

## Improved Returns: The Benefits of a 363 Sale for Secured Creditors



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by Michael Grau and Juanita Schwartzkopf  
Focus Management Group

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## The Benefits of a 363 Sale for Secured Creditors

The idea of relying on a 363 sale as a means of asset recovery can be a daunting prospect to a secured lender. What if no bidders attend? What if the stalking horse bid is the only bid? What if the debt is not covered by sale proceeds? What if there is a disagreement among lenders in a syndicated loan about whether or not to make a credit bid?

Just as debtors will use every available option to steer the sale process to their own benefit, lenders should also play offense, not defense, in order to realize the best result. A well laid out plan for a successful 363 sale starts before the petition date and may later include strategic DIP financing and making a credit bid.

### What is a 363 Sale?

A 363 sale is the disposition of a debtor's assets outside the ordinary course of business under Section 363 of the United States Bankruptcy Code. It allows for a stalking horse bidder as a means of establishing a valuation floor and has a number of advantages for both buyers and secured creditors:

- If the assets have been properly marketed, the sale can often be driven to close within approximately a month from the time of the bankruptcy petition date.
- The buyer may take title to the assets free and clear of liens and encumbrances.
- The buyer may be able to argue that it can take the title free of any successor liability claims.
- The buyer has the ability to "cherry-pick" favorable contracts and leases by including them in the sale.
- There is a broad scope of assets which can be sold via a 363 sale, including tangible assets and intangible assets wherever located.

- The secured lenders have the right to credit bid for their collateral in an effort to influence the outcome of the sale.
- A secured party can still challenge a 363 sale if the sales process is not conducted properly, if there is self-dealing, or collusion among bidders.
- The sale will be approved by the bankruptcy court after notice and a hearing, and will not be subject to attack as a fraudulent transfer.

From a secured lender's standpoint, there are certain things it will be able to control and others that will be beyond its control during the process leading up to a 363 sale. For one, the debtor may stonewall attempts to engage in a 363 sales process. In addition, while a secured lender often participates in the sales process, it is the bankruptcy court which sets the bidding procedures, and often a bankruptcy trustee or court-appointed investment banker or sales agent who spearheads the marketing efforts. In most cases, the secured lender generally can indirectly control the timing and direction of the sale process via influencing the debtor's funding availability.

Venue can also impact a sale strategy as different jurisdictions often have their own local rules, customs and procedural protocols dealing with key issues such as bidding procedures and timing. As a matter of practice, some jurisdictions allow 363 sales to proceed faster than others. Understanding these dynamics can help lenders better anticipate and manage challenges as they arise.





### What if the debtor refuses to agree to a 363 sale?

The Bankruptcy Code does not allow a secured lender to file a motion for a 363 sale—this can generally only be accomplished by a debtor or a trustee. A typical argument used against a 363 sale by company management is that such a process would disrupt critical customer and vendor relationships and impair the enterprise value of the business. Management might also argue that opening up the sales process to strategic buyers would divulge sensitive information to competitors who have no intention to act in good faith or make a bona fide sales offer.

Management might also threaten to resign for any number of reasons. While these types of strong-arm tactics may make for good theater, the trajectory of the business, a debtor's operating metrics and cash flow trends and the terms of a debtor in possession financing arrangement almost always dictate the proper course of action and corresponding timing.

Lenders generally rely on the rights and remedies outlined in their post-petition loan and security agreements to steer the narrative and effectively force the issue. Communication with management, both early and often, is the key in this regard. Any post-petition financing arrangements should be drafted with an eye towards the ultimate goal of a 363 sale.

Formal evaluation of the management team is also necessary to determine whether or not poor management represents one of the underlying causes of the debtor's distress. If so, then the threat of management resignations becomes a much more hollow threat. Seasoned turnaround professionals can immediately parachute into interim management roles and provide stability.

### Can management be provided with financial incentives to cooperate?

In cases where the management team is clearly important to the process, things may be more complex. Prior to the bankruptcy reforms instituted in 2005 under the Bankruptcy

Abuse Prevention and Consumer Protection Act (BAPCPA), it was commonplace for debtors to seek court approval for Key Employee Retention Plans ("KERPs") that involved any combination of retention payments, bonuses and/or severance payments to the CEO, CFO, executives and other insiders. Those days are largely gone, however, as BAPCPA created an amendment to the Bankruptcy Code, Section 503(c), in an attempt to limit these payments to "insiders" (directors and officers).

However, there is still a legitimate need to retain talented managers to help a debtor through the bankruptcy process, and retaining these managers can serve the secured lenders' interests as well. Courts will allow compensation from "incentive" plans tied to specific performance benchmarks, but not if they are easily achievable.

There have been other devices permitted by courts, such as the assumption of executive pension plans, the assumption of employment contracts, or having a retention plan funded by the secured lender or other non-debtor party.

### What type of pre-petition planning is important?

When deciding if a 363 sale strategy should be pursued, a secured lender should come to a conclusion regarding the ongoing enterprise value of the business versus the liquidation value of the assets. This might involve the assistance of financial advisors or internal resources (e.g., capital markets groups within the lending institution) to look at things like:

- Normalized EBITDA run rates
- Value drivers and trends specific to the debtor's business
- Recent and comparable sales multiples elsewhere within the debtor's industry.

Additionally, understanding a debtor's cash flows prior to a bankruptcy filing is extremely important, particularly when it comes to establishing time lines leading to a 363 sale. A secured lender who has access to well-prepared cash forecasts and a good grasp on cash burn rates has instant leverage,



for example, in negotiating terms of a DIP financing arrangement that contemplates a 363 sale. Lining up financial advisors in advance of the petition date will also generate a good head start on making fully informed credit decisions.

### **What are some of the issues to consider with respect to structuring DIP financing?**

Section 364 of the Bankruptcy Code provides the statutory framework for debtor-in-possession (“DIP”) loans. While it is possible for courts to authorize DIP financing secured by unencumbered estate assets, junior liens or even priming liens on property of the estate (subject to adequate protection provisions for existing creditors), the combination of highly leveraged balance sheets and the uncertainty in the credit markets over the last few years has made it much tougher for debtors to obtain DIP financing.

With this backdrop and the sometimes contentious circumstances leading to a bankruptcy filing, secured lenders are often wary of extending DIP financing. The Bankruptcy Code does, however, provide lenders with certain incentives and protections to do so. In most cases, the existing pre-petition lender strongly considers financing the debtor during the case as a defensive measure to protect its position and maintain going concern value. In structuring the DIP financing, lenders can go on the offensive and use the DIP financing negotiations to help dictate the terms of the 363 sale process. In this context, lenders can control the timing of the sale by only agreeing to provide funding for a limited period and by imbedding milestones for the sale process in the financing arrangement. While debtors always want DIP financing with the fewest strings attached, they are often reluctant to take too hard of a stance because of their poor bargaining position, the lack of alternative funding and the need for operating cash while in bankruptcy.

After the filing, official committees may also object to DIP financing terms perceived to be overreaching or dictating a 363 sale too early in the process, but they too must weigh

the consequence of a debtor with no operating cash.

In addition to negotiating for additional collateral, tougher covenants and better pricing, secured lenders can use DIP negotiations to impact the sale process itself. One effective tool is to draft a DIP financing agreement with a shorter loan term, which creates a time deadline and inherent pressure for a quick asset sale. At a minimum, the DIP financing agreement should explicitly state the lender’s right to credit bid and right of last offer in any sale.

### **What is the so-called “loan-to-own” approach?**

The “loan-to-own” approach is a strategy employed by hedge funds, private equity groups or other strategic investors in recent years to effectively acquire ownership of a company’s assets by purchasing the distressed debtor’s senior secured debt—often at a discount. In this scenario, the new lender is then in a position to quickly pressure the debtor into a 363 sale and, via credit bidding, effectively convert its position from debt to equity.

One of the perceived advantages to this strategy is that investors who pursue a loan-to-own scenario can then credit bid at the full face amount of the debt (not the discounted amount actually paid) and thereby create an artificially high bidding threshold which will discourage a competitive bidding process.

While this approach has been effective in many cases, there are risks involved as well. Historically, loan-to-own strategies have been challenged on multiple legal fronts, including breach of fiduciary duty, equitable subordination claims and attempts to re-characterize the debt as equity. However, in one recent case (*In re DBSD North America, Inc.*) the U.S. Bankruptcy Court for the Southern District of New York issued an opinion prohibiting the use of a loan-to-own strategy. The fallout remains to be seen, but nevertheless this type of strategy should be used with caution.



### What is credit bidding and under what circumstances does it make sense?

Credit bids are provided for in Section 363(k) of the Bankruptcy Code and allow lenders, absent a showing of good cause, to make a bid up to the full amount of their secured debt in order to acquire the assets in exchange for satisfaction of the debt in the amount of the bid.

Credit bidding essentially protects secured creditors against having their collateral sold for less than it's worth, so having a good understanding of appraised values (fair market value, orderly liquidation value, and forced liquidation value) is a key component of determining how much to credit bid. Credit bidding makes the most sense in cases where the bids are coming in below the value of the collateral. There may however be arguments against a lender's ability to credit bid, particularly if the validity of the lien is subject to dispute.

One of the challenges sometimes faced by courts is comparing an all-cash bid to a credit bid, especially since credit bids can also be mixed to include some cash component. Sometimes these mixed bids are necessary to trump an all-cash buyer who may be bidding on the secured lender's collateral plus additional assets.

Credit bids with no cash component may also present issues with respect to the wind-down of the estate, which is difficult if the debtor is administratively insolvent. This can also create some pressure for a secured lender's bid to have a cash component or to provide funding for the wind down.

Bankruptcy Courts are generally reluctant to approve sales where it appears that the process has been conducted solely for the benefit of a secured creditor. When that happens, the Court will generally not approve the sale unless the secured creditor funds administrative expenses, and in some jurisdictions, Courts may even require that a plan is funded.

### What if some members of a loan syndicate object to a credit bid?

There have been a number of cases in recent years in which a majority of lenders in a bank group authorized the agent to credit bid, but some members of the group objected.

Although every case is different, courts have generally sided with the majority, finding that a credit bid is neither a release of collateral nor an amendment to the credit agreement (as is often argued by dissenting lenders). In many cases, the courts have found that the credit bid is simply the exercise of a remedy and therefore permissible with majority consent.

These objections often revolve around core issues such as asset valuations and the overall financial condition of the debtor, and this is where good financial analysis is imperative in the pre-petition stages.

Credit bidding can also be complicated when second-lien debt holders are involved. Accordingly, similar to participation agreements, the issue of credit bidding should be contemplated when negotiating inter-creditor agreements.

### **Successful 363 Sale—Example #1**

In a recent case, company management advised its lenders that moving toward a 363 sale would disrupt vendor and customer relationships and could not be pursued. Management threatened they would leave if certain bidders were invited to the table, and key vendors would cease supporting the company if those same bidders were approached.

During this time, however, the bank group and its advisors continued to pursue alternative buyers by keeping those potential prospects informed regarding the sale process. When the 363 sale occurred, two alternative bidders were in place, resulting in a 100% recovery to the lenders, a 100% recovery to the unsecured creditors, and an ongoing lending relationship for the incumbent lenders with a new, credit worthy owner.

#### **Lessons Learned**

The first key to a successful outcome is the development of an expanded potential buyer list. The process of developing an expanded potential buyers list should include:

- Lenders should look in their own portfolios for potential candidates within the same industry who might be interested in expanding.
- Lenders should look at their fund management relationships for potential candidates with acquisition guidelines matching the enterprise for sale.
- Financial advisors to the lenders should contact their resources for similar potential buyers and research competitors and suppliers for approaches to expand the buyer universe.

Another key to a successful outcome in a 363 sale is keeping potential buyers informed. Often management elects to exclude certain groups by not readily sharing information or by not returning phone calls quickly. Lenders and their financial advisors must monitor the sharing of information. The approach used in the above example was to develop a reporting mechanism that the company was required to use to let the lenders know:

- Who has been contacted (name, phone number, address, title).
- What their requests for information have been.
- When the information has been provided and in what format.

This reporting mechanism was submitted to the lenders weekly and the lenders or their financial advisors randomly contacted potential buyers to ensure their needs had been met.

### **Successful 363 Sale—Example #2**

In another example of a successful 363 sale, it was discovered that within the universe of assets owned by the debtor, one particular type of asset—a television studio—was of most interest to potential buyers. By identifying this asset as one of significant interest, the lenders and their financial advisors were able to identify additional potential buyers and create more interest at sale. In this example, the 363 sale involved an aspect of the business whose value might have been discounted had the research with potential buyers not been undertaken. The 363 sale resulted instead in a full payout to the lender group and the unsecured creditors.

#### **Lessons Learned**

Exploring the value of all potential assets is critical to identifying potential buyers and improving recovery. In the example above, the keys to a successful 363 strategy were:

- Identifying key assets of interest to potential buyers,
- Developing an expanded potential buyer list based on the identification of desired assets, and
- Keeping potential buyers informed.



## Summary

While Section 363 sales can be challenging, a well laid out plan can help minimize the time it takes to conduct a sale—while maximizing the sales proceeds for secured lenders. Turnaround professionals, valuation experts, investment bankers and other financial advisors can add substantial value if engaged early in the process. It is critical to canvass

the widest population of potential financial and strategic buyers and attract interest with comprehensive financial analysis that is tailored to that end. In the context of marketing, due diligence, valuation or even structuring the transaction, seasoned financial advisors are generally integral to maximizing sale proceeds through a Section 363 sale.

## About the Authors



Michael P. Grau is a senior financial executive with over 25 years experience in the areas of accounting, commercial lending and management consulting. Mike has been involved with a number of bankruptcy cases including Section 363 sales and liquidating Chapter 11 cases and has testified in federal bankruptcy court. He has also supervised business wind-downs and asset sales conducted outside the realm of bankruptcy court.

Mike can be reached at (440) 925-2818 or via e-mail at [m.grau@focusmg.com](mailto:m.grau@focusmg.com).



Juanita Schwartzkopf has 25 years of experience in commercial banking, and financial and risk management. Juanita has an extensive background in credit risk assessment and loan portfolio appraisal, as well as working with a variety of companies involved in insolvency proceedings. Juanita has worked with creditor groups and with the company or its stakeholders through both court protected and out-of-court dissolutions and reorganizations.

Juanita can be reached at (813) 281-0062 or via e-mail at [j.schwartzkopf@focusmg.com](mailto:j.schwartzkopf@focusmg.com).

## Contact Information

Focus Management Group is a leading business restructuring firm headquartered in Tampa, with offices in Atlanta, Chicago, Cleveland, Dallas, Los Angeles and Philadelphia. For more information regarding our experience facilitating 363 sales, contact one of our experienced Managing Directors listed below:

### Corporate Offices

5001 W. Lemon Street  
Tampa, FL 33609  
Tel: (800) 528-8985  
Fax: (813) 281-0063  
[www.focusmg.com](http://www.focusmg.com)

### Key Contacts

Michael Grau: [m.grau@focusmg.com](mailto:m.grau@focusmg.com)  
Juanita Schwartzkopf: [j.schwartzkopf@focusmg.com](mailto:j.schwartzkopf@focusmg.com)

