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Client Alert

Business Restructuring & Bankruptcy Group February 2012

Delaware Bankruptcy Court Approves Contested *Real Mex* Section 363 Sale to Second Lien Noteholders Notwithstanding Administrative Insolvency

In yet another case demonstrating that Section 363 bankruptcy sales often present the best - if not only - option for selling a distressed business as a going concern, the U.S. Bankruptcy Court in Delaware recently approved the largely credit bid-based purchase of the Real Mex restaurant businesses to its second lien noteholders over the objection of unsecured creditors who would receive no recovery.

Bankruptcy Code Section 363 allows debtors to sell estate assets free and clear of property interests such as liens, provided that debtors demonstrate a sound business purpose for the sale. Purchasers are afforded successor liability protection and, because liens generally attach to the proceeds of sales, sales can be conducted quickly and not subject to resolution of creditor issues, such as competing interests in the property sold.

Background

Real Mex Restaurants, Inc. and its affiliates (the "Company"), with over 10,000 employees, operated, franchised or licensed approximately 200 restaurants under the Chevys Fresh Mex, El Torito and Acapulco Mexican Restaurant names. In the summer of 2011, the Company negotiated a comprehensive forbearance agreement in the wake of defaulting on financial covenants under its first lien credit facility and its inability to make a scheduled interest payment to its $130 million second lien noteholders (the "Noteholders") without jeopardizing its ability to stay in business or triggering additional defaults. Pursuant to the forbearance agreement, the Company was to submit an executed binding term sheet for a comprehensive restructuring by October 31, 2011. Realizing that compliance would have been unlikely, and that foreclosure would not have allowed a sale as a going concern, the Company filed for Chapter 11 bankruptcy in the U.S. Bankruptcy Court in Delaware on October 4, 2011.

In bankruptcy, the Company's $49 million DIP roll-up facility required a sale of the businesses to close on or prior to February 27, 2012. At auction, the Noteholders offered to pay $164 million for the businesses, consisting of a credit bid of $80 million of outstanding second lien debt, $46 million of cash to pay the DIP facility, and the assumption of $38 million of liabilities. The consideration to be paid by the Noteholders would further provide for the assumption of both encumbered and unencumbered assets and of avoidance actions.[1] A lone competing bidder offered $26 million in cash.

[1] In order to discourage debtors from favoring certain creditors over others on the eve of a bankruptcy filing, the Bankruptcy Code generally allows debtors to recover non-ordinary course payments made to creditors within 90 days prior to the bankruptcy filing, known as the preference period, if that payment would have put the creditor in a better position than it would have been had it been a creditor in the bankruptcy. This is a type of avoidance action that typically belongs to the debtor's estate. Purchasers seek to have avoidance actions assigned to them in order to prevent others from suing their new vendors.

The Objection

The creditors' committee objected to the Noteholder bid on multiple fronts because if the bid were approved, there would not be enough cash to pay administrative postpetition claims in full and there would be no cash available to pay general unsecured claims (e.g., claims arising from rejected leases). The creditors' committee argued that a sale leaving the Company's estates administratively insolvent had no sound business purpose, and that it would have been nothing more than a glorified foreclosure sale improperly conducted for the Noteholders' benefit. It also argued that the Noteholders should not have been able to credit bid for unencumbered assets and, noting nearly $80 million in transfers during the 90 day preference period, policy prohibited the transfer of avoidance actions to purchasers. The creditors' committee further argued that the Noteholders' cherry-picking of which liabilities to assume disrupted the Bankruptcy Code's priority scheme and that the Noteholders' appearance at auction chilled the bidding process. The Company and the Noteholders countered that the auction demonstrated that the estate was administratively insolvent in any event and that the bid provided the most overall value to the estate. They also argued that the sale met the sound business purpose requirement as the alternative would in all likelihood have been a liquidation leaving even less cash to pay creditors and resulting in the loss of at least 10,000 jobs.

The Bankruptcy Court's Ruling

On February 10, 2012, Judge Brendan L. Shannon approved the sale, finding that, notwithstanding administrative insolvency, the Noteholder bid offered far more value to creditors and interested parties than "any other viable alternative," that the bid was indeed the highest and best offer obtained in a fair and open sale process, and that there was no other "realistic alternative path." He also found that a sound business purpose existed because liquidation would have been "demonstrably worse for many, many creditors, not to mention the thousands of employees" and that denying the sale would lead to a greater administrative insolvency. The fact that administrative insolvency was a prerequisite to confirming a plan (see Bankruptcy Code Section 1129(a)(9)) was not a bar to approving the sale. Furthermore, he recognized the right of purchasers to "pick and choose those administrative obligations going forward from today that they would choose to pay or not pay" and affirmed the right of estates to sell avoidance actions. Judge Shannon recognized that the presence of credit bidders could chill bidding, but noted that credit bidding was a right afforded secured creditors under Bankruptcy Code Section 363(k). Judge Shannon was unpersuaded that the Noteholders were required to cash bid for unencumbered assets.

Conclusion

Real Mex is the latest ruling following the 2009 *Chrysler* Chapter 11 case making clear that, at least when dealing with the proverbial "melting ice cube," a Section 363 sale can be a viable option and that purchasers can pick and choose their assumed assets and liabilities even where the result would not satisfy Chapter 11 plan requirements and would disrupt the Bankruptcy Code's priority scheme. More importantly, *Real Mex* reinforces the proposition that Section 363 sales are often the best, if not only, means to maximize value and avoid liquidation of a business and that bankruptcy courts recognize the value in saving a business even if it would result in administrative insolvency and no recovery to general unsecured creditors.

Please feel free to contact any of the attorneys listed below or any partner with whom you work if you would like to discuss this case and its implications.

Michael S. Fox
mfox@olshanlaw.com
212.451.2277

Adam H. Friedman
afriedman@olshanlaw.com
212.451.2216

Jonathan T. Koevary
jkoevary@olshanlaw.com
212.451.2265

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