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Seizing Opportunity: Advantages of a Section 363 Bankruptcy Sale

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🔑 Key Take: *Hotel investors should look for opportunities to acquire hotels out of bankruptcy, which affords certain benefits that are not generally available in customary arm's length purchase and sale agreements.*

It is too frequent of an occurrence that prospective buyers of hotels at bankruptcy sales feel like outsiders with the deck stacked against them. Because of this, they sometimes miss out on good investment opportunities, as they are unfamiliar with how the auction process works and do not understand the bankruptcy case itself or the sales procedures, nor how to best craft their bids or evaluate the bids of others. The purpose of this segment is to shed some light on hotel sales under Section 363 of the bankruptcy code (Section 363), in the hope of fostering a more open and robust bidding process to perhaps turn some interested “would-be buyers” into successful bidders and owners of distressed hotels that are able to turn the

corner after being shed of their debt and repositioned.

When a hotel is sold pursuant to Section 363, there is often (but not always) a stalking horse bidder, who has agreed to purchase the hotel for a certain price that sets the floor of the bidding – the stalking horse bidder can be outbid by other potential buyers who have been qualified to bid at the auction (typically requiring the submission of a required bid deposit and satisfying some other qualification requirements by a specified deadline prior to the auction date).

There are significant advantages to being designated as a stalking horse bidder. For example, the sales procedure order approved by the court will generally provide for a breakup fee to compensate the stalking horse bidder for its reasonable fees and expenses, as well as lost opportunity costs.

Additionally, the sales procedures will provide for a minimum overbid amount, which is required to make a successful bid over the purchase price to be paid by the stalking horse buyer. The economics of the bidding process provide that the breakup fee to the stalking horse bidder, together with the minimum overbid amount, will yield a higher amount to the debtor's estate. For example, if a stalking horse contract had a \$25 million purchase price, a \$375,000 breakup fee (1.5 percent of purchase price), plus a \$100,000 minimum overbid amount, a qualified bidder would have to bid \$25.475 million at the auction to be a successful bidder. Like a typical auction, bidding continues until the final, highest bid is accepted.

Many potential buyers unfamiliar with the process may feel intimidated by the stalking horse bidder, which is usually chosen by its sophistication and credibility as a buyer, believing that the auction process may be a *fait accompli*, or that they do not have a good enough understanding of what they end up with regarding the hotel's assets, its contracts, or even its liabilities should it be the successful bidder. Buyers should bear in mind that a main goal of the Section 363 sale is to result in a finding that the

auction itself, and the resulting sale, were fair and reasonable. So, as just one example, these are not your typical fast-paced auctions with fast-talking auctioneers. The person conducting the sale is often the debtor's counsel, and if bidders request a pause of several minutes here and there to have a chat with investors, co-bidders, and/or lenders before increasing their bid, they will generally be granted this accommodation within reason, to foster a more robust bidding process and a higher yield to creditors and/or the debtor.

One of the key benefits of a Section 363 sale is that the successful bidder may select which leases or other contracts (and their liabilities, referred to as "cure costs," representing outstanding sums owed to the contract vendor) it is willing to accept, and which contracts (and liabilities) it does not accept. If it does not accept them, the applicable contracts will be rejected and the hotel will be conveyed free and clear of those contracts and their corresponding liabilities, and this also holds true for any franchise agreement or management agreement that the successful bidder does not wish to assume. An asset purchaser can also have contracts assigned to it. The anti-assignment provisions in these agreements can be ignored in a Section 363 sale so long as the outstanding defaults (typically the cure costs) are satisfied and the assignee of such agreements can demonstrate adequate assurance of its ability to satisfy future performance under such agreements. The cure costs are often a point of negotiation.

Another main benefit to the successful bidder is not having to be concerned that its purchase will be unwound, as the Section 363 sale process with the auction of a hotel typically results in a court order finding that the sale was "fair and reasonable," which, except in limited circumstances, protects the buyer from fraudulent transfer claims of creditors seeking to challenge the sale.

Often, hotels are sold under a bankruptcy plan that allows the sale to be free and clear of transfer taxes

or mortgage recording taxes if a mortgage loan is obtained to fund the acquisition of the hotel assets. In those jurisdictions where these taxes are applicable, this can help bridge the gap on pricing, as the tax savings should be factored into bids.

These are helpful issues for potential bidders to consider and to evaluate in deciding whether to bid for a distressed hotel in a Section 363 sale. As one can expect more distress to come to market in the form of hotel bankruptcies, it is wise to engage counsel to help a prospective bidder understand the bankruptcy case and the terms of sale, evaluate the stalking horse bidder's contract, and otherwise guide this party through the process. This includes not just skilled bankruptcy counsel, but also counsel with a sophisticated hospitality practice like Akerman.