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Selling Distressed Assets: Weighing 363 Sales, Other Options

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During the most recent bankruptcy boom in Delaware, many corporate debtors have used Chapter 11 to facilitate the sale of all or substantially all of their assets under Section 363 of the U.S. Bankruptcy Code. It has become standard practice for debtors to come through the doors of U.S. Bankruptcy Court in Wilmington, Delaware, seeking approval of this process, as evidenced by such recent examples as Big Ten Tires, NetVersant, VeraSun, and Whitehall Jewelers.

However, not every distressed company has the financial wherewithal to endure the time and cost associated with Chapter 11 bankruptcy. Other options are available for distressed companies that seek to sell and/or liquidate some or all of their assets besides a traditional 363 sale.

For example, many distressed companies have been able to streamline the Chapter 11 bankruptcy process by using prepackaged bankruptcies to facilitate quick and orderly sales of assets. Several commonly used out-of-court options also are available to

liquidate or sell the assets of a distressed company, including Article 9 of the Uniform Commercial Code (UCC), an assignment for the benefit of creditors, a composition of creditors, and the establishment of a receivership.

This article discusses basic considerations of Section 363 sales and out-of-court alternatives available in jurisdictions such as Delaware, and why restructuring professionals must be aware of these options when advising their clients.

Bankruptcy Court Sales

Many distressed companies file for Chapter 11 specifically to sell all or substantially all of their assets pursuant to Section 363 of the U.S. Bankruptcy Code (11 USC Section 363). Among other things, Section 363 permits a debtor to sell its assets “free and clear” of all liens, claims, and encumbrances.

Although not expressly required by the Bankruptcy Code, a Section 363 sale frequently is conducted via a public auction to produce competitive bidding from prospective purchasers to maximize value for all parties involved. A secured creditor is permitted to credit bid at the sale, and there is less potential liability for the purchaser because of the ability to purchase the assets free and clear, with a Bankruptcy Court order blessing the transaction.

However, no matter how quickly it can be accomplished, a 363 sale can often be a costly and time-consuming process. The sale timeline and the procedure must be approved by the Bankruptcy Court, and the process requires that notice be given to creditors and interested parties, who then have the opportunity to object to the sale and assert their own interests. Further, in addition to paying the fees and costs of its own retained restructuring professionals and the customary costs of navigating through Chapter 11 bankruptcy, a debtor also may be required to pay the fees of professionals for a creditors’ committee.

Some debtors have streamlined the Chapter 11 process by filing so-called prepackaged bankruptcies. These prepacks allow distressed companies to receive the shelter and

advantages of bankruptcy protection, but the cases are often handled more quickly than traditional Chapter 11 cases.

It is becoming an increasingly common alternative because of the benefits it provides. According to one report, 30 public filers with combined total assets of \$124 billion filed prepacks in 2009, compared to only three with combined assets of \$2 billion in 2007. Erin Fuchs, "Prepackaged Chapter 11 Filings Skyrocket" in 2009, Law360.com (November 10, 2009). In Bankruptcy Courts across the country, many large, reputable companies have chosen the prepack option. Some notable prepack filers in Delaware have included Source Interlink, Hilex Poly, Samsonite, Six Flags, and most recently, Simmons Bedding Company.

In a prepack case, ad hoc committees representing the lenders typically work with the debtor's management, equity holders, and/or other debt holders to develop a plan prior to the debtor filing its bankruptcy petition. This allows the lenders and certain select creditors to control the process and, potentially, the outcome, before the case is filed. The parties reach an agreement, negotiate an exit strategy, and draft a consensual plan.

The debtor then files its bankruptcy petition and plan and seeks to get in and out of bankruptcy as quickly as possible. This process may include the sale of assets pursuant to Section 363, and the sale is often approved by the Bankruptcy Court to proceed on an extremely condensed timeline.

It is important to distinguish a prepack from a prenegotiated Chapter 11 filing. They are distinct legal animals. A prenegotiated bankruptcy filing differs in that the overall structure of the deal is agreed upon prior to the bankruptcy filing; however, the actual votes to approve the plan are not solicited until after the case is filed. In jurisdictions such as Delaware, the timing of the solicitation is critical.

In general, prepacks usually encounter fewer speed bumps since most, if not all, parties with major interests are already onboard. However, while there are several distinct advantages to using a prepackaged bankruptcy to facilitate a sale of assets, there is still

a possibility that the proposed timeline and process could be disrupted and lengthened during the bankruptcy case. This could result in additional costs; concern from customers, suppliers, vendors, and the like; and, potentially, a serious disruption to the business or a default under the terms of the underlying agreement between the parties.

Out-of-Court Alternatives

Given the current economic climate and depending on the specific facts and circumstances surrounding a distressed company and its industry, it may be more cost-efficient and less time-consuming to pursue a sale of assets or liquidation outside of bankruptcy.

One or more of the following alternatives may provide a distressed company (or one of its lenders or creditors) with a better mechanism than a bankruptcy proceeding to liquidate or sell assets of the company. However, these options do not have the benefits of bankruptcy protection, including imposition of the automatic stay, the discharge of claims, the option to dispose of certain unfavorable contracts and leases, and the ability to sell assets free and clear by court order.

UCC Article 9 Sale. If a secured creditor wishes to sell the assets of a distressed company that secure its claim, it may do so under UCC Section 9-610(a). Delaware, like most jurisdictions, has adopted the UCC, and its Section 9-610(a) allows a secured creditor, after default, to “sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing.” *6 Del. C. Section 9-610(a)*.

An Article 9 sale can be accomplished quickly and is simpler and much less costly than bankruptcy. But strict notice requirements must be followed, and other risks must be considered. For instance, the secured creditor runs a risk that its claim is not properly perfected or secured, and a potential buyer assumes additional risk because its purchase of the assets is not free and clear of all other liens and claims. The secured creditor controls the terms and conditions of the sale. It has the option of conducting

either a public or a private sale, and it may credit bid for the collateral being sold. However, the burden is on the secured creditor to ensure that every aspect of the sale is “commercially reasonable,” including the “method, manner, time, place, and other terms.” *Id.*

If the issue is ever litigated, the entire process is scrutinized to ensure that the secured creditor met this standard, and this burden “requires the secured party to establish considerably more than that a presumptively fair price for the collateral was obtained.” *Hicklin v. Onyx Acceptance Corp.*, 970 A.2d 244, 250 (Del. 2009). In *Hicklin*, the Delaware Supreme Court found that the secured creditor failed to establish that the underlying sale was commercially reasonable and ruled that it was barred from recovering any deficiency. *Id.* at 253.

Even with its pitfalls, Article 9 “foreclosure” on collateral has been used increasingly by secured creditors to save the concomitant costs of a bankruptcy proceeding.

Assignment for the Benefit of Creditors. Some states, including Delaware, have statutes that provide for a liquidation alternative to bankruptcy — an assignment for the benefit of creditors (ABC). An ABC is an agreement under which a distressed company transfers title, custody, and control of its assets to a neutral third party (the assignee), who then liquidates the assets and applies the proceeds to paying off the company’s debts to creditors.

The assignee investigates and prosecutes claims against third parties, reconciles the claims and causes of action against the company, and makes distributions to creditors in a manner similar to the Bankruptcy Code’s absolute priority rule. An ABC may also entail a sale of all or substantially all of a company’s assets to a third party with the assignee liquidating any remaining property of the debtor.

An ABC is faster and less costly than bankruptcy, which means there is a potentially larger payout to creditors. The company (or its controlling party) is able to designate an assignee of its choosing and ordinarily selects someone with expertise in marketing and

selling assets in that particular industry. This process varies by state, and there may be little to no monitoring of the assignee.

An ABC is a particularly attractive option in Delaware because the state is one of the few in which statutes govern the process rather than relying solely on common law. See *10 Del C. Section 7381, et seq.* Additionally, the process is overseen by the very knowledgeable and respected Delaware Court of Chancery. The ABC is intended to be an efficient and orderly liquidation of a distressed business for the benefit of all creditors. The Court of Chancery supervises an assignee to ensure equal distribution, as Section 7387 voids any assignment that prefers some creditors to others.

Composition of Creditors. A creditor composition is simply an agreement between a debtor and its creditors under which the debtor makes one or more payments to creditors, and in exchange, creditors agree to refrain from taking any legal action against the debtor.

There is a great deal of flexibility in the form of the agreement, and the parties can establish restrictions, requirements, standards, duties, or other conditions appropriate to a given situation. Additionally, a composition could provide for procedures to sell certain assets of the debtor or provide for a systematic liquidation, but this option is more frequently used for companies that intend to continue operating.

If an agreement provides for less than payment in full, creditors often agree to waive payment on the unpaid portion. This usually results in a quicker and more substantial return to creditors. But for such an agreement to be a practical option, a debtor needs nearly all of its major creditors to sign off on its agreement. The claims and causes of action by nonconsenting creditors are not affected by the composition, so a debtor must convince creditors to cooperate for this method to be useful.

Receiverships. A receiver is a fiduciary appointed by either a state or federal court to take possession of a distressed company's assets and dispose of them for the benefit of its creditors. Ordinarily, the establishment of a receivership is sought by a creditor as

opposed to being voluntarily commenced by a distressed company.

A receiver manages and operates a debtor's business and property prior to sale, reconciles accounts, and collects amounts owing. Frequently, the court hearing the case also issues an injunction that is similar to the automatic stay in bankruptcy and bars creditors from collecting their claims.

As with an ABC, a receivership may be an especially appealing option in Delaware because of the expertise of the Court of Chancery and the respect accorded to Delaware corporate law. The receivership laws and procedures in Delaware provide for flexibility and guidance. See *8 Del. C. Section 291, et seq.* Any creditor or stockholder may seek the appointment of a receiver for an insolvent corporation. *8 Del. C. Section 291.* Yet, it is within the discretion of the chancellor whether to appoint one under the circumstances of a specific case; thus, this option may not be available in all cases. *Kenny v. Allerton Corp., 151 A. 257 (Del. Ch. 1930).*

Maximizing Value

There are a host of options available for restructuring professionals to consider when seeking to sell or liquidate the assets of a distressed company. An ABC or composition of creditors may be appropriate if the debtor's business will continue after the sale under a new owner that wishes to draw a line in the sand between liabilities of the old company and those of the new operating company.

A UCC Article 9 sale may be a practical solution for a secured creditor looking to foreclose on its collateral, while a receivership might be preferable if a complete liquidation and cessation of the business is desired. As always, if tax ramifications, rejections of leases or contracts, subordination of claims, or other challenging issues are present, Chapter 11 is still a viable option, albeit a more time-consuming and costly one. But, if a debtor can gather the requisite support pre-petition, it may be able to file a pre-pack and spend less time in bankruptcy.

All options are worthy of consideration when advising clients that are on the verge of

insolvency to find the most appropriate means to maximize value for all parties.



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