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BANKRUPTCY

AN INSIDER'S GUIDE TO 363 SALES

With commercial Chapter 11 filings jumping in October, dealmakers should review their strategies for buying assets through bankruptcy.

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With commercial Chapter 11 filings jumping 25% in October, dealmakers should review their strategies for buying assets through bankruptcy.

In fact, a number of trends suggest that Section 363 bankruptcy sales may become more common, offering bargains for buyers sitting on dry powder.

For example, commercial Chapter 11 filings in eight of the past 10 months matched or exceeded the prior year's filings for the same periods. Further, in those eight months, filings jumped by an average of 22%, year-over-year. Separately, the Conference Board's survey of CEO confidence declined in the third quarter to its lowest level in nine years. Two-thirds of CEOs surveyed expect worsening economic conditions, up from just 44% in the midyear survey. Finally, the Financial Times reported recently that U.S. corporate insiders – CEOs, CFOs and board members – sold stock in their own companies at the fastest pace in two decades. The FT describes such sales as, "A rough marker for the confidence of executives in their own companies' prospects." Of course, we also recognize the Dow, S&P 500 and Nasdaq indexes recently reached historical highs.

Whatever the future holds, dealmakers should review their growth strategies periodically and consider the following guidance to ensure that they are ready to act swiftly when distressed assets become available in 363 auctions.

Similarities Between 363 and Straight M&A

Both a 363 bankruptcy sale and traditional M&A begin with the seller retaining investment bankers and other advisers to value the assets and market them. Sellers may offer pieces of a business or the business as a whole. When potential buyers are found, confidentiality documents are signed and due diligence is conducted. Then a buyer makes an indication of interest. After that, the paths diverge.

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Differences Between 363 and Straight M&A

First, a buyer in a traditional M&A transaction may avoid competition entirely, by moving quickly and delivering the right offer (with limited or no recourse to seller). Buyers involved in a 363 sale almost certainly will face competition through an auction. Second, in traditional M&A, offers are reviewed by the board, whose duty is to shareholders. In a 363, the interests of the seller's various creditors must be taken into account, not just shareholder value. Third, 363 sales are supervised by a bankruptcy court that oversees the auction process and must approve any sale.

Additionally, 363 sellers almost always seek out a stalking-horse bidder. Generally, a stalking horse offers the seller a chance to maximize the value of their assets, by establishing a baseline offer. Next, the bankruptcy court conducts a preliminary hearing to review that offer and to determine the auction process, setting any qualifications and deadlines. Then, the seller seeks higher or otherwise better offers through the auction process.

Before and during the auction, sellers typically use a "credit/debit sheet" to compare each offer. The sheet details risk factors – such as the expected timeline to close or regulatory hurdles – and prices those risks into the offer. For example, a buyer might offer $100 million. But the seller might subtract $10 million due to uncertainty over the buyer's ability to close, resulting in a $90 million offer value on the sheet. Sellers also identify and take into consideration any liabilities not assumed, as well as those that may be created, by the offer. Of course the buyer always has a chance to negotiate the amount of those assessments and find other ways to add value. It is important to note that certain creditor constituencies may prefer a buyer that offers the most certainty – even sacrificing on the final price. Meanwhile, in a straight M&A transaction, boards seek the highest price and then mitigate risks through breakup fees or "Hell or High Water" covenants.

Finally, in a straight M&A transaction, the deal is expected to close unless a third party intervenes. In a 363 bankruptcy sale, the judge must approve the auction outcome.

Tips for a Successful 363 Purchase

Gain access to the 363 pipeline. To be kept apprised of 363 opportunities, private equity firms, strategic buyers and others in the market for assets should alert investment bankers and lawyers who regularly work with distressed assets. Those intermediaries can ensure buyers are notified of sales early, offering a chance to serve as the stalking horse.

Consider serving as the stalking horse. The advantages are significant. The stalking horse designs the parameters of the deal against which others must bid, sets the starting price, has more time for due diligence and may be able to impose eligibility standards on other bidders, such as creditworthiness or earnest money deposits. This process also may entrench the stalking horse with the management team, creating additional advantages. Finally, only the stalking horse may be entitled to a breakup fee, expense reimbursement or both if it loses at auction.

Utilize alternative strategies if you are not the stalking horse. Despite those advantages, outside bidders do win auctions. They may offer greater certainty of closing, overcoming challenges faced by the stalking horse. They may also approach the creditors' committee, secured creditors or others to highlight the strength of their offer. While the stalking horse may grow close with management, the views of important creditors will be considered by the court as well.

Execute exceptional due diligence. In many instances, after the sale there is no significant post-close recourse. Buyers may have limited tools to manage and allocate risk because the seller may no longer exist. Integration risk falls primarily on the buyer as well, as there is likely to be no long-term transition services agreement. Strategic buyers may need to take special care, especially if they do not onboard the asset's employees. Those employees may have essential institutional knowledge or relationships required for continuing operations.

Understand your regulatory hurdles to close. Know your offer's risk factors to closing and those of your competitors. Speed and certainty close deals in the 363 context, often better than highest price. If the seller devalues your offer, be prepared to negotiate to reduce the penalty, not just with the investment banker but with various creditor groups. When possible, seek regulatory review as early as possible to try to allay any concerns.

Communicate with all constituents. Understand the seller's capital structure and the different constituencies and the competing interests that result. Keep lines of communication open with the management team, secured creditors, unsecured creditors and other interested parties. Engage with the various groups' outside consultants, including investment bankers, counsel and restructuring teams.

Don't get overwhelmed by the process. A 363 auction shares similarities with the NBA draft or Christie's auction house. Buyers may lowball their offers, knowing that the assets are distressed and they will get another bite at making an offer, increasing competition. Participants must prepare for an emotional ride and decide ahead of time their limits.

Compared with straight M&A, a 363 sale offers a host of idiosyncrasies for the uninitiated. Dealmakers who understand and embrace the procedural peculiarities of the 363 process and the associated risks will be best positioned to craft a successful bid and then manage their new acquisition successfully.

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