Where's The Fire? Viewing 363 Sales Through A Market Lens

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The question of who gets paid what and when has resurfaced as a hot topic in Chapter 11 bankruptcy filings. As part of that debate, the increasing use of Section 363 sales — going-concern sales or sales of all or substantially all of the debtor’s assets separate from a reorganization plan — has drawn alarm and criticism from some industry participants and observers.

In a 2014 report, the American Bankruptcy Institute’s Commission to Study the Reform of Chapter 11 pointed to the increased use of 363 sales, and the increasingly fast pace at which they have been completed, and concluded that this was an area in need of reform.

Since the release of the report, this debate has only intensified. While many practitioners maintain the traditional view that reducing the length of Chapter 11 cases by employing strategies like 363 sales reduces costs and increases overall recoveries, others continue to take the opposite view. For some, 363 sales are emblematic of what is now a broader “problem” with Chapter 11 cases that are proceeding too quickly. A recent article blames “quick auctions” for the fact that in 2016, the average Chapter 11 case took only 7.3 months, lamenting that in the ’90s, some companies “spent years protected from creditors.” It further states that secured creditors — specifically, hedge funds that have replaced traditional lenders in this role — are at fault for frequently orchestrating “hastily arranged auction[s]” to maximize the investment returns on their claims. Others have put forward more benign explanations for this trend, such as the evolution in the way...
company boards approach Chapter 11. Directors of insolvent firms now focus on maximizing value for all stakeholders — not just equity holders. As such, they are more likely to pursue value-maximizing sales in lieu of protracted court proceedings meant to increase the option value of out-of-the-money stakeholders.

A closer look at 363 sales in the context of the market shows that the increased use of this option is in line with broader trends and does not result in lower valuations. On the one hand, bankruptcy courts and practitioners alike generally favor a balance of market-based valuations and expediency. In this regard, 363 sales arguably represent one of the more efficient ways to resolve a Chapter 11 bankruptcy proceeding.

Chart 1

![Chart 1: Section 363 Sales in Public Company Bankruptcies](source: ABI Report, p. 203.)

The recommendations from the ABI Commission to Study the Reform of Chapter 11 were based on a review of data from large public companies. The report shows that, on average, 363 sales in Chapter 11 have exhibited “a positive linear trend” in growth between 1985 and 2013. Over the same period, the average time required to complete a 363 sale shortened, leading the ABI to note that “the sale process has become much more abbreviated” in recent times.

Unfortunately, instead of viewing these trends as positive developments, the report stated that they are evidence of secured lenders increasingly using this option to effectuate quick sales at unfairly low valuations. The report noted that 363 sales are “typically preferred by post-petition lenders and pre-petition secured creditors because of faster payoff” and that “quicker than necessary sales can potentially reduce the value available for stakeholders in the chapter 11 case.” To remedy this perceived problem, the report
suggested additional requirements for approval of 363 sales, as well as a mandatory 60-day moratorium on sales following the petition date.

However, these trends appear to be less alarming when viewed in the historical context of broader market factors. Furthermore, a look at various valuation measures indicates that more 363 sales have occurred during periods when companies are relatively overvalued than when they are undervalued. This suggests that 363 sales are far from being the fire sales that the ABI — and others that hold a similar view — are concerned about, making the suggested reforms wholly unnecessary. First, it’s true that there has been an increase in Chapter 11 cases involving 363 sales, but this increase is in line with the growth in overall mergers and acquisitions activity over this time period, which exhibited a similarly positive linear growth trend (see chart below). Since bankrupt firms represent a source of supply for both strategic and financial buyers, it’s not surprising that 363 sales have become more prevalent as M&A activity has increased in recent times. An increasing appetite for acquisitions provides more incentive to place assets on the market.

Chart 2

![Chart 2](Image)

Source: Institute of Mergers, Acquisitions and Alliances

Second, the faster pace of 363 sales — measured as the time between the petition date and the sale date — is similarly in line with broader market trends. In fact, all Chapter 11 cases have been faster since passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), so it only makes sense that 363 sales would proceed more quickly, as well. Studies have shown that the duration of traditional Chapter 11 cases has fallen by over 30 percent since the 2005 amendments. Looking at more recent time periods, the average case duration fell from 439 days during 2004-2007...
to 210 days during 2010-2013. Tellingly, these changes are in large part driven by an increase in preplanned cases fostered by BAPCPA. Given that the 363 sale marketing process often begins prior to the debtor’s Chapter 11 filing, what is seen as a “quick sale” may more likely be the result of a lengthy advance marketing process.

Lastly, given that valuation (or, more specifically, undervaluation) is an area of focus throughout the ABI’s report, it’s worth considering 363 sales in the context of broad market valuation levels, such as overall M&A premiums and stock market valuation multiples. Generally, the M&A premium is the amount by which the acquisition price exceeds the target company’s stock price at the time of the M&A transaction. Higher premiums typically result from increased demand for acquisition targets and reflect the higher prices paid for target companies. The chart below shows that while historical premiums can vary quite drastically, they typically were very high during periods when 363 sales were most prevalent. Given the high demand, it is hard to imagine that bidders in 363 sales would be able to acquire companies or assets at below-market levels.

![Chart 3](chart3.png)

Sources: Institute of Mergers, Acquisitions and Alliances, UCLA-LoPucki Bankruptcy Research Database

In addition to premiums, market valuation levels can also be used to see if historical valuation levels are low during periods when 363 transactions have occurred. Because all valuation approaches are market-based, purchase prices for sales conducted during a particular time period will necessarily reflect overall market levels. Evaluating market multiples produces an objective indication of general valuation levels.

The table below summarizes whether 363 sales occurred during periods of market undervaluation or overvaluation (relative to historical norms) using two ratios, the monthly price-to-earnings (P/E) and price-to-book value of equity (P/BV) multiples for the companies comprising the S&P 500 Index. The results show that on balance, more
sales were conducted during periods when market multiples, and hence valuations, were above average. In line with premium levels, only about one-third of the sales were confirmed during low-valuation periods as denoted by market valuation measures.

Chart 4

<table>
<thead>
<tr>
<th>Multiple Type</th>
<th>Time Period</th>
<th>Average Level</th>
<th>Market Multiple Below Average</th>
<th>Market Multiple Above Average</th>
<th>Total</th>
<th>Confirmed During Low Valuation</th>
<th>Time Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price : Earnings</td>
<td>1999-2014</td>
<td>24.8</td>
<td>61</td>
<td>125</td>
<td>186</td>
<td>32.8%</td>
<td></td>
</tr>
<tr>
<td>Price : Book Value</td>
<td>1999-2014</td>
<td>2.7</td>
<td>57</td>
<td>110</td>
<td>167</td>
<td>34.1%</td>
<td></td>
</tr>
<tr>
<td>M&amp;A Premium</td>
<td>1999-2014</td>
<td>44.4%</td>
<td>55</td>
<td>131</td>
<td>186</td>
<td>29.8%</td>
<td></td>
</tr>
</tbody>
</table>

Sources:

In summary, neither the increased use of 363 sales nor the faster pace appears to be out of the ordinary given the broader market context. In fact, 363 sales represent one of the more efficient ways to resolve a Chapter 11 bankruptcy proceeding while valuation indicators appear to show similarly favorable signs. The above findings should serve as a caution against rushing in to fix a process that may not be broken.

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