

BUYING ASSETS FROM A BANKRUPTCY

According to Warren Buffett, the smart investor is fearful when others are greedy and greedy when others are fearful. Right now, it's safe to say that most investors are fearful—and with good reason. Global and national economies are in turmoil, with some regions in severe economic distress. Chrysler and General Motors have filed for bankruptcy, and auto production has stalled, causing adverse, cascading effects on the steelmaking and scrap industries. 2009 promises to be a record year for business bankruptcies.

Many businesses are restructuring in one form or another as they downsize and trim expenses. In many instances, owners are looking to dispose of a business, a division, or machinery; it is difficult to do so in an illiquid marketplace, however. For a lot of businesses, it's simply not practical to liquidate because of financial and legal obligations to secured lenders, trade creditors, landlords, and employees. In the absence of new financing, a company's options are limited. Bankruptcy often becomes the only alternative: either reorganizing the business or liquidating it to satisfy creditor obligations to the greatest extent possible.

So much for the dark cloud—let's look at the silver lining. For one, this situation presents tremendous business opportunities for those who have the means and the appetite to acquire assets from distressed situations at bargain prices.

THE PROS AND CONS OF BUYING DISTRESSED ASSETS

Section 363 of the bankruptcy code permits an entity in bankruptcy, with court approval, to sell some or all of its assets “outside of the ordinary course of business.” What does that mean? For a scrap processing company, it can sell its scrap as normal during bankruptcy proceedings. But if it wants to dispose of property such as its processing equipment, that transaction is not within its ordinary, usual course of business, thus it must get court approval to do so. The company files a motion with the court to approve the manner and process of a proposed sale, which usually involves establishing auction procedures and criteria for qualifying bidders at the auction. Next, it files a motion requesting authority to sell the assets at auction free and clear of liens and encumbrances.

An important goal of a 363 sale is to maximize the estate's value. To do so, the seller might provide prospective bidders and buyers with certain protec-

tions. For unsuccessful bidders, these protections may include a break-up fee or expense reimbursement for the costs expended performing due diligence and the risk sometimes associated with providing the “first price.” For buyers, they include the ability to obtain assets at reduced prices, first, and assets that are free and clear of all liens and encumbrances. Buyers also may “cherry-pick” the assets, negotiating which assets and liabilities they wish to include or exclude and which contracts and leases they wish to assume or not assume. They also may bargain for purchase price adjustments going forward based on market conditions or other factors. Moreover, the 363 process provides substantial protection from successor liability risks.

On the other hand, the bidding process that accompanies the 363 sale allows competing bidders to drive up the assets' prices. To be deemed a “qualified bidder,” purchasers usually must show they have the financial wherewithal to complete the transaction. Bankruptcy acquisitions sometimes have significant transaction costs, including engaging bankruptcy counsel that must attend multiple hearings and prepare pleadings. The bidding and sale process is a matter of public record in bankruptcy filings and is subject to scrutiny by the court and interested parties, which might be too much publicity for some potential buyers. Motivated dissenters also may try to block the sale, as in the recent Chrysler bankruptcy sale.

Business asset sales in bankruptcy present unique opportunities for buyers. Though the transaction costs may be higher than an out-of-court purchase, the actual cost of the assets often is considerably lower. Astute buyers at 363 sales are searching for—and often finding—bargains.

It has been said that more millionaires were created during the Great Depression than during any other time in the nation's history. Though we hope the current economic slump is not heading toward depression-type levels, the same principles hold true during this recessionary period. Opportunities abound for those who maintain a level head while others are fearful. ■

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