



Restructuring, Bankruptcy & Creditors' Rights NEWSLETTER

SCHIFF HARDIN LLP

VOLUME 2

SPRING 2008

IN THIS ISSUE:

- 1 Section 363 Sales – Bargain Shopping In The Bankruptcy Bin
- 5 Asset Sales In Bankruptcy: The Financial Advisor's Perspective
- 9 Save the Date: Teach-In
- 10 Is A Right Of First Refusal An Executory Contract? *Maybe*

SECTION 363 SALES – BARGAIN SHOPPING IN THE BANKRUPTCY BIN

By J. Mark Fisher

The past several years have seen a marked increase in the number of sales of debtor's assets to firms under Section 363 of the Bankruptcy Code. These sales, free and clear of existing liens and interests, provide the most expeditious way for buyers to selectively purchase the economically attractive assets of a debtor, or of a non-debtor company that is amenable to filing bankruptcy after a purchase agreement is reached, while avoiding the assumption of most liabilities, including burdensome leases and unperformed contracts. In essence, a Section 363 sale "washes" the assets of a financially distressed company, thereby giving the buyer "cleaner" title than it would otherwise receive in a non-bankruptcy sale.

With the exception of a few bargain hunting firms that traditionally target such Section 363 opportunities, most companies rarely, if ever, get involved in such transactions. Thus, when these opportunities do arise – as has increasingly been the case in recent years – the typical private company is often proceeding into uncharted territory. This article provides a practical introduction to the strategy and tactical considerations in successful Section 363 sales (particularly those sales utilizing leverage).

The Stalking Horse

The stalking horse is the bidder who signs a purchase agreement with the debtor, subject to Bankruptcy Court approval and possible competitive bidding. The terms of

that purchase agreement – including price and the ability and speed of the bidder to consummate the transaction – then serve as the benchmark for all other bidders to top.

Perhaps the most significant advantage of being the stalking horse is the greater access to, and the ability to "lock up," management before other bidders. The stalking horse usually enjoys greater access to due diligence and a longer period to conduct its investigation. The stalking horse will also dictate the terms of the deal, often to the detriment of other bidders. For example, through its enhanced due diligence and management relationships, the stalking horse can often sign a purchase agreement with fewer "outs" and with other terms that may not be acceptable to other bidders with less information. Because of the scarcity of lenders in distress situations, the stalking horse also may enjoy a head start to obtain financing. The stalking horse often (but not always) may be positioned to know what the competing bidders are doing; always an advantage in what is essentially an auction. Finally, the stalking horse often receives an agreed upon break-up fee or expense reimbursement fee, subject to court approval, which can cover legal and accounting fees and sets an initial "jump" in the price that a competing bidder must offer to make an economically superior bid.

The disadvantages of being the stalking horse are fairly obvious. It is risky and potentially expensive. While a break-up fee is common in such transactions and is designed to absorb many – if not all – of the

due diligence costs, it may not be sufficient to cover all costs. There is no assurance the stalking horse will be the eventual purchaser since the stalking horse will need to fend off other competing bids presented per the court-ordered sale process. Overall, however, we have found that our clients view the advantages of being the stalking horse to generally outweigh the disadvantages.

The Break-Up Fee

As a rule of thumb, a break-up fee of up to 3% of the purchase price can be negotiated. The amount of the break-up fee, however, varies by jurisdiction, the size and complexity of the transaction, and the level of interest in the deal. Moreover, the stalking horse should not treat court approval of the break-up fee as a “slam dunk.” Creditors and other potential bidders might challenge the level of the break-up fee as an unnecessary waste of corporate assets, particularly if several potential buyers have expressed interest. In one transaction, we called as witnesses the debtor’s investment banker and our own client to testify as to historical data on deal-related fees and the necessity of the break-up fee to induce our client to serve as the stalking horse. In other cases, it has been possible to obtain advance approval of the fee from the secured lenders and creditors’ committee during negotiations over the letter of intent. In one recent deal, these parties agreed in advance to reimbursement of deal expenses (up to a cap) in lieu of a break-up fee.

The Earnest Money Deposit

Many potential buyers abhor earnest money deposits. In a Section 363 setting, however, the debtor and creditors – as well as the court – often expect cash or its equivalent to prove the *bona fides* of the offer before they will initiate and consider the sale process. For those averse to earnest money deposits, sometimes the debtor will accept a letter of

credit in lieu of a cash deposit. A buyer with strong banking relationships may be able to use this alternative to the undesirable requirement of posting earnest money in cash.

The Customers and Suppliers

In conjunction with its due diligence, it is important that the buyer promptly contact customers and suppliers of the debtor in a Section 363 sale. Customers of the distressed debtor may already have secured alternate sources of supply to ensure the continued flow of product. Suppliers may have pursued alternative customer channels and, in extreme cases, may be financially impaired by unpaid pre-petition receivables from the debtor. Certainly, the suppliers may have put the debtor on COD terms and may decline to build necessary stocks of inventory or special-order product. The buyer needs to know if these relationships are beyond salvage and, if possible, persuade the customers and suppliers that the buyer’s management team, financial resources and commitment can be relied upon.

These calls can sometimes reveal a bidder’s advantage over its rivals. In one instance, key suppliers were convinced that our client offered the best long-term management and financial source. The debtor was thus persuaded that only a purchase by our client would convince key customers and suppliers of the continued viability of the business upon emerging from bankruptcy. The buyer must know the price of support of key customers before it closes. Customers can require assumptions of certain supply contracts (with full payment), delivery of specialized components or, in one case, an operating manual. Bottom line: the Bankruptcy Court’s order cannot cure the operating issues that determine whether the acquisition will succeed or fail. Only careful, extensive customer and supplier calls during due diligence avoid being blindsided and identify

those concessions the debtor must provide to preserve these important relationships.

The Financing

Cash is king in bankruptcy; the buyer's financing will determine whether the debtor and Bankruptcy Court believe its offer is real. Creditors fear bids that may fail for lack of money, particularly if a new entity will be specially formed by the buyer. A warehouse facility with the equity firm's principal lender or equity provided by its limited partners can be critical bridge financing until a final loan can be underwritten. Final debt financing may face a longer, more stringent credit approval process as the lender's credit department makes its own assessment of whether the new company still has the flaws that bankrupted the debtor.

The Liabilities

As in any asset purchase, the Section 363 sale allows the buyer to select which liabilities of the debtor to assume – if any. An added advantage of the Section 363 sale is the “sale order” directing the sale of the company to the winning bidder *free and clear of all liens and other interests*. This is enormous protection for the buyer. Of course, the buyer may very well agree to assume certain liabilities to ensure continuity of employees and customer or supplier relationships and to otherwise remain competitive with other bidders. The ability to allocate these costs to the bankruptcy estate (through a purchase price adjustment or otherwise) will be a matter of negotiation. It is clear, however, that the assumption of selective contracts and liabilities can allow the buyer to target its purchase price to the most important suppliers or to suppliers who will agree to renegotiate terms so long as they get a larger portion of their existing debt paid at some point.

Some cases push the limit of the Bankruptcy Code and dispose of contingent claims and

even successor liability to those creditors who receive adequate notice of the terms of the sale (as approved by the Bankruptcy Court). There are three possible exceptions to this general rule where successor liability theories could create liability for the purchaser notwithstanding the sale order: The first two are fairly well known, namely successor liability for environmental matters and “future” claims, where persons have been exposed to products (like asbestos) but are not injured or aware of their injury. Effective bankruptcy, insurance and environmental counsel are critical to determine if these are real risks in your deal. Insurance or a purchase of assets under a plan of reorganization that deals with these claims may be the only protection. The third possible exception is less well known, but can be as critical to the buyer. Even if the debtor's former employees elected COBRA coverage, the debtor may not provide the necessary insurance coverage following the sale because of a lack of the need (or the means) to maintain coverage. The acquiring company may by law be forced to provide that coverage.

The Contracts

A Section 363 sale provides the buyer with the great advantage of picking and choosing which contracts to assume. Quite literally, the buyer can acquire the bankrupt company with an ideal complement of contracts. With a few exceptions, the non-bankrupt party generally cannot rely on a “nonassignment” clause in the contract to object or otherwise withhold consent to the assignment.

In order to assume a contract, Section 365 of the Bankruptcy Code requires that all prior defaults must be cured at the time of assumption, or within a reasonable time thereafter. Allocation of these cure costs between buyer and debtor thus becomes a point of negotiation with the debtor. Although the nonbankrupt party to an assumed contract

[Section 363 Sales continued on page 4](#)

is often happy to have a new, financially sound party to deal with, it might try to assert enormous costs to “cure” defaults and require the buyer to demonstrate “adequate assurance” of its ability to cure defaults or to perform the contract. We have seen these challenges develop into a mini-trial in the Bankruptcy Court regarding the buyer’s ability to perform. Assuring that proper notice is sent to each nonbankrupt party to a contract will avoid the headache of post-closing objections and litigation in the Bankruptcy Court.

The Purchase Agreement

As a general matter, the buyer is well advised to view the purchase agreement with the debtor as an elaborate bill of sale, “as is, where is.” Few of the customary protections against post-closing surprises will exist or be collectible. Debtors and their creditors fight hard against indemnifications and the post-closing survival of representations and warranties. Only a holdback of a portion of the purchase price or an escrow to fund indemnifications or a working capital adjustment favoring the buyer can protect the buyer’s rights.

Conditions to closing will be minimal. Do not expect to have any financing, due diligence or other customary outs after the time of the auction. A bring down of the representations and warranties and a “MAC” are standard conditions, however. Additional conditions reduce the competitiveness of the bid and will be strongly resisted or rejected outright. Depending on the particular facts and circumstances, the following conditions may be appropriate to require: obtaining and maintaining a certain level of Debtor-in-Possession (DIP) financing; no loss of key customers or key employees (especially if the bankruptcy is expected to extend a long time and the continued loyalty of key employees is more likely to erode).

The Additional Features of the Section 363 Sale Process

The buyer should include in its letter of intent and purchase agreement provisions describing the acceptable content and timing of Bankruptcy Court orders defining the sale process, including the break-up fee, bidder qualifications and earnest money, due diligence rights, bidding increments at the auction, notice provisions relating to the sale for creditors and nonbankrupt parties to executory contracts, the buyer’s right to review and overbid other competing bids, and the ultimate court hearing. That way the rules of the auction are more or less set before competing bidders are on the scene. The purchase agreement should set a deadline for the entry of a satisfactory sale procedures order and allow the buyer to terminate its obligations if the debtor fails to meet the deadline or comply with the procedures, or if the Court does not approve the necessary conditions or set a schedule sufficient to meet deadlines. Since most of the protections afforded the buyer depend on notice, the buyer’s counsel must audit compliance with these rules every step of the way to avoid any surprises.

The purchase agreement will also specify as a closing condition the entry of a final order of the Bankruptcy Court approving the sale by a set deadline. The terms of the order are central to the protections of the buyer particularly since the sale order provides that the assets are being sold “free and clear” of all liens and interests.

The Debtor’s Banks and Creditors’ Committee

The role of the secured creditors as well as the committee of unsecured creditors must be appreciated by the buyer, who should always assume the secured lenders and other creditors may be, in reality, “calling the shots.” Their relative power

will depend on whether and how much equity exists over the secured debt and (if the auction goes really well) even over unsecured claims. The details of the DIP financing may also define the leverage of the parties and determine whether the debtor has financing that can support continuing operations through the sale much less the longer term plan process.

The unsecured creditors' committee, even if it is out of the money, will attempt to assert whatever negative leverage it can to assure for unsecured creditors a cut of the sale proceeds that would otherwise go to the secured creditors. If a "vulture" fund has purchased a portion of the debt at a deep discount that will create divergent interests among creditors that could affect the dealings among the parties, including the buyer.

The Costs

Managing the costs in a Section 363 sale will be challenging. Active deal management is required. As mentioned earlier, bridging the acquisition with equity or a warehouse

line will eliminate costs inherent in typical third-party debt financing, at least until the deal has successfully closed. Similarly, closing with buyer's prospective management team based on a term sheet (albeit, a fairly detailed one) will defer the costs of definitive employment and shareholders agreements until the deal has, hopefully, closed. Finally, being smart with legal due diligence is essential, as the bankruptcy protections allow the buyer to be selective in what it chooses to ask its lawyers to review.

Conclusion

A client once said that "this bankruptcy deal will be his last" – his stalking horse bid will either be outbid, in which case this was a lot of effort for nothing, or his stalking horse bid will prevail, in which case he will be set for life with no further need to do a bankruptcy play. In reality, the Section 363 sale, while truly challenging and, for the most part, uncharted ground for most companies, offers a tremendous opportunity for those with fortitude, an "eye for a bargain," and the patience to master the nuances of this potentially attractive acquisition vehicle.

ASSET SALES IN BANKRUPTCY: THE FINANCIAL ADVISOR'S PERSPECTIVE

By Clare Pierce, Cathy Vance and John Wheeler
Development Specialists, Inc.

Section 363 sales in bankruptcy, which are named for the Bankruptcy Code provision that governs them, have become a prominent and important feature in Chapter 11 over the last several years. Section 363 of the Code permits the bankruptcy trustee or, in most chapter 11 cases, the company itself (called the "debtor in possession") to sell, lease or use property outside the company's ordinary course of business.

A Section 363 sale has characteristics that have no corollary outside of bankruptcy, notably that an asset can be sold "free and clear" of interests. This means that liens and other interests are stripped off the asset to be sold and attached to the proceeds of the sale. As an example, say a debtor wants to sell its inventory, in which the debtor's lender holds a security interest. Section 363 permits the security interest to be separated from the inventory. The buyer acquires the latter free of the bank's interest. The bank doesn't lose its lien, but instead of attaching

[Asset Sales continued on page 6](#)

to the inventory, the lien rights are in the proceeds, which remain within the debtor's bankruptcy estate.

Another big advantage of Section 363 sales is the protection afforded the buyer. Like the lienholder in the above example, claim holders can look only to the proceeds of the sale and the buyer is immunized from most successor liability claims. Moreover, because most Section 363 sales are finally approved by the Bankruptcy Court (some courts won't sign a sale order if no one complains) and the order will include findings that the sale is in the best interests of the bankruptcy estate and is a good faith transaction, the buyer is protected against attacks on the sale transaction itself.

(A disclaimer is in order here. Just about any property can be sold via a Section 363 sale, which forces us to talk in generalities. Specific types of assets may be governed by state or federal law in a way that diminishes to some degree the ability of the buyer to acquire the property "free and clear" of all interests.)

It might seem as if Section 363 was designed to tilt heavily in favor of the buyer, but the seller, and the bankruptcy estate's creditors, also benefit from these sales. Most obviously, the property is likely to command a higher price if it can be sold without its liabilities. This creates a larger pool of cash that the debtor can distribute to creditors. A debtor might also make use of Section 363 early in its case to create needed cash flow or it might sell off property, such as a manufacturing line, that has proven to be unprofitable and a drain on the company's resources. Whatever the reason for the sale, the debtor's decisions are tempered by the fiduciary duty it owes to creditors, who must be made better off by virtue of the sale.

There is no "typical" Section 363 sale. The property subject to such a sale can range from a single car to an operating

company. Trustees in consumer cases and large companies that are trying to reorganize make similar use of the Section 363 sale option. Whether the sale is small or large, simple or complex, the procedures for effectuating the sale are largely the same.

However, the greater the complexity of the transaction, the more likely it is that financial advisors will play crucial roles for both seller and buyer. Financial advisors can be thought of generally as the business counterpart to the legal expertise the attorneys provide and can be valuable in moving the sale forward and ensuring that it's done right.

On the seller's side, one of the first tasks for the financial advisor is to market the asset. Usually, the financial advisor creates a package of vital information about the asset, along with information about how the sale will proceed and how a potential buyer should respond, and then finds a way to get packages into the hands of likely buyers. Some marketing avenues are obvious, while others require some creativity. Take a car, for example. An ordinary car of average value will be marketed differently than a vintage model, and a fleet of Bentleys will not pique the interest of the same crowd as a Chevrolet dealership's inventory.

Once the package is sent to the target market, the financial advisor's job is to "work the room" as it were, figuring out who will have a genuine interest in bidding on the property. Ideally, the financial advisor will find among this smaller group of potential bidders one that will be the "stalking horse," which is to say someone interested enough to perform the necessary due diligence and work out terms of a sale.

The seller is almost always better off if a stalking horse bidder can be found because a good amount of uncertainty is eliminated. The sale terms negotiated between the seller

and the stalking horse bidder will form the basis of the notice that will go out to all affected parties, which means that the notice itself will be more specific. In addition, the seller knows its worst case scenario; if no one makes a higher or better offer, the seller has a buyer and can move forward with the sale.

Financial advisors often play a lead role in negotiations with stalking horse bidders, who are not only interested in buying the asset, but also in protecting themselves against subsequent bidders who often rely on the stalking horse's due diligence and negotiated sale terms (formed with the aid of their own financial advisors) to form their bids.

Part of the financial advisor's job, then, is to negotiate appropriate "break-up" or "termination" fees, which give the stalking horse bidder some compensation for the work it has done in the event it is not the winning bidder. The goal here is to strike the appropriate balance between what the stalking horse bidder wants and what is in the best interest of the bankruptcy estate. Courts examine break-up fees carefully and will disapprove those that are excessive or that will chill the bidding process.

(Another disclaimer: Just what a court will approve can vary by jurisdiction and different courts have their own preferences and pet peeves, not just with break-up fees, but with many aspects of the sale. Know your jurisdiction!)

Another important aspect of the negotiations is over bid increments, to which the courts also give careful scrutiny. Again, the concern is the best interest of the bankruptcy estate and the courts will view with disfavor bid increments that discourage others from making their own offers for the property. Indeed, any fees or other terms that seem designed to ensure that the stalking horse is the winning bidder could jeopardize sale approval by the court.

If no stalking horse bidder is found, the financial advisor faces the task of finding out why. It could be that the property needs to be reevaluated and a different marketing strategy created. In some cases, the property will go to auction without a stalking horse.

With or without the stalking horse bidder, Section 363 requires that proper notice be given to all parties who may have an interest in the property or its sale, and anyone with an objection must be provided an opportunity to be heard. This requirement is the most important in effectuating the Section 363 sale and is the means by which the buyer is able to take the property free and clear.

The content of the notice may vary depending on the property, but there are certain aspects that are true in all cases, in which the notice

- Alerts those with an interest in the property of the sale and advises them of the effects of the sale;
- Informs parties how the sale will take place and what the terms are;
- Describes the property to be sold;
- Explains why the sale is in the best interest of the bankruptcy estate, including a discussion of the fair value of the property; and
- Includes all details that are pertinent to the purchaser, including that the sale is an arms-length transaction and is made in good faith.

The notice may trigger objections or, if there is a stalking horse, additional bids for the property. With respect to the latter, the financial advisor will evaluate the terms and assist with a determination of whether any subsequent offer is better than the stalking horse bid. Just because a bid is for a higher dollar amount

[Asset Sales continued on page 8](#)

does not mean it is a better offer. The financial advisor may conclude, for example, that the higher offer has contingencies or less certain financing, which may have a negative effect on the estate.

To confirm a sale the Bankruptcy Court must find that there is a sound business purpose for the sale, the notice given is reasonable and accurate and the price paid is fair and reasonable.

Any number of objections to the sale may be raised. A party may, for example, assert its own right in the property. There may also be allegations that a bidder is not acting in good faith, that the sale is, in essence, a plan of reorganization disguised as a sale (called a "sub rosa plan"), that there is collusive bidding or that bidding devices, such as break-up fees, are unreasonable or geared toward limiting alternative bidding.

Also, courts are unlikely to approve sales for a price that is less than the value of liens on the property. Although the attorneys take the lead on matters that go before the court, the financial advisor may be called to testify about the substance of the transaction, such as the good faith of the parties' negotiations or why the sale price represents the fair value of the property. The court may also require the financial advisor to testify about the scope and nature of the marketing of the assets.

In general, courts tend to defer to the seller's business judgment. Some circumstances will trigger closer judicial scrutiny, such as when the assets are being sold to a company insider. But these are exceptions to the general rule that provision of notice and an opportunity to be heard is the key to Section 363 sale approval.

Once the Bankruptcy Court approves a Section 363 sale, it is very difficult to mount any sort of legal challenge to the sale's terms. A party that wants to appeal must do so within ten days and must get a stay of the sale order pending appeal. Absent a stay, an appellate court will consider only the limited question of whether the sale is to a good faith purchaser. Even with a stay, there will likely be a heavy dose of deference to the Bankruptcy Court's findings.

In other words, a properly noticed and approved Section 363 sale is practically bulletproof, which, along with stripping off the liabilities, makes the advantages and appeal of Section 363 – and the need for the right professionals throughout the process – apparent.

For reprints of this newsletter, permission to reprint any of the articles, or to be added to our mailing list, please contact Jon Vigano at jvigano@schiffhardin.com or 312.258.5792. We welcome any feedback.

THANKS



Schiff Hardin LLP would like to thank Development Specialists, Inc. ("DSI") for contributing to our Spring 2008 issue and for contributing to our Spring 2008 Teach-In. DSI is a nationally recognized leader in crisis management, financial consulting and corporate restructuring. John Wheeler, Clare Pierce and Cathy Vance are resident in the firm's Chicago, Miami and Columbus offices, respectively. For more information about DSI, please visit www.dsi.biz.

SAVE THE DATE

To further develop and discuss the information outlined in this issue's lead article and the enclosed checklist, the attorneys of Schiff Hardin LLP's [Restructuring, Bankruptcy and Creditors' Rights Group](#) will be hosting a panel discussion.

Teach-In:

*“Section 363 Sales:
Perspectives from the
Debtor, Purchaser and
Financial Advisor”*

March 12, 2008
9:30 a.m. – 11:30 a.m.

Moderator:

[Eugene J. Geekie Jr.](#)

Partner, Restructuring, Bankruptcy and
Creditors' Rights Group

Panelists:

[J. Mark Fisher](#)

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[Roger R. Wilen](#)

Partner, Corporate and Securities Group;
Private Equity and Venture Capital Group

Guest Panelist:

[William \(Bill\) A. Brandt Jr.](#)

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If you would like to attend, please log on to <http://www.schiffhardin.com/events/restructuring/> to register. The deadline to register for the Spring 2008 Teach-In is [March 5, 2008](#). We look forward to discussing these and other Section 363-related issues with you at that time.

IS A RIGHT OF FIRST REFUSAL AN EXECUTORY CONTRACT? *MAYBE*

By Patricia Fokuo and Ebba Gebisa

Consider this: You decided to sell your assets via a Stock Purchase Agreement to Company B but only because you knew if Company B decided to dispose of those very assets, you, before anyone else, would have the opportunity to grab those assets back if you wanted them. We have all seen and heard about them – the so-called “right of first refusal” provisions – but does a right of first refusal clause create an executory contract that Company B can assume or reject if it files bankruptcy?

What Constitutes An Executory Contract Under the Bankruptcy Code?

Section 365(a) of the Bankruptcy Code provides that a “trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.”¹ Despite the importance of the determination, courts are inconsistent concerning what constitutes an executory contract, in large part because there is no precise definition of “executory contract” as applied under the Bankruptcy Code. However, three general approaches have arisen among the courts to determine whether a contract is executory in nature. A majority of the courts have adopted Professor Countryman’s definition, which provides that an executory contract is “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.”² Accordingly, such courts find a contract to be executory when both sides are still obligated to render substantial performance.³

¹ 11 U.S.C. § 365(a) (2008).

² Vem Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

³ See *In re Enron Corp.*, 2003 Bankr. LEXIS 2263, *11-14 (Bankr. S.D.N.Y. 2003) (discussing the three executory contract tests).

Other courts have adopted a less stringent test derived from legislative history, which provides that an executory contract “generally includes contracts on which performance remains due to some extent on both sides.”⁴ Finally, other courts utilize a more lenient “functional approach” and focus on the benefit or burden to the estate of assuming or rejecting the contract.⁵

Is a Right of First Refusal An Executory Contract?

While little attention has been given to the executory nature of a right of first refusal incorporated into a purchase agreement, numerous courts have found it instructive, regardless of the context under which they are addressing a right of first refusal, to look at other courts’ treatment of a “right of first refusal” or “option” concerning the purchase (or repurchase) of real property. However, at least one court has expressly distinguished between the executory nature of a stock option and option to purchase real property and concluded that a stock option is not an executory contract.⁶

Courts are split regarding whether a right of first refusal or an option—the two are often treated analogously—is an executory contract.⁷

⁴ *Id.* (citing H.R. Rep. No. 95-595, at 347 (1977)).

⁵ See *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 687, 696 (Bankr. S.D.N.Y. 1992).

⁶ *In re America West Airlines, Inc.*, 179 B.R. 893, 895-96 (Bankr. D. Ariz. 1995) (finding that the stock options given by the Debtor to its pilots were not executory contracts because the pilots did not have material obligations that remained unperformed).

⁷ See, e.g., *In re Parkwood Realty Corp.*, 157 B.R. 687, 690 (Bankr. W.D. Wash. 1993) (citing *In re A.J. Lane & Co., Inc.*, 107 Bankr. 435, 437 (Bankr. D. Mass. 1989)) (holding that the stock repurchase rights under the Shareholders Agreement made it an executory contract; and finding that the analysis for real estate purchase options was pertinent; noting that “it is the contingency of exercise which makes the option executory...Upon exercise, substantial performance remains on both sides”).

Some courts broadly assert that a right of first refusal is an executory contract that may be assumed or rejected pursuant to Section 365(a).⁸ Such courts adhere to the rationale that “a requirement to offer a right of first refusal prior to consummation of a sale is an unperformed obligation of a contract containing such condition,” and focus on whether material obligations exist for both sides of the contract and to whom the obligations are owed.⁹ For example, in *In re Enron Corp.*, the Bankruptcy Court for the Southern District of New York asserted that a right of first refusal is an executory contract because it obligates one party to give notice to the counterparty of any offer to purchase the property or stock and to sell it to that counterparty if it matches the price, and then obligates the counterparty to exercise or waive the right of first refusal within a specified time.¹⁰ Conversely, other courts have held that a right of first refusal is not an executory contract that may be assumed or rejected pursuant to Section 365(a). Most notably, Ninth Circuit case law provides that a right of first refusal is not an executory contract when no sale is pending at the time the bankruptcy is filed, and similarly, an unexercised option at the time of bankruptcy is not an executory contract.¹¹

Enforceability Issues Arise If a Right of First Refusal Is Deemed an Executory Contract.

When the right of first refusal incorporated into an agreement is determined to be an executory contract that is assignable under the

⁸ See *In re Enron Corp.*, 2003 Bankr. LEXIS at *14; *In re Kellstrom Indus., Inc.*, 286 B.R. 833, 835 (Bankr. Del. 2002); and *In re Teligent, Inc.*, 268 B.R. 723, 729 (Bankr. S.D.N.Y. 2001).

⁹ See *In re Teligent*, 268 B.R. at 729 n.7; but see *In re LG Phillips Displays USA, Inc.*, 2006 Bankr. LEXIS 1092, *17 (Bankr. D. Del. 2006) (rejecting the Debtor’s argument that the right of first refusal created an executory contract because if the option holder exercised the right of first refusal it was obligated to give notice to a third-party, the owner of the property, rather than the debtor).

¹⁰ 2003 Bankr. LEXIS at *14.

¹¹ See *In re Bergt*, 241 B.R. 17, 19 (Bankr. D. Alaska 1999).

Bankruptcy Code, some courts find that the right of first refusal is unenforceable. Such courts view the right as an “anti-assignment” provision that hinders the Debtor’s ability to assume and assign the property or stock. For example, in *In re Adelpia Communications Corp.*, the Bankruptcy Court held that rights of first refusal are generally unenforceable under Section 365(f) (1) because they “prohibit, restrict or condition” assignment to an unacceptable degree.¹² Conversely, in *In re Capital Acquisitions & Management Corp.*, the Bankruptcy Court for the Northern District of Illinois held that a right of first refusal is enforceable because it was neither an *ipso facto* clause nor an impermissible restraint on assignment.¹³ Additionally, the *In re Capital* court noted that Seventh Circuit case-law provides support for a narrow definition of an executory contract.

How Do I Know How My Right of First Refusal Contract Will Be Treated?

With no precise definition of “executory contract” under the Bankruptcy Code and inconsistency among the courts regarding the approach taken to determine whether an executory contract exists, one should be cognizant of the various factors a court *may* assess in order to make this determination. While this varies by jurisdiction, when the right of first refusal stands alone, the determination likely depends on whether the court views the contingency of the right as creating material, unperformed obligations for both parties to the agreement. When the right of first refusal is incorporated into another agreement, the enforceability of the right likely depends on whether or not the court generally views the right as an impermissible restraint on assignment.

¹² *In re Adelpia Corp.*, 359 B.R. 65 (Bankr. S.D.N.Y. 2007); 11 U.S.C. § 365(f)(1) (2007) (permits assignment of an executory contract notwithstanding provisions in the contract that prohibit, restrict or condition assignment).

¹³ 341 B.R. 632, 636-38 (Bankr. N.D. Ill. 2006).

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