

# Appendix A: Acquiring assets in bankruptcy

Why, in a publication designed for directors, would we include a discussion involving bankrupt companies? Because, although traditional merger and acquisition activity has understandably been well below ordinary levels during 2009, bankruptcy courts' activity has been in high gear. Many strategic and financial buyers have taken advantage of opportunities to purchase some or all of the assets of companies in bankruptcy to add capacity or expand into new markets and regions.

Buyers can purchase assets from a company involved in a Chapter 11 bankruptcy either through the plan of reorganization or through a "Section 363" asset sale, named for the relevant section of the US Bankruptcy Code. The former requires that each class of creditors votes to approve the sale. Conversely, a purchase of assets under Section 363 requires only the approval of the bankruptcy court, subject to creditor objections, and is arranged through an auction process.

Section 363 sales are becoming increasingly popular. During 2009, two major US automakers participated in this type of transaction, with newly formed companies buying certain assets and assuming specific liabilities from the bankrupt entities.

## Why are Section 363 sales attractive?

The advantages include:

- The buyer gets the acquired assets free and clear of most liens and claims.
- The buyer generally can "cherry-pick" the assets, contracts, and parts of the business it wishes to accept. This allows the buyer to get the components of the business that are beneficial and leave behind those that would be a burden or are duplicative to the buyer's existing operations.
- The time frame to close a Section 363 sale is a fraction of that ordinarily seen in a traditional reorganization. The shorter time frame usually results in lower legal costs for the buyer and the bankrupt company.

A Section 363 sale typically requires the "stalking horse" to commit substantial resources to prepare a bid, and the results of such due diligence are available to the other bidders. Thus, the stalking horse faces the risk of doing all the work without closing the deal.

### **What is a stalking horse?**

A stalking horse is the party chosen to enter the initial bid in a Section 363 auction. Although the stalking horse bidder can increase its bid during the auction, if the stalking horse doesn't ultimately win, it is generally entitled to a breakup fee and reimbursement of its expenses.

Although a Section 363 sale offers many advantages, some buyers choose to acquire assets through the plan of reorganization. Why? This route could allow a buyer to negotiate favorable terms with the bankrupt company's existing lenders and creditors rather than having to arrange third-party financing. In addition, this type of acquisition can be done via a stock sale, allowing for the transfer of the bankrupt company's tax benefits. Section 363 sales generally would not include these tax assets.

## Seizing an opportunity

For many companies, an acquisition of assets through a Section 363 sale might present a great opportunity. By focusing the purchase on components of the business that are profitable and leaving behind those that hindered the bankrupt company, it is possible to acquire a strongly performing entity or a significant portion of its assets without the baggage that caused it to enter the bankruptcy process.

### **Directors' action**

Understand, if management is evaluating potential opportunities for acquisitions, whether management has explored the possibility of acquiring assets available through bankruptcies to increase the company's capacity or expand into new markets or regions.

### **How does a Section 363 asset sale work?**

Although these sales can take many forms, one common scenario begins with the company in bankruptcy seeking bankruptcy court approval to proceed with a sale under the Section 363 process. During this process, the company and its advisors identify and establish the procedures to hold the auction and to solicit other bids. Creditors and other interested parties have the right to be heard prior to the court's approval of the 363 sale and can object to the sale if they believe it is not in their best interest.

Once approved, the initial bidder, the "stalking horse," negotiates an agreement with the bankrupt company to purchase some or all of its assets. The stalking horse bidder in many cases gets to set the terms of the auction, including the specific assets (and, in some cases, specific liabilities) that are to be included in and excluded from the transaction and how competing bids must be structured.

After a solicitation period during which additional bidders are invited to participate, the auction takes place, and the bidder that offers the "highest and best" value for the transaction is declared the winner. A hearing is held to approve the auction results, and the consideration is transferred to the bankrupt company in exchange for the assets. The bankrupt company is responsible for distributing the proceeds to the creditors of the estate under the supervision of the court.