

Nota Bene Podcast Ep. 132 2021 Business Bankruptcy Trends with Ori Katz

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The beginning of 2021 saw a decline in business bankruptcy filings, in contrast to the corona virus-related surge in filings witnessed in 2020. Will this trend continue, or will bankruptcy filings pick up as more businesses struggle to recover from the effects of the pandemic? Joining me to explore the 2021 bankruptcy trends in the business world is bankruptcy attorney and expert Ori Katz. Ori shares his insight on the intricacies of business bankruptcies and the popular 363 bankruptcy sales.

Guest:

Ori Katz is a partner and Practice Group Leader of the Finance and Bankruptcy Practice Group in Sheppard Mullin's San Francisco office. Ori specializes in business bankruptcies and other aspects of insolvency law. He has represented debtors, individual creditors, creditors' committees, parties purchasing assets out of bankruptcy and parties involved in bankruptcy litigation. He has successfully reorganized companies in a wide range of industries, including real estate, retail, construction, biotech, telecommunications, media and the internet. He has also represented lenders in connection with receiverships, loan workouts, restructurings, foreclosures and borrower bankruptcies, and acted as receivership counsel in connection with various appointments. Ori is a frequent speaker on matters relating to bankruptcy and insolvency law.

Transcript:

Michael P.A. Cohen:

Welcome to Sheppard Mullin's Nota Bene, a weekly podcast for the C-suite, where we tackle the current national and international legal headlines affecting multinationals doing business without borders. I'm your host, Michael P.A. Cohen. Let's get started.

Michael P.A. Cohen:

Welcome to episode 132 of the Nota Bene podcast. And thank you so much to all of our listeners in more than 100 hundred nations around the planet. We so appreciate your continued participation in our ongoing conversations, and please keep your feedback coming. It continues to help influence our program. We value it greatly.

Michael P.A. Cohen:

Before we get started today, I'd like to put in a little plug again for my second week in a row for a new podcast called the French Insider which Sheppard Mullin launched in June. The French Insider focuses on French companies doing business in the United States and features interviews with business executives at those companies sharing their experience and sharing with each other and the world things that they have found multinationals need to know, particularly of French origin, when they are thinking about expanding, growing, or entering the United States.

Michael P.A. Cohen:

The podcast launched June 1st with three episodes, including interviews with Julie Myers Wood, CEO of Guidepost Solutions, and Paula Clozel, plant manager for Creapharm CS in the United States. So find the French Insider if you are French, or working with the French, or interested in that subject matter. It stands to be super interesting. I've listened to both episodes and found them fascinating and it will certainly be a critical part of my own monthly podcast education going forward. And I hope it will work its way in for those in our multinational audience who find it meaningful to them as well.

Michael P.A. Cohen:

Back to our podcast today, my guest is Ori Katz, one of my favorite people on the planet, as well as one of the leading bankruptcy experts in the United States of America. Ori received his undergraduate college degree at the University of California, Santa Barbara. He received his Juris doctorate degree at Boston University where he graduated magna cum laude. I don't know about BU, but at my law school, that meant top 5% of the class. I'm not sure what it means there but I know this, it means that Ori graduated academically in the top of his class in some significant meaningful way.

Michael P.A. Cohen:

Ori leads the Sheppard Mullin finance and bankruptcy practice worldwide. He formerly managed the San Francisco office, including for a stint where I came in and out of that office a bit, and resides and practices in San Francisco today. Ori is from San Francisco and a soulful neighborhood in the city that favors my own heart for its proximity to the Pacific Ocean versus the bay for a city that sits on a peninsula surrounded by both. And I have paddled out in that San Francisco Pacific to surf on the smallest of days, which are the biggest days in the Atlantic, so to speak in Ocean Beach, San Francisco, which is actually a famed surf location on the Pacific coast. Probably as much for its nastiness as for the quality of its waves, but suffice to say it's big surf and a sharky break. Ori is ranked among the best bankruptcy experts in the country by just about every peer review publication out there. Ori Katz, welcome to the Nota Bene Podcast.

Ori Katz:

Hey, thank you very much, Michael. Thanks for the kind words and the great intro. I appreciate it.

Michael P.A. Cohen:

If I remember once, we were sitting around somewhere discussing how you used to skateboard to school or grab the back of buses on your skateboard on the way to school, something to that effect. Am I getting that anywhere close?

Ori Katz:

Pretty close. I did grow up skateboarding in the City at a time when skateboarding was just starting to crack the mainstream. And I didn't drag on the back of buses, but I certainly took Muni, which is the local SF bus system all over the place. And then on many a Sunday when the City would close down Golden Gate Park to traffic, I'd get my skateboard out there and there would be ramps set up, and I could just kind of hang out and skate with everybody else. It was a great time.

Michael P.A. Cohen:

Yeah. I find skaters a lot like at least surfers of my generation, that's certainly different today. There's so many people being introduced to the ocean. But when I was a kid, skaters and surfers were a lot alike, and often the same people. And I wonder if there was some of that crossover, probably some of that crossover in your skate crowd when you were growing up too.

Ori Katz:

There absolutely was, although I never made the crossover. I'm just too much of a wimp when it comes to cold water. And even with a wetsuit, I just cannot handle Ocean Beach. Love to go down and do a bonfire down there and hang out for the day, but never big on getting in that water.

Michael P.A. Cohen:

Well let me tell you my friend, there are a whole lot of surfers around the world that can't handle Ocean Beach. Ocean Beach is one of those breaks where you got to duck dive through two sets before you get to the surfing waves. And there isn't a wave on that beach from Slope through Noriega, down to Kelly's Cove that isn't forcible energy. So you're not alone in that regard. And there is never a day that I've paddled out in Ocean Beach where I haven't been as sharply focused as I could possibly be. There are certainly those folks that you know I'm sure growing up that do it every day. And I probably have more respect for those surfers than any surfers on the planet, man. They are great waves, but they are some of the most serious waves on a daily basis that you'll see anywhere on the planet. And there's nothing California sunny about that experience. I've paddled out at OB on days where I couldn't see the outer break through the fog. It's an experience for sure.

Ori Katz:

Absolutely.

Michael P.A. Cohen:

I have to just get this one plug in, especially from the Balboa surf theater. But that's generally, at least from where I grew up on the central coast all the way through Northern California, Ocean Beach is the heart of the people as we would say, in the surf community as. So I'm sure that was true with the skate community too.

Michael P.A. Cohen:

Hey listen, I wonder if you wouldn't mind Ori just before we get started here, sharing a little bit about your own path and journey from those skating days to your current position there in San Francisco and specialty in bankruptcy and finance. How'd you get from the streets and the wheels to the towers and this area of practice expertise?

Ori Katz:

Well, I was at UC Santa Barbara and thinking about law school because my uncle was a lawyer. And he made a big impression on me. Even before I was in college, I was visiting him in his office. He was bringing me to court occasionally. And it just seemed to me like the most amazing job in the world.

Ori Katz:

So when I graduated Santa Barbara, I had a year off where I worked, including at some law firms. Studied for the LSAT and took it, and was thinking about where I wanted to go next. And at the end of the day, it came down to two options. UC Hastings right here in San Francisco or Boston University on the East Coast. And I'd never been on the East Coast. And I decided I wanted to try something totally different. I was a little worried that if I stayed in San Francisco, I would be living at home with my mom. I'd be having a lot of distractions from my high school buddies. And I wanted to go somewhere where I didn't know anybody and I could just completely immerse myself in the law school experience. So I went off to Boston, not knowing anybody or anything about the city.

Ori Katz:

And partway through first year of law school, it came time to start looking for that first summer job. And it's always very tough for first year law students to find a paying job. So I was focused primarily on clerkships and working for judges. And the internet was in its infancy back then, this would have been around 1998. So not a lot of research online, but there was the NALP book, kind of the Bible for law students when they're doing their job search, especially for clerkships with judges or externships. And I was just paging through it.

Ori Katz:

And I started out calling federal circuit courts and federal district courts. But either I'd moved too slow or those spots were just filled. But when I started calling around the bankruptcy courts, I found that there were some openings.

Ori Katz:

And then something really interesting happened. I called a bankruptcy judge, Judge Lynne Riddle down in Orange County, California. I knew I wanted to be back in California for the summer. And a woman answers the phone in Chambers. And I start speaking with her about whether there's an opening available for a summer externship. And about halfway through the conversation, the woman says to me, "By the way, this is Judge Riddle you're speaking to." She hadn't said that at the outset of the call. And she said, "You seem like a nice fellow. Why don't you come visit me next time you're out here?" And I had had a school break coming up, "Maybe it'll be a good fit." So I was out a few weeks later in Orange County, California. I met with Judge Riddle and thought she was great. We hit it off real well. She offered me the job and I accepted on the spot.

Ori Katz:

And going in, I knew nothing about bankruptcy. Most students don't after their first year of law school, because bankruptcy is not the kind of class you take as a first year. But that didn't matter to her, and it didn't matter to me. So I just dove right in. I dove right into that externship and learned so much. And at the end of that summer when I got back to Boston University, and then it was time to dive right into my job search for the next summer, I just decided that every law firm I was looking at that I would add to my list of potential employers should have a bankruptcy department so at least I'd have that flexibility. So that ultimately led me to Sheppard Mullin in San Francisco. And then during that summer, I did a lot of work with the bankruptcy group, which I loved. And the rest is sort of history.

Michael P.A. Cohen:

And it's such a beautiful story in so many ways. The East Coast is big, so I wouldn't characterize Boston as the only representative of anything other than Boston, right? To experience New York would be to experience New York, to experience Washington, or Atlanta, or Miami would be very different experiences. Which is one thing I actually like about the East Coast. I think that the cities are extraordinarily different and there are a lot of them, which is also different than the West Coast.

Michael P.A. Cohen:

What I love about your path Ori was that the judge picked up her own phone. I would want to work with a judge that picked up her own phone. I mean, I just think that says so much about the judge, and so many good things about the judge, that it's just an amazing story, and one that can't just be a consequence. That's just wonderful. And another thing I guess I noted, which I think I've known, but that you've been at the law firm your entire career. And that's a really special experience.

Ori Katz:

Right. It really was serendipitous. With the judge, it was about 3:00 pm Boston time when I made the call, and everybody else just happened to be out at lunch. And the judge just was walking by the front desk on her way out to lunch and decided to pick up. So it really was a lucky moment for me.

Michael P.A. Cohen:

Perfect. There are no lucky moments. There're just magic moments. And that was a magic moment. Let me do some staging here for our audience. We're going to talk about bankruptcy today, and ultimately a particular form of bankruptcy called I think a 363 proceeding, but Ori will straighten all that out. I get the numbers in bankruptcy wrong all the time.

Michael P.A. Cohen:

Just by way of some broad strokes, bankruptcy filings spiked again in March and in April, according to recent statistics on top of an already historic pace in America. But year over year bankruptcy filings for the first four months of 2021 versus 2020 are actually down 38%. They all include individual bankruptcy filings, all these statistics, as well as other types. And I'm not really sure for that reason, whether any of it is meaningful one way or another, or even how to break it down.

Michael P.A. Cohen:

So I thought I would start Ori and just ask you what trends you're seeing in commercial filings, and to see if you could break down the types not necessarily by trend or number. But are you seeing any trends in commercial filings in 2021 that you want to note? And then let's maybe get into the basics of commercial bankruptcy filings. But don't worry about that. We can get there when we get there.

Ori Katz:

Sure. So we do see some trends, and I'm really talking now at a macro level. I think if you were to go back at a macro level commercial filings only, I would say the last 12 to 18 months generally was a very busy time. And we had activity in a lot of different sectors or areas. You saw it in retail I'd say towards the beginning of that last year with some big retailers filing

bankruptcy. Neiman Marcus comes to mind, but really many others. A lot of name brands, household names.

Ori Katz:

At the same time, you saw a lot of fallout in oil and gas. Again, big names, big cases, mega cases with hundreds of millions or billions in liabilities. We saw a decent amount of fallout, distress, and bankruptcy filings in the hospitality space. And some of that's continued. We saw it in the restaurant and entertainment space, and that's continued. And then to some extent, we've seen it in real estate. Although I think there, a lot of that really lies ahead of us. I would say, that's a backwards look about a year, a year and a half. And for me personally, one of the busiest periods of my entire 20 plus year career.

Ori Katz:

You're right to point out though again at a macro level, the first quarter of this year and especially I'd say the last 60 days had seen somewhat of a lull. And that was pretty pronounced in April and in May. But something interesting happened at the end of May where we had a flurry of filings. And I think there's a question about whether that flurry was a blip or something that is going to be representative of a bigger uptick.

Ori Katz:

And then even in June now, once again, it feels like there's been an uptick. Now that's really representative of only a few weeks, and so hard to say at the end of June or the end of July how will the first two quarters for example look compared to last year. But there had been a lull. And either we're going to have a small uptick and remain in the lull. Or I think what we may see is some increased activity and growing distress and filings.

Michael P.A. Cohen:

Yeah. It's really a fascinating time in many ways to kind of, this is my own view. I want to throw it out to you for reaction. It's based on some things I've been reading. At least I have been seeing it this way. I've been reading about bankruptcy because it is an interesting thing that folks track. And I think often read into a lot of prognostication, particularly by economists as to health of this, that, or the other thing. Whether it's industry sector or economy, these kinds of things.

Michael P.A. Cohen:

But what I wanted to share with you for reaction is this. I have this notion that is nothing but intuition that bankruptcy filings in America might also be an evidentiary form of reflection not just of economies ebbing and flowing, but a seismic change in a new economy that emerges from this pandemic.

Michael P.A. Cohen:

I take restaurants for example. The restaurant business depending on where you are may come back to be exactly the same. .But it may be drastically different. Takeout and delivery may be almost a much larger percentage of the restaurant business than ever before. Who does that, how it's done might matter greatly. I'm seeing restaurant industry businesses themselves report that the only way for them to get known nowadays is to be through those channels. And some of the major technology platforms that serve them which themselves are business models in question.

Michael P.A. Cohen:

So here's what I'm trying to say is that there seems to be a shakeup in the economy not just that it's coming back or went away, but that it's going to be a very different economy in major sectors than ever before. How things are done will be different. New services will emerge. Old services may not reemerge. And the continued pace of bankruptcy through the economy as it emerges may be in my view as reflective of the change in the economy as in its particular direction. What's your reaction to any of that?

Ori Katz:

I agree with that, Michael. I think we will see a new normal as we emerge from the pandemic. And any time we have something as seismic, a seismic shift to a new normal, because a new normal implies a lot of big changes, because the normal touches on everything. And when you have a new normal, there are all sorts of changes. It's so far reaching in terms of industry, geography, the way we live, the domino effect of that.

Ori Katz:

So there will be a new normal. I see it in the restaurant industry. I see it in other spaces. And whenever you get a new normal and that kind of a seismic change, you're going to have winners and losers. And the losers are those that are unable or unwilling to adapt to the new normal. And those are the ones that tend to need bankruptcy help. Either reorganization, disposition of their assets, because they're not going to make it.

Ori Katz:

I look at the restaurant space, Sheppard Mullin represented Sizzler Restaurants in connection with its Chapter 11 reorganization. They were in and out of bankruptcy in about three and a half months, very quickly. But when I look more broadly at the restaurant space and I see the level of adaptation, and it's far beyond just takeout, which is a big change for these restaurants. But you look at restaurants in warmer geographies and the way they've moved sometimes half or even 100%, they've doubled their seating by taking advantage of sidewalk space or a parking lot, even. And those were changes that were necessitated by the pandemic, but some of those are going to stay.

Ori Katz:

So footprint changes for restaurants and the way they have to serve their clients. You look at certain counties and cities that allowed for takeout of alcoholic beverages. And now, there are going to be cities and counties that allow restaurants to continue to let you take alcohol to go, which you could never do before. And does that change the dynamic for restaurants?

Ori Katz:

All of these things are going to create the winners and losers that are going to dictate who ends up in bankruptcy and who doesn't. And by the way, many of those winners who don't end up in bankruptcy are going to be looking to be opportunistic to acquire the assets of some of the losers through 363 sales, which is what we're going to talk about later today. So big impacts from the new normal.

Michael P.A. Cohen:

That's fascinating. Just sticking with restaurants for a second because it's such a great example to use only because it's such a constituent part of the normal, right? I loved your point Ori that

when you're talking about a new normal, that's a pretty significant thing, man. It's like you're talking about something that's touching everything. And restaurants seem to be the bellwether where we experience it in a way where there is some common at least platform of experience to share.

Michael P.A. Cohen:

But one thing that I found fascinating in the restaurant business is this. Food service kitchens are emerging as full on restaurants. They don't serve anybody at all on the sidewalk or in a location. They're literally housed in an industrial part of a city in warehouse space like a food service kitchen might be. But instead of serving commissaries or other types of things, these are now full on restaurants with brands and menus. They're just takeout only, or delivery only. And they're entirely designed without retail, without waiters and waitresses, without dishwashers, or any of those things in mind. And they're doing a pretty good clip, and they're certainly emerging in big cities and maybe outpacing far and away the traditional foot traffic restaurant. So I would consider that injection of a whole new segment into that industry. And what it displaces or what it co-exists with is really an open question to our point. And we're likely to see some of that sort through in restructuring and finance.

Michael P.A. Cohen:

So let's talk about that. You mentioned the 363, which is where I'd like to get. But Ori, could you just kind of map out for our audience what bankruptcy in America is? A form of finance or a form of dissolution? What are the types? And maybe we could use that footprint to drill down to the 363 experience.

Ori Katz:

Sure. So the bankruptcy system is a federal system governed by the bankruptcy code. And when I say federal, it means it governs all the states. It's one uniform bankruptcy code for the entire country. So we don't have a different bankruptcy system in different states. It's all uniform.

Ori Katz:

And bankruptcy for individuals is one thing, consumer bankruptcy that we don't intend to go into today. But there are commercial bankruptcies, which are available to entities. Companies that are doing business. And when we think generally of bankruptcy in the United States on behalf of entities, we think of two chapters within the bankruptcy code. One of those is Chapter 7, which is liquidation. And the other is Chapter 11, which is reorganization.

Ori Katz:

And in a Chapter 7, the easiest way to think about it is on the day of the bankruptcy filing by that company in a Chapter 7, an individual, a Chapter 7 trustee is chosen usually from a panel that is established with the court. And that person replaces all of management of the company, all of the board of the company. That Chapter 7 trustee steps in. And essentially, their job is to turn out the lights and liquidate all of the assets as efficiently as possible, and as quickly as possible, to create a pot of money that then gets distributed to creditors in accordance with priority that is established under the bankruptcy code. So Chapter 7 is operation cease, assets are liquidated. And then the money is distributed.

Michael P.A. Cohen:

And the trustee is really acting to maximize return in some relationship for the creditors at that point, right? Anybody who's ever involved in the company is not the concern apart from the fact

that they may be able to serve by way of capital, or otherwise, creditors. So a trustee is operating I guess for creditors. Is that fair to say?

Ori Katz:

They are. I mean, their job is to maximize the value of the bankruptcy estate for the benefit of creditors or other parties and interest. Maybe it's a solvent estate and equity is getting something back. Although usually if you're in a Chapter 7, you're insolvent. But you never know. When you go to liquidate the assets, you may have a surprise. But you're absolutely right. That trustee is a fiduciary for the estate, and their job is to maximize value there by way of the liquidation.

Michael P.A. Cohen:

That's the relationship I was looking for, but couldn't find on the tip of my tongue after 33 years of practice, fiduciary. So that's perfect Ori. All right. Take us into a Chapter 11. That was great.

Ori Katz:

All right. So Chapter 11 is reorganization. And in contrast to a Chapter 7, there is no trustee appointed. On the day of the filing of the Chapter 11 petition, the company's officers and directors remain in place. And the goal there boils down to trying to preserve going concern value from the continued operation of the company, and seeking some exit in Chapter 11.

Ori Katz:

And a reorganization can mean a lot of things. It can mean a balance sheet restructuring. Shedding some liabilities as you reorganize the company and maybe emerging with a different footprint, but the core business intact in a Chapter 11. It can also mean a going concern sale, a transaction that sees the assets sold out of bankruptcy, but as a going concern where the business is continuing. So in contrast to a Chapter 7 where you might be selling property, desks, chairs, other property, real estate, whatever it is, here, the focus is really on going concern value. So Chapter 11 is the right vehicle if you're trying to maximize going concern value through some transaction.

Michael P.A. Cohen:

What are the different criteria that can lead you to one or the other? Let's take Chapter 7 first. Is that a compulsory business situation, or is that just voluntarily throwing your hands up and saying, "I no longer want to be in business." Liquidate it all.

Ori Katz:

I mean, it can be both. There are so many drivers for a company to take into account or be forced into a bankruptcy. Sometimes, things might be going fine at your business. And there could be a litigation event out of the blue that just destroys your company. Other times, you may have some sort of valuable IP or other viable business asset. But you're just losing too much money along the way. And you're not going to be able to break even, or get additional investment, or get additional debt to continue to give you the runway you need to get there. So you've just got to go into bankruptcy in order to stop the bleeding.

Ori Katz:

I mean at the end of the day, if you are burning through cash and you run out of cash, and there's no additional source of money that can come in, you're done. And if you have a viable going concern business, and somebody sees the value in it and is willing to fund a runway for

example for a Chapter 11 to preserve that going concern value, then you have an 11. But if you don't even have that and you have no way to fund your bankruptcy, because Chapter 11 is not cheap. It's an expensive process. So if the stakeholders, if no one's willing to step up and fund that, then you might end up in a Chapter 7 because you can't afford an 11, or the market for your capital structure or those within it are telling you it's not worth it to do a Chapter 11.

Michael P.A. Cohen:

And is there some definitional test you have to meet to declare bankruptcy? And in other words, let's say you're perfectly well going concern, and you're profitable and everything else. But you'd like to eradicate some of the leverage that you've taken on. You can't just declare bankruptcy, right? It's got to be some kind of litmus I think for it.

Ori Katz:

There is a litmus. There are parameters. And one of the parameters is every bankruptcy filing needs to be in good faith, which is a flexible, broad standard. But a healthy company that's not otherwise in distress, but is looking to weaponize the bankruptcy code in a way that just doesn't seem like good faith, that case might be subject to dismissal. And you see that occasionally, although rarely.

Ori Katz:

A company does not need to be insolvent in order to file bankruptcy. And generally speaking, in most jurisdictions, we do have a little bit of difference in case law among the bankruptcy judges, even though they're all interpreting the same bankruptcy code, different circuits have different views on this issue. But generally speaking, if the case has some valid bankruptcy purpose, and most courts define that to include wanting to take advantage of or benefit from a provision of the bankruptcy code. Generally speaking, that case will stick and is not going to be seen as not in good faith. But occasionally, we see people being overly opportunistic, doing something that just feels extreme or a weaponization of the bankruptcy code. And those are the types of situations.

Ori Katz:

And to give you an example, a two-party dispute. In most jurisdictions, two-party disputes are not appropriate to resolve in bankruptcy court. If you're a company that really has very few creditors save for one, and you're in nasty litigation in state court with that one creditor, and you decide you want to get an advantage, file bankruptcy, and then deal with your one creditor in that forum, that case is unlikely to be found to be in good faith. Yeah it's depending on other factors as well, but those are the types of situations that are right for a discussion about whether the filing was appropriate to begin with.

Michael P.A. Cohen:

Got it. Boils down to something we hear in shorthand and the Wall Street Journal and other American business media. I didn't mean to single out the WSJ, could have been any other fine business section of major publications from the San Francisco Chronicle to the LA Times on the west coast. And I don't want to leave Seattle or San Diego out of that mix. I just don't know the names of their papers. Or the New York Times, or Washington Post. Boston Globe, or Miami Herald on the East Coast. I think the Atlanta paper might be called the Constitution. I don't know. I should. And my point is I'm hearing and reading in media all the time about what is generally shorthanded as a 363 proceeding in bankruptcy. Bring us there if you would.

Ori Katz:

Sure. So anyone who's talking about 363 is talking about a section of the bankruptcy code, section 363. It's always going to be in the greater context of either a Chapter 7 or a Chapter 11 case. And both a Chapter 7 trustee or the company itself can take advantage of section 363.

Ori Katz:

And you often hear people talk about a 363 sale or a 363 transaction. And that's just shorthand for the appropriate section of the bankruptcy code. I think the question is why do we hear so much about section 363? What's so powerful about it?

Ori Katz:

And basically, what section 363 says is that you can sell your assets free and clear of liens, claims, and interests, if you meet certain criteria set out in the bankruptcy code. And it's that free and clear part that's really significant and why section 363 gets so much attention. Because if you're talking about a debtor, a company in bankruptcy, you're usually talking about some significant level of distress. And when you're in a distressed situation as a company looking to sell yourself, one of the biggest issues you're going to have is confidence in the market, confidence among buyers that they can engage in an asset transaction with you, and not have the liabilities, and the distress, and the negative associated with those assets follow the assets to the buyer.

Ori Katz:

And because there's so much concern about things like successor liability, or distress following the assets, the market prices that in and either puts an extremely low value on those assets, or more often than not, it's just not worth the trouble. And there's no way of disposing of those assets. No way to monetize them because of the deep levels of distress.

Ori Katz:

And what section 363 does is provides a solution with its ability to sell assets free and clear. The solution is in the form of a bankruptcy court order that the buyer obtains from a federal bankruptcy judge saying, "You have acquired these assets free and clear of everything." There are minor exceptions to that we can get into. But now you can see how the market would react very favorably to something like that. Because now you can buy with confidence that all of the noise, and distress, and trouble associated with the seller and the assets is not your problem. And that's significant.

Michael P.A. Cohen:

And why does the code allow this in certain ... well first of all, what are the circumstances? I mean is that again, a voluntary path? Or are there criteria you have to meet in order to use this powerful weapon of free and clear sale? Which as you point out, would essentially make it a market sale, right? A market auction sale at kind of commercial rates that would seem to maximize returns for the potential creditors. Right? So it's a good thing in many ways.

Ori Katz:

Right. So there's two things at work here. One of them is the notion that we should be trying to unlock as much value as possible from distress situations. Because that's going to benefit creditors as a whole, generally speaking. So there's a benefit to unlocking that value. Because

otherwise in a distress situation, the value essentially evaporates, and that's not good for creditors.

Ori Katz:

But second, and you alluded to this, you do have to meet certain criteria in order to be able to sell assets free and clear. And really, the criteria speak to primarily secure creditors. Meaning those creditors who have liens on the assets, right? You're selling somebody else's collateral. And if you're going to sell somebody else's collateral, in order to do that, you do need to meet certain criteria.

Ori Katz:

So there's several things. One is you can do it if the lien holder consents to the sale. And think about it. If I am a lender and my collateral is essentially your business, and I can either get a bunch of tables and chairs in a Chapter 7 if it goes that route, right? In a turn out the lights liquidation. Or I could take a shot at getting a lot more money in a going concern scenario, even though I may not be paid in full as the senior lien holder. I'd much rather get as much as I possibly can and see my collateral disposed of in a going concern manner, unlock that value. So even though I'm not being paid in full, I just might consent.

Ori Katz:

And in fact, we see a lot of consent from lien holders in bankruptcy. They're usually the ones funding the process and providing the runway for a going concern sale, because they're benefiting quite a bit from the value that's unlocked. So that's one way is through consent.

Michael P.A. Cohen:

Does that consent have to be uniform, or is it a majority of say lien holders or secured creditors? Or does it have to be 100%? What's the litmus there?

Ori Katz:

So because there are other criteria, it doesn't have to be 100%. And it's not uncommon that you have multiple secured creditors in a stack, and that some of them are very happy to consent to a process. Maybe they'll get paid in full out of this. Others are less happy, maybe they're completely out of the money. But there are ways other criteria and other tools in the bankruptcy code that let you deal with all manner of secure creditor. So you always would love to have consent. That makes it easy. But you have other tools in your toolkit under section 363 that let you deal with holdouts.

Ori Katz:

So one of the other tools is let's say the lien or the claim is in some sort of bona fide dispute over its validity. In that situation, you can sell free and clear of that disputed lien. Maybe the person isn't consenting because they've got some strategic ulterior motive, even though they're going to be paid from the proceeds of the sale. Well, if they're going to be paid from the proceeds of the sale, it doesn't matter whether they consent. You can do it over their opposition.

Ori Katz:

And then there is a provision that provides you can sell even without consent and even if you're not paying in full if a non-bankruptcy statute or law, non-bankruptcy law permits such as sale. And then there's kind of a catch all that says we can sell free and clear of a lien so long as you

can otherwise compel that sale free and clear in some other proceeding, in a non-bankruptcy proceeding.

Ori Katz:

So generally speaking, we have those tools I've mentioned and a few others that give a pretty high degree of confidence that you'll be able to consummate a transaction free and clear of secured claims.

Michael P.A. Cohen:

Fantastic. Now, did I interject at a time where I took you off track of the other criteria or are there other criteria, or did we cover them in the tools there?

Ori Katz:

I think we've covered all the materials, significant ones that you generally think of.

Michael P.A. Cohen:

Talk to me if you would, a little bit about how these 363 proceedings go. I know, and I can offer from the competition law standpoint that if the sale were to present a buyer with strategic competitive antitrust review concerns in America, that you can seek antitrust. You can start the antitrust process if you will, the merger review process on something far less than a letter of intent. Just a qualified bid, I think. And that the agency timeframes are super-fast, meaning they have to do a merger review quickly or forever lose the ability to do it.

Michael P.A. Cohen:

And I'm not sure what they do if they find there is a problem. I guess they go into the bankruptcy court and tell the judge, but the judge could still do whatever the judge wants. He's not necessarily bound by the federal antitrust laws in that regard.

Michael P.A. Cohen:

But put all that aside. Let's not make it an antitrust podcast. How do these sales go? There seems to be a typical type of auction process with cool terms like stalking-horse bidders and other things. Maybe you could walk us through a little bit of that.

Ori Katz:

Sure. So if we're talking about a 363 sale, usually what happens is you have a company that is either in some distress or can see that its runway only gives it a certain amount of months before it's going to have a significant red line it can't cross operationally. So usually, this isn't always, but usually you have the company that's in distress engaging in some sort of marketing process pre-bankruptcy. You're not talking about 363 sale at this time. What you're really doing is going to market in a rapid fashion though, because you may have a shortened runway. But you are marketing your assets with an investment banker or otherwise in order to go through what is often a typical sale process, only is often on an accelerated timeline.

Ori Katz:

What often happens though is the market. The buyers will see distress at the seller. And often, it's the buyers who dictate that this is a transaction we're interested in, but we need the protection of a 363 sale process in a court order if we're going to consider buying these assets.

Ori Katz:

Sometimes, 363 sales start out as a normal investment banking process where the market tells you, "Sorry, this is going to have to be via a bankruptcy in order for us to be interested." Other times, the distress is so significant that it's clear this needs to be marketed from the get-go as something that can only be consummated in a bankruptcy as a 363 sale. So you will have some form of marketing process usually. Sometimes it's very short, and sometimes there is no pre-bankruptcy marketing. But in most situations, 30 days, 60 days, 90 days, something that shows you've gone to market.

Ori Katz:

And the reason you do that is because in an ideal world, as a company in distress, you don't want to file bankruptcy without some game plan in hand, without a floor for your sale process. And by marketing pre-bankruptcy, really what you're looking for. And you have alluded to this, is what's called a stocking-horse bidder. That stocking-horse bidder is somebody that you've already reached an agreement with pre-bankruptcy on certain key terms of the sale transaction that is going to set the floor for you. It's going to set the floor on price, which is critical. It's going to set the floor, hopefully on a timeline. And I'll get into bid procedures in a minute. And it'll set a floor on process.

Ori Katz:

So in an ideal world, your 363 case has had this pre-bankruptcy marketing process. Then there's the actual bankruptcy filing. And on the day of the filing, you have an asset purchase agreement in hand and signed telling the world even if nobody else shows up to bid on these assets and nothing changes for the better in this bankruptcy case, we have a transaction in hand. That is our floor.

Ori Katz:

And by the way, sometimes the market doesn't react too favorably to your pre-bankruptcy marketing process. Buyers say, "Look, rather than engage now, we'll take a look after you filed." And it's not uncommon for your senior secured lender to put some sort of floor in place, maybe through a credit bid. And then what you do is you announce on day one of your bankruptcy case, "We're going to run a post-bankruptcy marketing and sale process for X many days," however long you have, depending on your runway. And if no one shows up, our lender is going to credit bid, and it will take the assets. Most lenders would prefer not to take assets. But occasionally you get, especially among non-financial institutions, but more opportunistic lenders, you have people who do loan to own. And they're ready, willing, and able to run this business. And they want to run the 363 sale process because they want the protection of a court order telling them they won't have any successor liability. So that's the general timeline of what these look like as they come in

Michael P.A. Cohen:

A lot of strategic deals that would otherwise provide competitive complications, I have always felt ... and there'll be a lot of people that don't agree with me on this, so I should state that right away. But I've always felt that they go through in a 363 process where they wouldn't in a normal sale process. In other words, deals that present competitive problems from the competition law standpoint would normally get a second request for information and be hung up with a year-long merger review. They sometimes fly through in a 363 process not because of some bankruptcy exception and antitrust, but from the human dynamic that a lot of the folks who do merger review with the government have never tried a merger case. So it daunts big on them. It's like, "Oh my God, it's huge to go to trial. It's huge to challenge a case."

Michael P.A. Cohen:

And in these circumstances man, you're not talking about second request for information. The government's got to pony up and challenge it or not, one of those two things in a very short timeframe. So you get a bunch of folks at the government who really haven't tried merger cases, and it looms so large on them that that decision becomes so big, that they fall back on the fact that it's a bankruptcy and it's going to just happen fast. And we'll see what happens in the marketplace and all these other types of things.

Michael P.A. Cohen:

So the reason I kind of find that interesting is the stalking-horse process that you mentioned. Oftentimes you can see a stalking-horse bid by a strategic competitor for 363 assets that only a competitor would pay for, because it means more to that competitor in the marketplace in terms of industry consolidation than it would a buyer who is entering the field or trying to vertically integrate or do something to that effect.

Michael P.A. Cohen:

And that stalking-horse bid can be so high because of the strategic value of the asset that it dials the market for anybody else, just like you said. The market may not favor that stalking-horse bid.

Michael P.A. Cohen:

And I find this to be a particular use of the 363 process that is somewhat designed, at least in part, to put a different type of pressure on the competition review for assets that might not otherwise survive that competition review, simply because of the human dynamic in a government agency. I am totally postulating that from my own head. I don't think there's a lick of agreement I'll get from anybody on it. But I am curious to see whether you've ever experienced anything like that Ori.

Ori Katz:

I haven't personally experienced it, but I'm aware of it. And if you think about it, in a typical non-distressed non bankruptcy situation where you have two healthy companies engaged in a transaction, and you have the government reviewing it for antitrust concerns, usually the two participants in the transaction aren't the proverbial melting ice cubes, right? If the transaction doesn't go through, it usually doesn't mean the death of one or both of the companies. Doesn't mean thousands of creditors who won't be getting paid. There's not as much of a parade of horrors in that situation.

Ori Katz:

Now imagine the bankruptcy situation. Nine times out of 10, the debtor in that bankruptcy case is a melting ice cube. And if a transaction doesn't go forward, you will have thousands of creditors who are going to be upset, because value will not have been maximized. And they're going to be left holding the bag.

Ori Katz:

So if I'm the governmental antitrust attorney looking at the transaction, I'm thinking about all the voices that I would never have to deal with, right? You don't have to deal with creditors in that same sense in a healthy antitrust situation. But now you do. And you have to think long and hard I think if you're the government about whether to even show up and make a big deal about it. Because if you show up and make a big deal out of it in a bankruptcy case, you may scare

the market. And you may even if you decide not to go forward, just by announcing yourself and creating delay, you may make it so that the debtor doesn't have the runway it needs to get a deal done while you're doing your process as a governmental entity. And now all of a sudden, the market is scared off, and the ice cube melts.

Ori Katz:

Now I do know you do have some transactions that go through subject to antitrust review. I think American Airlines is an example of that. In a bankruptcy scenario where you had a transaction that was completed, I believe that was via a Chapter 11 plan as opposed to a 363 sale. But you had a transaction that was significant go through subject to subsequent antitrust review. And I believe there was a full blown trial in bankruptcy court. Ultimately, the bankruptcy judge didn't disturb the transaction. And you can imagine how much pressure there must have been not to disturb that sort of transaction. The eggs must've been pretty scrambled at that point post-closing, but they still did a trial. So it's not unheard of.

Michael P.A. Cohen:

Look. The fact that we're able to have this conversation just kind of confirms in my own heart that I'm 100% right here. But again, I'll state right up front, I could have a debate with antitrust lawyers and particularly government lawyers about this forever.

Michael P.A. Cohen:

But what I loved about your point just now, or your description just now was high marking the policies at stake, right? It's hard for one government to kind of carry its policy into a courtroom. Where another government, right, a bankruptcy court is trying to implement a policy that is designed to maximize the value for the creditors. So there could be policies of potential for consumer harm and maximizing creditors that don't sync up.

Michael P.A. Cohen:

What I find really interesting about the way you described that is this. There's a bankruptcy exception in antitrust review. It's called the failing firm defense. So it's basically an exception to a deal that would otherwise present a competitive problem under the Clayton Act. It can through and pass so long as there's a failing firm.

Michael P.A. Cohen:

But the failing firm defense is built on the fact that no other buyer is available to pick up the asset. In other words, the strategic buyer who will implement consumer harm be able to raise price through the consolidation is the only buyer available. And this is where I think this process gets interesting. It's the stalking-horse process that I mentioned earlier, if a strategic bidder is the stalking-horse bidder and prices the assets at essentially double the value of the market because of the ability to raise price post-merger, right? The long-term gain from the competitive problem if you will, that drives out every buyer in essence, because nobody else has that reason for the asset. And this is where I find there to be an interesting interplay between law, and policy, and process, and procedure in these proceedings. That's probably worth flagging as much for our potential strategic buyers in 363, as it is for folks who might otherwise be raising their eyebrows at the bid they see. It's an area where a lot of rubber is meeting a lot of road in the current marketplace, where consolidation is actually becoming a question mark again in U.S. policy. And big is becoming bad for its own sake in much the way it was at the turn of the 20th century here in our turn into the 21st century. I'll just mark it as something we should keep an eye on.

Ori Katz:

Hey Michael, that was so fascinating to me what you just said. I want to add something to that. Because I'd never thought about what you just said in terms of this tension between the bankruptcy system and antitrust system. That scenario you described where my stalking-horse bidder, let's say I'm representing a company in distress, we're going into bankruptcy. And my stalking-horse bidder has made an offer that is double the 'market value,' double what any other rational buyer would be willing to pay. And in doing so, has completely scared away all those buyers so that there is no competition. No one's going to even show up. In my mind from a purely bankruptcy perspective, that is my dream scenario. I am thrilled. The creditors of the company are thrilled. Everybody is thrilled.

Ori Katz:

At the same time, from that antitrust perspective, which I'm usually not focused on in any way, that is your nightmare scenario. I mean, that's horrible, right? You've just created this anti-competitive outcome where the market didn't even get a chance to speak because of that one strategic buyer. And it never occurred to me that that tension existed. It seems very significant.

Michael P.A. Cohen:

And it's significant from the human dynamic. Because if the merger review team at the agency is what I will call folks who have not been in the courtroom, going into the courtroom for the first time and facing down the bankruptcy system and all of those creditors is daunting. Right? Forget about your first career loss. You know? I don't even want to go raise my head. That's the human element to the law, not the business of it. Yeah. That's exactly what I was trying to say. I'm so happy to hear your feedback on it, because I don't always get that point across.

Michael P.A. Cohen:

And look, I'm not saying Ori, I'm not kind of positing this as a monument to justice. In fact, I might very well be sitting there in the boardroom of a strategic buyer for one of these assets and say, "Oh man, we've got a 363 here. This is an opportunity." My point is to flag it as a business issue for our multinational audience. It is something to think about. And it's something that people may experience on both sides of it. There could be people looking to legitimately integrate production for example, of a particular input that they use in subsequent production. So they typically buy it in the marketplace. The U.S. market price for that input is tripled, 363 asset comes up and seems like a good entry opportunity. And then they wonder why the stalking-horse bid is three times everything they valued. Well, that's why. And people don't think about it in the competitive terms, but they should. And they need to assess these 363 auctions with that in mind. Because I mean, let's face it. Competition law is not always the driver in the deal if you will, but it's usually a driver and the reason for it.

Ori Katz:

One other really interesting thing I've just thought of Michael is if I'm advising that buyer, and I know I may have some competitive advantage strategically if I acquire the assets, I almost feel optically like I'm better off going with a pretty low stalking-horse offer, knowing I'd be willing to pay more than anybody if I'm certain of that. Letting the auction play out and having others come in and bid, and then just having my bid at the end of the day be the proverbial \$1 more than anyone else. It won't really be a dollar more, but it'll be the highest bid. But allowing the competitive process to take place and not paying 3X the value in order to scare off the market ahead of time. But instead, I'm probably doing my best to make it look as though it's any other 363 sale. I just happen to come out on top by a little bit. I mean, I think there's a lot of strategy at play there.

Michael P.A. Cohen:

But here's why that doesn't work. That failing firm defense requires that there be no alternative bidder. And if you let that process play out the way you did, then the antitrust authorities have a whole stream of second, third, fourth, fifth, highest bids to look at and say, "Well, there were plenty of alternative bidders."

Michael P.A. Cohen:

And not only that. Secured creditors are a lot less pissed off for a dollar less than the 3X. I mean, we'll just flag this kind of interesting point. I mean, literally I did not come into our conversation today to talk about it, but it kind of came up organically. There is a strategic play here in law and process by competitive bidders and 363's where the law might not be well-suited to serve one purpose, but very well suited to serve the other, as you mentioned. And I think we should both mark it perhaps for maybe a conversation down the road, if we kind of see this angle playing out.

Michael P.A. Cohen:

And the only reason I flag it now is because I think we're going to see a lot more 363's. And I'm wondering Ori if you already are. I always heard Chapter 11, Chapter 7. I never heard the term 363 until recently. And I think that's because the visibility in 363 filings is becoming a more powerful and desirable tool. How are you experiencing that as somebody in the know?

Ori Katz:

So section 363 sales are a hallmark of bankruptcy filings, both 7's and 11's. So when we see an uptick in filings, we tend to see an uptick in 363 sales. And when we see a lull in the filings, there tends to be a corresponding lull. But using section 363 as a means to monetize assets is just a staple of both chapters and something that I think we're going to continue to see. But it's so robust and so well-established as the mechanism for monetizing assets and maximizing value, that I don't think we're seeing more use of 363 in bankruptcy cases. What I do think we've seen ... but this is not the product of the last few months or even the last few years. It's probably the product of a couple of decades, is the normalization of 363 transactions. The negative stigma associated with bankruptcy in general and a 363 sale is reduced. The willingness and sophistication of the market to be a buyer only keeps going up.

Ori Katz:

And so I think what we'll see is a similar number of 363 sales rising and falling with the number of bankruptcy filings, but an increased willingness and ability for the market participants and the buyers to do a 363 sale. I don't think people are scared off by it, and I think many people see the value and would make a play for assets that would be deemed too risky otherwise, but are acceptable in the context of a 363. And I think that's only going to continue. Especially as we see buyers getting really good deals in distress scenarios.

Michael P.A. Cohen:

Super context. Super, super, super stuff to know. Ori, I have uncharacteristically kept you well beyond the allotted time period that I promised you. I'm usually pretty good about these things, but I think I enjoyed our conversation so much that I got carried away with your time. In wrapping up, is there anything else you feel our multinational audience ought to know about our topic today?

Ori Katz:

I think one last thing. And that is, because we only scratched the surface on stalking-horse bidders. But some people might be saying, "What does that really mean? And what's the advantage? Do I want to be a stalking-horse bidder?" And one thing people should know about a 363 bankruptcy process is that it's highly transparent. There are no secrets in bankruptcy. There are very, very few. So when you are acting as the stalking-horse bidder, usually you have already entered into an asset purchase agreement with the debtor, with the seller. That agreement is going to serve as the model for anybody else coming in also wanting to bid on the assets. So the terms of your transaction as a stalking-horse bidder are out there for the world to see, down to most of the details. And you've paved the way for the market and other buyers to come in and participate ultimately in what's going to be some form of auction or competitive process.

Ori Katz:

So a lot of people say, "Why would I want to do that? Why not paying back, let somebody else do that work, and then I will jump in and piggyback off the work they've already done and use it to my advantage?" But there are some benefits to being a stalking-horse bidder. And generally, bankruptcy courts, and the companies, and their creditors recognize the benefit of having that floor in place. So it's not uncommon and it's very typical for a stalking-horse bidder to be given a breakup fee. So that in the event that it is not the successful bidder and it outbid, it's getting some fee. It ranges anywhere from 1% to 3%. It could be higher. It can be lower. Really fact and circumstance specific to the transaction. But some amount of money to kind of compensate it for having served as the stalking-horse bidder.

Ori Katz:

We often see expense reimbursements either as part of the breakup fee or on top of it to compensate that stalking-horse bidder for the out-of-pocket expenses it has. And not only that. The stalking-horse bidder often has a lot of say in the bid procedures, meaning the timeline and the process associated with the sale. So if you're a stalking horse bidder, you've usually got a leg up on the buyers, and you're going to want to see a pretty tight timeline so that your competitors or other buyers don't have a lot of time to catch up. Of course, the seller's going to want to push back on that and want the opposite. So will its creditors. But as a stalking-horse bidder, you can dictate certain terms or try to when are bids due, what are the bidding increments going to be at the auction? When is the auction going to be held? What do other people need to do to qualify? So there's some benefit in trying to mold the ground rules. So those are things that I think somebody thinking about participating should keep in mind if they're thinking about being a stalking-horse bidder.

Michael P.A. Cohen:

Yeah. It's super important to know. I'm so glad you added it. All this talk about stalking-horse bidders makes me recall a business organizations class I taught at the Monterey College of Law. And one of my students in an exam answer that involved a stalking-horse, but not in the bankruptcy context. As our multinational audience will know, the stalking-horse can come into a variety of corporate contexts, including regular M&A sales that have to go through board fiduciary and could be contested by subsequent bidders, tender offers, and many other things.

Michael P.A. Cohen:

Long in the short of it Ori is this. The student wrote a brilliant exam answer, and I was very impressed with it, but for the spelling of stalking-horse to be S-T-O-C-K-I-N-G like it was a horse

and a stocking, rather than the traditional stalking horse. And I'll never forget it. I took away no points for it just so you know, and corrected the student on his exam, but nonetheless. Or her exam, I don't know. They were all numbers, graded anonymously, but something I'll always remember.

Michael P.A. Cohen:

Ori Katz, thank you so much for spending so much time with our audience today on the Nota Bene podcast and for bringing to life in very real and practical ways the bankruptcy code of the United States. And even more specifically, the 363's we're all experiencing. And now as I know, largely as an uptick to bankruptcy filings and the number of bankruptcies, not because of some special use. So good to learn from you as always, and so good to see you and talk to you.

Ori Katz:

Likewise, Michael. I really appreciate being with you today. Thank you for having me.

Michael P.A. Cohen:

Thanks again. That's it for this week folks. Next week, we'll be exploring the growing trend toward renewable energy in America driven by economics, not by altruism. And that usually means it's going to stick and exacerbate, meaning it's going to increase a whole lot real fast. And we'll have a couple of guests from around the country joining me to talk about what they are seeing, experiencing, and how to navigate this super new, interesting field in the world of energy. Until then, as always, thanks so much for listening.

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