the auction sale. The stalking horse bidder’s expenses are usually paid if it loses the auction. Sales during the case are governed by Bankruptcy Code § 363 and are brought before the bankruptcy court by a noticed motion. Creditors and

other interested parties will get notice of the proposed sale, and may object. Such sales can be completed as quickly as circumstances require, but usually take 60-90 days to allow for notice, diligence, bidding and completion of the process.

- (2) *Disadvantage:* Occasionally, you may conclude that, due to the particular circumstances of the sale, the better strategy may be to sit back and not serve as the stalking horse bidder, for example, where you expect your competitors to be bidding and you want to see what structure they propose before you go public with your offer.
- (3) *Note:* Third parties rarely overbid the credit bid of an undersecured senior debtholder because the value is not there, but sometimes the secured creditor may decide to accept the cash out.

C. Offer exit financing/acquisition

You could infuse cash and buy either the assets or the equity of the reorganized debtor under a plan. This usually requires leaving at least some money on the table for other classes of creditors, and sometimes even a bone for old equity. It may also require providing debtor-in-possession financing during the case, if existing lenders won’t fund.

- (1) *Advantage:* This is usually a “private” sale (without overbidding) because the creditors get to vote on the plan.
- (2) *Disadvantage:* Sales under a plan are governed by Bankruptcy Code § 1123(b). The sale is incorporated into the plan itself, subject to the disclosure and plan confirmation procedural requirements. The plan process often takes six to nine months or more, because the terms upon which the prepetition creditors are to be paid must be fully resolved.
- (3) *Note:* The equity purchase alternative may make sense if it makes sense to continue operations as the same entity (e.g., for retention of net operating losses; preservation of essential governmental contracts or operating licenses; or assumption of intellectual property licenses granted to the debtor).

IV. Strategies for buying assets without continuing the operations

If you are interested in buying assets of a chapter 11 debtor *without* continuing the business, the threshold question is whether the sale would be of substantially all of the assets,

or of assets that are necessary for the debtor to operate the business. It is much easier to justify selling core assets if the debtor has already shuttered the business or is facing a forced closure, due to lack of funds. If the business is still operating, the unsecured creditors would likely resist such a sale without a very significant sweetener that would persuade them to forgo any upside potential. But once the business is closed, no one can seriously argue with the idea of selling off the assets.

A. Sale of substantially all assets (closed business)

The same kind of elaborate bidding and sale procedures apply as a going-concern sale, but without the urgency, as continuing financing of payroll and operating losses will not be necessary.

Note: Snaring the stalking horse position can still be a plus.

B. Sale of limited, ancillary assets

Sales of nonessential assets routinely proceed on relatively short notice under Bankruptcy Code § 363. Auction sales are still favored, but are not always required for minor sales.

Debtors usually initiate the sales process, often by having investment bankers or auctioneer representatives solicit expressions of interest, looking for a stalking horse bid. If you are not on the list of likely prospects, this initial solicitation may not reach you. In any event, if you know you want to buy assets from a company in financial distress, you should not hesitate to reach out to management to try to obtain the stalking horse position. If you are an insider or existing investor in the company, those connections would have to be disclosed to the court and creditors, but they are not disqualifying.

Similarly, even if you are not the stalking horse, do not hesitate to propose an overbid. Overbids trigger auctions. In the auction process, overbids may well succeed. The debtor (or the chapter 7 trustee) will be looking for the best price, but ability to close and the likelihood of a prompt closing also factor into the decision of which offer is “best.” The debtor or trustee has considerable discretion to select the “best” offer, subject to the right of creditors and other interested parties to object.

C. Special considerations for specific types of assets

“Property” in bankruptcy includes intangible assets that usually are not bought and sold in the marketplace, but that can be acquired in a bankruptcy sale. Three types are worth noting here.

- (1) *Contract and lease rights:* Section 365 of the Bankruptcy Code confers special rights on debtors

with respect to pending contracts and leases of personal and real property. Debtors can decide whether to keep (assume) or repudiate (reject) contracts and leases, depending upon whether they are beneficial or burdensome for the bankruptcy estate. Moreover, a debtor can assume, cure defaults, and retain its rights under a contract, even if outside of bankruptcy the other party to the contract could have terminated the contract due to the debtor's breach. And, most importantly for this discussion, only in bankruptcy can a debtor assign a contract to a third party despite terms of the contract prohibiting assignment. This means that, so long as the nondebtor party will receive generally the same performance to which it was entitled from the debtor, the debtor can sell its contract rights for a profit, or keep the contract and enforce its rights to aid its on-going business.

- a. *Going concern sale:* The buyer in a going concern sale can direct the debtor to assume good contracts and reject bad ones as part of the overall purchase transaction.
 - b. *Separate asset sale:* Some contracts are sufficiently distinct from the underlying business that they can be separately assumed by the debtor and assigned to a third party. This is especially common for below-market real property leases. Retail store chains often market their store leases individually or in batches, after completion of going-out-of-business inventory sales.
- (2) *Intellectual property licenses and interests:* Intellectual property sometimes constitutes the main asset of a chapter 11 debtor. Under Bankruptcy Code § 365(c)(1), IP licenses and related contracts are treated differently from most contracts. In general, rights of IP owners and licensees that are protected under copyright, patent and trademark law cannot be overridden in bankruptcy just to maximize the bankruptcy estate. Thus, a debtor that is the licensee of IP generally cannot assign (sell) those license rights to a third party without the consent of the IP owner. Conversely, the debtor that owns IP generally cannot eliminate rights of its licensees; any buyer of the IP will take it subject to licensees' rights.

If you are seeking to buy IP assets or to obtain assignment of IP rights as a licensee stepping into the

shoes of the debtor, make sure that you will actually be acquiring the rights for which you are paying. Obtain the consent of the nondebtor party if possible. On the other hand, if the nondebtor IP counterparty fails to object to the sale or assignment of the IP, then it may be deemed to have waived its rights. (Of course, if you assert any interest in IP either owned by you and licensed to the debtor, or jointly owned with the debtor, or licensed from the debtor, you would need to assert your rights to protect those interests if the debtor files a sale motion.)

- (3) *Litigation “assets”*: A debtor or its estate may hold potentially valuable – albeit perhaps speculative – rights to sue third parties. For example, the debtor may have a breach of contract claim against a customer, or patent infringement claim against a competitor. Debtors and trustees are sometimes interested in monetizing such claims if possible, rather than spending years to litigate them. Such claims may be sold during a bankruptcy case.

It is also worth noting that defendants in suits brought by debtors may in effect buy the cause of action either as part of a settlement with the debtor or as a purely defensive measure, especially if multiple defendants and cross-claims exist. An auction may be required. If you are a defendant in such a suit, consider whether preemptive purchase of the litigation claim might be a useful element of your overall strategy.

Conclusion

Bankruptcy sales have sometimes been compared to rummaging around in a second-hand shop. Sometimes that bargain painting turns out to be a Wyeth or Jackson Pollock; that gilded cabinet may prove to be a Louis XIV treasure. Or not. You are buying without warranties, but also free of any residual liens or claims. And if you already know the asset well (or think you do) from long involvement with the now-bankrupt company, it may be worth the investment.