

Selling Contract Rights in Bankruptcy



A close reading of the daily financial news reveals that many public corporations that embrace chapter 11 with the goal of reorganizing, wind up selling their assets to pay their bondholders and creditors. When a business heads down the path of liquidation, the Bankruptcy Code gives it certain rights that are intended to help it sell assets and recover money for creditors. This article discusses the sale of rights arising under contracts such as purchase agreements, license agreements, permits and royalty agreements.

Even though a bankrupt company has defaulted on making payments under its contracts, the contract rights may still be preserved by using a sale under the Bankruptcy Code. For example, a bankrupt company may have a valuable license to use a famous trademark in the sale of sporting goods, but has failed to make the required royalty payments. By using provisions of the Bankruptcy Code, the auctioneer can sell the valuable trademark and use the sale proceeds to pay the royalty payments that were past due. The trademark licensor gets paid its past due royalties, the seller/bankrupt company recovers some money for creditors, and the buyer gets to use the trademark in its ongoing business.

All of this can be accomplished by using sections 363 and 365 of the Bankruptcy Code. Part of the auctioneer's role is to identify assets for which there is a potential market and to help the bankrupt's lawyer determine if the potential value is more than the amount owed to cure defaults under the contract.

When the bankrupt has defaulted under its contracts by not making the required payments, there are often issues about whether the contract can be sold, particularly if the other party to the contract has sought to formally terminate the contract. The auctioneer should discuss with the bankrupt's attorney the basic legal issues, since prospective bidders will want to understand what has happened and to review any termination notices or other documents relating to the contracts to be sold. Quite a bit can be accomplished through negotiations, but if there is an objection to the sale of a specific contract then there is a legal procedure to bring the matter before the bankruptcy judge for decision.

Many contracts contain clauses that attempt to automatically terminate the contracts if there is a bankruptcy filing by one of the parties. In general these types of provisions are not enforceable against the bankrupt company and the bankruptcy judge will enter an order that specifically approves the transfer of contracts where the seller's right to sell is being disputed.

What should you look for to determine if a contract of a bankrupt company has potential value? Of course, the starting point is finding out if the rights under the contract result in any specific cash flow or profits that can be traced to the contract. For example, there may be specific sales records relating to licensed trademarks, and these sales records can be examined by potential bidders to help them determine whether the rights will enhance the profits of their own companies. The auctioneer should compare royalty rates under licenses to see if the rates are above or below prevailing market rates, since if the royalty rates being paid by the debtor are low then the license may have enhanced value.

Some contracts grant rights to specific geographic areas—some good, some bad. The auctioneer needs to examine the contracts since there may be bidders who have an interest because of unique features of the contract. In some case a contract right may be valuable because it enables a business to exclude a competitor from a particular geographic area or business segment. In determining what has potential value, the bankrupt company's employees often have valuable knowledge and they should be consulted. In addition, other records that relate to contract rights such as royalty payment records, customer lists, sales records and records of related accounts receivable need to be preserved and available for inspection by bidders. If these records are preserved in electronic format, then bidders may find it easier to conduct their due diligence.

When an auctioneer is asked to sell contract rights at a bankruptcy auction, the auctioneer needs to be part of the process and should be kept informed by the bankrupt and the bankrupt's attorney. In addition to holding the auction and getting a cash bid, the auctioneer and other parties need to determine if the high bidder is able to *qualify*. What do we mean by *qualify*? While the Bankruptcy Code permits the sale of many types of contracts if the monetary defaults are paid, it provides some protection to the other party to the contract by requiring that the high bidder provide "adequate assurance of future performance of the contract." The bidder should be able to show that it is competent, has the financial ability to perform the contract in the future and that performance is likely. If the bidder has no prior experience relating to the rights it is buying, then it may have to provide a stronger financial statement than otherwise. In practice what constitutes adequate assurance of future performance is a matter for negotiation between the parties to the contract, since most parties recognize that the bankruptcy judge will not let unrealistic demands by one person prevent a bankruptcy sale.



Once the high bidder for a valuable contract is determined the bidder and the other party to the contract often will enter into negotiations to consensually modify the rights that have been acquired. For example, the high bidder may want to add some additional rights and the counterparty may want to make changes in geographic coverage or payments. Once the auction is concluded and the sale approved, the parties are free to revise the contract as they please. These negotiations may have begun before the bankruptcy auction is held, and the auctioneer needs to be alert so that there is no collusive bidding or other actions taken that discourage bidding or depress the value of the asset.

The special ability to sell contract rights exists only if the seller is a debtor or trustee in a bankruptcy case. The auctioneer may encounter business liquidations where the seller would be better off if it sold its assets in a bankruptcy auction, since the bankruptcy filing is an effective tool to enhance the value of contract rights that would be lost in non-bankruptcy liquidation.

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