

Business Asset Purchase in the US

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Our office often works with Canadian lawyers to affect their client's purchase of businesses located in the United States. Most often these transactions are initially negotiated by the Canadian principals with a US seller. There are, however, opportunities for a Canadian business to purchase the assets of a US business where that business has filed a petition in U.S. Federal Bankruptcy Court under the provisions of Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code"). As long as there is value in the US business, purchasing the assets of a going business through a properly structured sale under the Bankruptcy Code can work to the advantage of a Canadian purchaser.

Acquisition

Buying assets or an on-going business, or some or all of its assets, from a company while it is in Chapter 11 can be an excellent way of acquiring valuable assets free and clear of liens, claims, encumbrances and other interests. In fact, many Chapter 11 proceedings are commenced primarily, if not exclusively, to facilitate this type of sale.

Advantages

A sale of assets of a Bankrupt Company (the "Debtor") pursuant to Section 363 of the Bankruptcy Code, commonly referred to simply as a "363 Sale", is a procedure¹ to facilitate the sale of the Debtor's assets within the context of the Debtor's bankruptcy case. A 363 Sale allows the Debtor to fulfill its fiduciary obligations to its creditors and ownership by maximizing value and minimizing transaction costs. Purchasers, on the other hand, typically get enhanced value by proceeding quickly in oftentimes deteriorating circumstances, by obtaining the protections of a "free and clear"² sale order, and the enhanced finality of the sale.

The Bankruptcy Court must approve a 363 Sale after notice of the sale is provided to all creditors and parties in interest of the Debtor. Depending on the transaction, there may be an auction with competing bidders. Once the purchaser or successful bidder is identified, the Bankruptcy Court conducts a hearing and at its conclusion, if the sale is approved by the Bankruptcy Court, the sale order is entered. One of the goals is to have the Bankruptcy Court find that the sale of the assets by the Debtor was for "fair consideration", thus minimizing the risk of a fraudulent conveyance challenge. A finding by the Court that the sale was "in good faith" is also necessary to protect against reversal of the sale order on appeal. Section 363(m) protects sales made in "good faith" from

¹ The procedural aspects of a 363 Sale are not discussed in this article.

² "Free and clear" as long as the price of the assets exceeds all existing liens or all lienholders consent to the sale.

reversal on appeal unless the court stays the implementation of the sale order while the appeal is pending. This provision essentially moots the ability of any party to contest the transaction once the sale is closed, thus providing a degree of finality not available to purchasers outside of bankruptcy.

Significantly, Section 363 also allows a Debtor to assign to the purchaser or a third party favorable unexpired leases or executory contracts (contracts unperformed by both parties), but does not require the purchaser to assume the Debtor's obligations under unfavorable unexpired leases or contracts. The ability to selectively accept or reject executory contracts of the Debtor is one of the most attractive features of Chapter 11 as a whole, and can be accomplished through the 363 process.

Limitations

While there are benefits to a 363 Sale, there are also limitations. First, a Section 363 Sale cannot be used to circumvent other requirements of Chapter 11. Oftentimes 363 Sales of substantially all of the assets of the Debtor are not approved because they appear to violate the rights of creditors which they might otherwise assert, as, for example, their right to vote for or against a Chapter 11 reorganization plan. Courts have struggled to differentiate between allowable 363 Sales and sales that appear to be disguised reorganization plans and therefore attention must be paid to this issue when structuring the sale transaction.

Another limitation is that potential purchasers may not like that the 363 Sale process takes place in a relatively transparent atmosphere of the bankruptcy case.

Finally, and probably most significantly to purchasers, the "free and clear sale order" ultimately obtained as a result of the 363 Sale does not act as an absolute bar against the imposition of future successor liability. While courts have developed several tests to determine whether a claim survives against a purchaser of assets of a Debtor as a "successor in interest", a buyer can minimize the risk depending on the specific facts of each case by, for example, 1) building protections into the asset purchase agreement, 2) setting aside a reserve fund for unknown claims, and/or 3) discount the purchase price for possible significant unknown claims in amount to cover potential successor liability.

These potential hurdles can be addressed, however, and should not deter a potential purchaser from considering the acquisition of financially distressed assets. With advance planning, a transaction that maximizes value and fulfills the fiduciary obligations of both buyers and sellers can be structured under the provisions of Section 363 of the Bankruptcy Code, with the resulting benefits of speed in completing the transaction and the finality that comes with a 363 "free and clear sale" order.

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