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2010: a return of the dynamic section *363* auction?

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2009 saw significantly reduced activity in US-based mergers and acquisitions, both in terms of number of transactions and transaction values. 'Mergers & Acquisitions' reported that only 5514 deals, totalling $703bn, were closed by US buyers or sellers in 2009 – a significant decline from the 7917 deals totalling $999bn that closed in 2008. These statistics tell only part of the story. This recession is unique from prior downturns because the financial services sector was a primary casualty. As lenders faced their own crises, the credit market tightened much more than in prior recessions, resulting not only in fewer M&A transactions, but also in different types of transactions and variations among transaction processes.

Nowhere was this trend more evident than in the distressed M&A market. In one case after another, Chapter 11 petitions were filed concurrently with motions to sell substantially all of the debtor's assets under section 363 of the US Bankruptcy Code. In large part, these quick bankruptcy sales have been the direct result of the tightening of the credit markets, leaving debtors unable to acquire debtor-in-possession financing to fund their reorganisations. The lack of available debt financing also helped chill competitive bidding in recent section 363 auctions and little, if any, upward movement from the 'stalking horse' to winning bid.

In 2010, we expect many distressed sales to mirror those we saw in 2009, with few bidders and quick sales to stalking horse bidders shortly after the Chapter 11 filing. But signs of change are surfacing. According to the Federal Reserve Board's January 2010 survey, the number of banks reporting further tightening of commercial and industrial loan terms in the fourth quarter of 2009 was "considerably below those from recent surveys" and some of the largest domestic banks "reported having eased loan terms to large and middle-market firms". Private equity firms, having largely sat on the sidelines over the past 18 months, are feeling pressure to close deals and put more of their commitments to work. Indeed, we anticipate that private equity funds and strategic acquirers will start to be more active in the distressed M&A market in the upcoming year, and the debt and equity markets will slowly start allowing additional capital into the markets to help consummate more deals.

The section 363 auction process, which can be daunting to newcomers because of its complexity and fast pace, remains one of the best places to find acquisition opportunities. For those unfamiliar with section 363 sales, this article provides a brief overview of the 363 process, its unique terms and rules, its timeframe, and a few tips on how private equity funds and strategic acquirers can take advantage of what we anticipate will be growing opportunities in the distressed M&A market.

An overview of the auction process

Upon filing for federal bankruptcy protection, the debtor may elect to sell some or all of its assets in accordance with section 363 of the US Bankruptcy Code. A sale in compliance with section 363 results in a transfer of assets free and clear of any liens, claims and encumbrances (with several limited exceptions). In addition, the purchaser can elect to assume those of the debtor's contracts that it finds desirable, allowing the debtor to 'reject' those contracts that no longer provide value.

Section 363 provides discretion for the debtor to establish specific sale procedures, but the process generally provides for the following:

First, after initial negotiations, the debtor enters into an asset purchase agreement (APA) with one bidder. This agreement becomes a stalking horse bid for the assets, against which higher and better offers may be made.

Second, the APA usually provides bid protections for the benefit of the stalking horse bidder, including a break-up fee (typically less than 3 percent of the purchase price) – payable to the stalking horse bidder in the event the assets are sold to a competing bidder – and reimbursements for legal and other expenses incurred with respect to the auction process.

Third, the debtor must provide adequate notice (at least 21 days) of the auction and sale approval hearing to all creditors and to potential participants in the auction.

Fourth, after the notice period expires, competing bidders and the stalking horse bidder participate in an auction governed by bid procedures approved by the bankruptcy court.

Fifth, after completion of the auction and selection of the winning bidder, the court enters a sale order, authorising the sale to the winning bidder.

A typical 363 sale will: (i) require competing bidders to be 'qualified' prior to the auction in accordance with the court-approved bid procedures; (ii) close within days after a final order approving the sale has been entered; (iii) provide for the full purchase price to be paid in cash; and (iv) provide little or no representations, warranties, indemnification, escrows, or holdbacks. Section 363 also permits secured creditors to participate in auctions of the debtor's assets, and to 'credit bid' for those assets up to the amount of their secured claim.

Participating in the process

In non-bankruptcy transactions, potential purchasers have the luxury of being able to perform lengthy industry-specific due diligence, and have significant flexibility with respect to financing, because such transactions are not subject to statutory time constraints. Bankruptcy sales, however, are conducted on an aggressive timetable, affording potential purchasers limited opportunity to arrange financing and conduct due diligence on the debtor or its industry. The aggressiveness of this timetable necessarily makes section 363 sales more challenging to navigate than non-bankruptcy sales. In many cases, however, sophisticated, or properly advised purchasers, quickly come to the conclusion that benefits of purchasing assets under section 363 – including obtain- ▸▸

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ing them free and clear of liens and jettisoning unfavourable contracts – outweigh the challenges.

Indeed, by employing several techniques, parties interested in participating in section 363 transactions can simplify the process and increase the likelihood of ultimate success.

Line up financing in advance. As a general matter, section 363 bid procedures require that purchases be entirely in cash or cash equivalents. Seller notes, warrants, and other debt instruments are often discouraged – if not expressly prohibited. Accordingly, and given the expedient nature of section 363 sales, private equity funds or strategic buyers should consider stockpiling cash in anticipation of potential deals, or having an arrangement in place with a financier to fund purchases on an expedited basis. Potential purchasers may consider working with non-bank lenders – even though the price of borrowing may be higher – if those lenders can provide faster turnaround time and greater certainty of closing.

Limit your industry focus. While strategic buyers generally focus on a limited number of industries, and therefore are well-positioned to pounce on section 363 transactions in their areas of expertise, private equity buyers can be hamstrung by too broad a focus. In order to be both competitive and prudent in section 363 auctions, private equity firms and other financial buyers should employ a similar approach, focusing on several core industries. This method will allow buyers to overcome the limited due diligence and bid formulation timetable in most section 363 processes, and will allow buyers to formulate more robust bid packages in a shorter period of time.

Know the bid procedures. Finally, pay close attention to the 'bid procedures' that establish the rules for the auction. Be aware that bid procedures generally grant the debtor substantial latitude over how the process is governed such as 'qualifying' competing bids. Given this control position, buyers need to be willing to make on-the-fly adjustments to their bids in order to accommodate debtors. Comprehensive knowledge of the applicable bid procedures will allow buyers to use them offensively to gain an advantage over – or perhaps even disqualify – a competing bidder. ■

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Freeborn & Peters LLP is a Chicago-based law firm comprised of more than 115 attorneys. Our practice platform focuses on Litigation; Business Law; Real Estate and Land Use; Bankruptcy, Reorganization and Creditors' Rights; and Government and Regulatory Law. Recognised internationally, our Bankruptcy, Reorganization and Creditors' Rights Practice is known for its aggressive, cutting-edge solutions to assist our clientele. We are well-versed in representing debtors, creditors, creditors' committees and trustees in US bankruptcy and insolvency proceedings and in a variety of related cross-border insolvency matters, including cases filed under Chapter 15 of the US Bankruptcy Code. In addition to our renowned bankruptcy litigation practice, we have substantial experience handling complex distressed mergers and acquisitions, particularly those conducted under section 363 of the US Bankruptcy Code. In 2009, the Turnaround Management Association (Chicago/Midwest Chapter) awarded partners Aaron Hammer, Thomas Fawkes, William Howard and Jeff Mattson with the 'Large Transaction of the Year Award' for their role as counsel to the Official Committee of Unsecured Creditors in the Chapter 11 proceedings of In re Trinsic, Inc. et al. In this case, Freeborn & Peters shepherded the Committee through an expedited, highly contentious section 363 sale of Trinsic's assets, which resulted in a dramatic increase in the sale price that will ensure a meaningful distribution to unsecured creditors.