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Practical tips for buying real estate in bankruptcy - Part 1 of 2

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Hinckley, Allen & Snyder

Bankruptcy sales can present unusually attractive opportunities for real estate investors. This article provides an overview of the bankruptcy sale process and offers some practical tips on how to maximize the advantages of the process and minimize potential pitfalls.

Overview of the 363 Sale Process

Section 363 of the Bankruptcy Code authorizes a bankruptcy court to sell assets of the bankruptcy estate free and clear of all liens, claims and other interests. These sales, known as “363 sales” can be consummated either under a confirmed reorganization plan or by a separate proceeding in the bankruptcy.

The 363 sale process typically takes the form of a public auction governed by detailed, court-approved procedures. The bankruptcy trustee or

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debtor-in-possession (DIP) often negotiates the terms of a proposed sale with a “stalking horse” bidder. These terms should be as fully negotiated as in any other comparable transaction, although as explained below, there are a number of ways in which the terms of a 363 sale will differ from most other similar arm’s-length transactions.

Once the trustee or DIP and stalking horse bidder have negotiated the terms of the contract, the bankruptcy court holds a hearing to approve the contract and proposed bidding and auction procedures, and to set a date for an auction. Once the court has granted that approval, other prospective buyers typically have a relatively short period of time to submit competing bids to the trustee or DIP. At the auction, each qualified competing bidder

can continue to improve its bid until the trustee or DIP selects a winning bid. The bankruptcy court then holds a hearing to approve the winning bid. While the court’s approval order is subject to appeal, Section 363 provides significant protection to good-faith purchasers, so parties often proceed to closing before the expiration of the appeal period or even after an appeal has been filed.

Advantages of the 363 Sale Process

The 363 sale process presents significant potential advantages for buyers that are familiar with the process.

- Because most 363 sales are distress sales, they often represent an opportunity to acquire an asset for a bargain price and on other favorable financial terms.

- The bankruptcy court has the ability under Section 363 to order a sale of the property free and clear of all liens, encumbrances and other interests. This can enable the buyer to acquire a “cleaner” title than it would in most other transactions.

Potential Pitfalls of the 363 Sale Process

The 363 sale process is not for the faint of heart. The process moves very quickly and is frequently more contentious than most other types of real estate transactions.

- The prospective bidders other than the stalking horse have very little time to conduct due diligence and submit competing bids, and very little ability to vary the non-monetary terms of the stalking horse bid. (For this reason, a prospective buyer will generally prefer to be the stalking horse rather than a competing bidder; the stalking horse has much more influence over the process than other bidders.)

Part 2 will appear in the July 6 Northern New England edition.

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Part 1 appeared in the June 1 Northern New England edition.

• A number of steps in the process (the initial hearing on approval of the stalking horse bid and the bidding procedures, the auction, and the hearing on approval of the winning bid) present opportunities for aggressive parties interested in the property to disrupt the proceedings to their advantage.

• Finally, a 363 sale is typically an “as-is” sale with no post-closing recourse against the bankruptcy estate. The combination of a limited opportunity to conduct due diligence with an as-is sale presents a higher level of risk than most buyers would prefer.

Issues Arising in 363 Sales of Real Estate

A number of issues frequently arise in connection with 363 sales involving real estate. These include:

Scope of Interests Extin-



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guished by the Sale Order: Although Section 363(f) generally authorizes the bankruptcy court to sell assets free and clear of “any interest”, courts generally agree that in order to sell free and clear of a particular lien, encumbrance or other interest, the trustee or DIP must give the holder of that interest notice of the proposed sale and an opportunity to object. The trustee’s or DIP’s counsel will sometimes try to dismiss this concern, but the careful buyer will want to ensure that at a minimum, the record clearly reflects that the holder of each known claim or interest was given notice of the proposed sale and an opportunity to object. In addition, the buyer may not want to extinguish certain interests (for



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example, an electrical easement in favor of the power company). The buyer should be sure to except these interests from the sale order so that they are not inadvertently extinguished.

Compliance with Laws: While the bankruptcy court can sell free and clear of interests, this does not excuse the buyer from continued compliance with all applicable laws and regulations. This distinction frequently arises in connection with environmental matters. Even if a sale order provides that property is to be transferred free of all environmental claims, the buyer may (and in most cases would) have the responsibility to address any existing environmental problems on the property, even if the buyer did

not cause those problems. This reinforces the need for careful due diligence notwithstanding the accelerated schedule that most 363 sales have.

Conclusion

The 363 sale process presents a number of unusual opportunities and challenges. A prospective buyer of real estate in a 363 sale should get bankruptcy and real estate counsel involved as early in the process as possible. Understanding the advantages and potential pitfalls of this complicated, fast-moving process can put the buyer in a position to use the process to its advantage.

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