Toto, I've a Feeling We're Not in Kansas Anymore: Bankruptcy Sales Outside the Ordinary Course of Business

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The general bankruptcy paradigm is as follows: Chapter 7 is for the liquidation of either an entity or an individual's assets for the benefit of creditors; Chapter 11 is for the reorganization of the debts owed by an entity or an individual.[1] Bankruptcy courts do, however, allow a debtor's orderly liquidation through the Chapter 11 process, generally involving the sale of assets. Orderly liquidation under Chapter 11 is the preferred liquidation method, because it allows the debtor to continue operating the business pending liquidation, as necessary, theoretically with knowledgeable management in place at the helm, while allowing the entire creditor body, not just a small minority of secured creditors or the most vocal unsecured creditors, to participate in the liquidation process.

The recent mega-bankruptcy filings by Chrysler and General Motors raised the public's consciousness regarding bankruptcy sales. However, questions frequently arise about how sales of a bankrupt debtor's assets outside of the ordinary course of business are conducted and the issues attendant thereto. Many bankruptcy practitioners now "affectionately" refer to a Chapter 11 filing followed by an immediate motion to approve sale of all or most of the bankrupt entity's assets pursuant to § 363 of the Bankruptcy Code as a Chapter 3 bankruptcy. In Chapter 3 cases, sales procedures are often approved before an unsecured creditors' committee can be formed to review the sales procedures meaningfully and, in most large bankruptcy filings, before many creditors even receive notice of the motion and subsequent hearing to approve the proposed sales procedures.

On the other hand, Chapter 3 debtors often face the classic scenario of having a gun at their heads: the bankruptcy filings are typically preceded by lengthy out-of-court efforts to restructure and/or recapitalize the companies with little to no success and the debtors find themselves lacking sufficient cash to continue operations during a court-supervised reorganization and plan confirmation process, forcing them to sell their assets quickly or risk running out of operating funds. As a result, Chapter 3 debtors can be faced with closing their businesses, laying off their employees, and liquidating their assets at fire sale prices. Creditors are forced to accept the sales, because the proposed assets to be sold are generally depreciating, and forcing the debtors to hold and sell them in a nonoperating context may result in a marked reduction in the value of the bankruptcy estate and the return to creditors as a whole. Bankruptcy courts in this scenario find themselves facing a Hobson's choice—to allow the sale and preserve the value of the assets, however meager, for the estate, potentially save jobs, and protect vendors or to proceed to liquidation whereby unsecured creditors are virtually assured that they will receive little or no recovery.

Nevertheless, the early liquidation of all or substantially all of a debtor's assets raises procedural concerns that the bankruptcy process may be subverted. Bankruptcy courts and appellate courts alike are concerned that certain protection for the entire body of creditors' rights can be subverted for the benefit of a few or that the creditors' role in the process—that is, negotiating and voting on a plan of reorganization—is marginalized. This article reviews the basic structure of a modern day § 363 sale and then addresses some of the common issues faced by courts and practitioners in connection with sales of all or substantially all of a debtor's assets outside of the debtor's ordinary course of business.

A Basic Overview of Bankruptcy Sales

Section 1123 of the Bankruptcy Code provides that a "plan may … provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among holders of claims or interests." Section 363 of the Bankruptcy Code governs the sale of any and/or all of the bankruptcy estate's assets and generally allows the sale of goods made in the ordinary course of the debtor's business without the approval of the bankruptcy court—for example, if the debtor sold widgets before the bankruptcy in the ordinary course of business, the debtor will be allowed to sell widgets after the bankruptcy without the approval of the bankruptcy court.[2] However, debtors seeking to sell their goods outside of the ordinary course of their business must give notice to creditors and obtain the approval of the bankruptcy court.[3] A party with an interest in the property sought to be sold is entitled to request adequate protection of its interest.[4]

In addition, if the debtor seeks to sell the asset or assets free and clear of any interest in the asset—that is, liens, encumbrances, and the like—then the debtor must show that one or more of the following conditions exist:

- All applicable nonbankruptcy laws permit the sale of the asset free and clear of the interest.
- The interest holder consents to the sale free and clear.
- The interest is a lien and the asset is being sold for more than the aggregate of all liens against the asset.
- The interest is in "bona fide dispute."
- The interest holder could be compelled in a legal proceeding to accept money in satisfaction of such interest.[5]

Section 363 also provides that, as long as the sale was conducted in good faith, a subsequent reversal of the bankruptcy court's order approving the sale, does not affect the validity of the sale, even if the purchaser knew of the pendency of the appeal, unless the bankruptcy court's order is stayed pending appeal.[6]

The Parties: Who is Interested in a Sale Under § 363?

When considering sales of assets under § 363, one should be aware of all interested parties whose competing interests will drive the process: the debtor, the secured lender, unsecured creditors, and the purchaser. Because each party has a hand in shaping the form and process of a § 363 sale, considering the parties' perspectives can assist in ascertaining their motivation. Whereas trade creditors dominated unsecured creditor pools in the past, many recent cases involve more bondholders than trade creditors, changing the underlying interest of this class of interested parties. Trade creditors will ascribe value to a sale of the debtor's assets in ongoing business opportunities, and bondholders are merely interested in maximizing the value that is paid to their constituents at closing. In addition, two of these parties may be consolidated, changing the negotiating landscape. Often, the initial interested purchaser is either a bondholder or a secured lender, narrowing the negotiations from a four-party "square" to a three-party negotiation. In rare cases, there is a fifth category of interested parties: equity. This category is unusual because, in order for equity to have any hope of recovery, unsecured creditors must be paid in full, which is very unlikely when considering a § 363 sale of assets.

Some of the debtor's equity owners may also be employees, giving them an incentive to negotiate with the purchaser in an effort to preserve their jobs at the new company. Employees who are also the debtor's officers and/or directors must put their fiduciary duties owed to the debtor's creditors above their own interests in future employment while they hold those positions. This situation provides an interesting quagmire when the main contact for debtor's counsel finds himself or herself more interested in his or her own employment than in maximizing the value of the debtor's assets for the benefit of its creditors.

When Does a § 363 Sale Make Sense?

A § 363 sale generally is considered before a bankruptcy case is filed. When management realizes that it may be unrealistic to reorganize the debtor's debts and to continue operations, the company's options are reduced to liquidation or sale as an ongoing concern. In most cases, selling a business as an ongoing concern, whether as a whole or in parts, generates more value than liquidation does. Sometimes, this realization comes after fruitless negotiations with secured lenders, and in other cases it comes after receiving an offer to purchase the business from an interested third-party purchaser. These offers can be unsolicited; however, many management teams hire investment bankers or other marketing teams to look for potential acquisition partners. Whichever path is chosen, once a debtor decides to sell its business under § 363, the process begins, springing into life the negotiations that will provide the framework to sell the company's business.

What is a "Stalking Horse" Bidder?

In most cases, identifying a potential purchaser for the debtor's assets before seeking approval of a § 363 sale and auction process is critical to maximizing value. This initial interested purchaser is referred to in the industry as a "stalking horse." Generically, this term refers to a person who tests a concept anonymously, and once the concept proves beneficial, the stalking horse can make his or her identity known; on the other hand, if the concept fails, the person can remain anonymous. This term originated as a reference to a hunting practice. Human hunters would notice that animal prey fled immediately upon sighting a human but tolerated the presence of other animals, such as horses. Therefore, human hunters would walk alongside their horses, staying out of sight until their prey was within striking distance. As used in the context of bankruptcy sales, maintaining anonymity is impossible, because the stalking horse must be identified in court filings. The purpose of a stalking horse in the context of a § 363 sale is to establish a competitive floor or minimum bid amount for the purchase of the debtor's business, thereby preventing lowball offers that would fail to provide a minimum amount of value. Thus, finding a stalking horse bidder is important for the § 363 sale process, because it provides the initial framework for the auction and sale process. As mentioned above, if there is no interested third-party purchaser, a secured lender could act as a stalking horse bidder, but that rarely serves the purpose of enticing other industry bidders. Moreover, the process is murky in specialized or mega-industries, in which a stalking horse bidder for all of the debtor's assets may not materialize quickly, if at all.

If a Debtor Finds a Purchaser, What Happens Next?

Outside of a bankruptcy context, once a company finds a purchaser, an asset purchase agreement is negotiated and signed, and the assets are transferred. Although all these transactions occur within a § 363 sale, the sale also includes an auction process—the process of establishing the procedures by which the debtor confirms that this offer to purchase the debtor's assets is the highest and best offer. When a stalking horse bidder is not involved, this process is designed to solicit the highest and best bid possible for the sale of the assets in an attempt to flush out a purchaser who will preserve the value of the ongoing business concern. When a stalking horse bidder is involved, this process is designed to evaluate the initial offer made by the bidder to ensure that no other bidder exists who is willing to pay more for the purchased assets. Thus, in addition to the normal due diligence and asset purchase agreement negotiations, the parties will also negotiate the terms of the auction process.

The auction process is a delicate balancing act, particularly when a stalking horse bidder is involved, because of the competing interests that are usually part of this process: The stalking horse wants to be the successful bidder (usually);[7] the secured lender wants to be paid in full by any party; and the debtor and the unsecured creditors want to encourage new bids to pay more for the debtor's assets as a way to maximize return to their constituents. These competing interests create the conflict involved in the negotiation—balancing the need to locate the highest and best bid without losing the stalking horse bidder or chilling the bidding process.

How are Stalking Horse Bidders Protected?

A stalking horse bidder will typically be very involved in negotiating auction procedures. Understandably, by providing the floor for all future bids, these bidders are entitled to some bid protections. Thus, auction procedures usually include a minimum amount by which the first competitive bid must exceed the stalking horse's bid in order to be considered at auction; this is referred to as the "topping fee." That topping fee can consist of the following components: expense reimbursement, a "break-up" fee, and a minimum incremental increase.

The expense reimbursement is usually engineered to reimburse the stalking horse bidder for all expenses incurred in reaching the auction and sale process. As a stalking horse, this bidder has paved the way for future bids by (1) performing all the due diligence needed to verify the value and existence of the debtor's assets, (2) negotiating the asset purchase agreement that will form the basis for all other bids, often placing a good faith deposit, (3) and spending funds in the form of attorneys' fees to provide for the accurate documentation of the entire transaction. A "break-up" fee is an amount designed to repay the stalking horse for his or her role as the initial bidder, drawing in the other bidders. This is typically a percentage of the consideration or purchase price bid by the stalking horse. Finally, the minimum increment simply provides the amount by which all bids must exceed one another to be considered as a higher bid than the one offered by the last bidder. The minimum increment may or may not be included in the initial topping fee depending on whether the increment is included in the other components.

What are Bid Qualifications?

Other common provisions sought by a stalking horse bidder to protect his or her interests include qualification of other bidders. Bid qualifications have become a hot area of negotiation. Even though the intent of requiring bid qualifications is to ensure an interested bidder's veracity, difficulty qualifying as a bidder can chill the bidding process.

Such requirements often include the following:

- submission of an executed asset purchase agreement on the same terms as the stalking horse bidder's agreement with minimal changes (often limited to purchase price);
- submission of a good faith deposit (often larger than the stalking horse's deposit), which will not be refunded until the transaction closes;
- an agreement to commit to the submitted bid—that is, an agreement to be a backup bidder in the event the winning bid does not get to closing—until the transaction is completed;
- providing assurance of adequate funds to pay the proposed purchase price; and
- submission of all materials, including corporate authority to close the transaction, by a date certain.

Controversy arises when the requirements for a qualified bidder exceed those met by the stalking horse bidder, especially in regard to deposits. In addition, stalking horse bidders often want to review potential bids for qualification, which can chill the bidding process involving industry competitors, allowing the stalking horse to review competitors' financial data and providing access to confidential information. Debtors must ensure that their stalking horse does not chill the bidding process by providing reasonable bid qualifications. This is one area in which negotiating the auction process after a bankruptcy filing provides an advantage by giving unsecured creditors the potential to organize and retain common counsel through the committee process provided under the Bankruptcy Code. Committee counsel can be invaluable in assisting with negotiating against a stalking horse bidder to prevent bid chilling. Prepetition, unsecured creditors are typically not organized and have not employed counsel, and as such, their participation in negotiations is limited or even nonexistent. Thus, if a debtor seeks to negotiate the auction and sale process prior to filing for bankruptcy, the unsecured creditors typically will not have a voice and cannot offer effective assistance in these negotiations. This is something to weigh when determining whether to have these negotiations before or after a debtor files for bankruptcy.

Credit Bid Rights: A Secured Creditor's Trump Card

Once the bid protections and qualifications have been negotiated, the main area of negotiation remaining is a secured lender's right to credit bid. Under § 363(k) of the Bankruptcy Code, a secured lender has a right to preserve his or her credit bid.[8] Practically speaking, if there is a stalking horse bid that will provide for payment in full of the secured creditor's claim, this provision is merely a backstop to ensure that if the deal does not close the secured creditor can credit bid and move forward almost in a foreclosure setting to purchase the assets in exchange for bidding a portion of the debt. However, in the absence of a stalking horse, a secured lender is likely to seek protection of this right. A debtor without a true purchaser may have little choice on this matter. Assisting in appropriately limiting a secured creditor's credit bidding rights is another negotiating area in which an unsecured creditors' committee counsel can also assist the debtor's counsel.

Common Pitfalls in Auction and Sale Negotiations

With all the terms involved in the auction and sale process, one must watch out for many practical pitfalls and other issues. The first is the purchase price, which can consist of many factors—most often cash and assumption of certain liabilities. In the event the stalking horse bidder is assuming certain liabilities, a value should be ascribed to those to allow other bids to be compared as apples to apples. For example, if the stalking horse purchaser is the debtor's largest trade creditor and holds a $500,000 pre-petition claim, such a bidder may agree to forgive that debt as a portion of the purchase price or consideration. Another purchaser must ascribe some value—although maybe not 100 percent—to this consideration.

Deadlines are another pitfall in the auction and sale process and many of them could be encountered, including, but not limited, to due dates for the following:

- submitting bid qualification materials,
- approving qualified bidders,
- performing due diligence,
- making deposits,
- refunding deposits,
- determining who will attend any auction,
- holding the auction,
- objecting to auction procedures,
- holding hearings on the approval of the auction and sale of the assets,
- filing a motion to sell the assets,
- closing the sale,
- notifying backup bidders of their need to close the transaction, and so forth.

The prudent practitioner should be sure that these deadlines actually are reasonable and attainable.

The third pitfall is timing. One should onsider whether to negotiate issues before or after filing for bankruptcy. If a debtor will need the leverage of an unsecured creditors' committee to battle a strong secured lender or stalking horse purchaser, post-petition negotiations are advisable.

Finally, it is important to be aware of one's standing for participation in the sale process. If a third-party potential purchaser needs to make auction or sale process objections, one should consider purchasing a claim to give standing to object. Many courts deem that an unsuccessful bidder has no standing to contest irregularities in the sale and auction process.

Asset sales under § 363 are an interesting process. Parties often end up in a room with multiple lawyers and clients, along with a court reporter recording the activities of usually a very short (confirmation of the stalking horse bid as the only qualified bid) or occasionally all-night auction. The process involves bids flowing back and forth between the parties, consideration of additional and often differing forms of purchase price payment, and potentially multiple offers for varying sectors of a debtor's business. The unpredictability of the outcome of the process certainly leaves the Chapter 3 bankruptcy as the remaining Wild West-type frontier in these matters, as further evidenced by recent sales of automobile manufacturers.

Notice of the Sale

Section 363 of the Bankruptcy Code requires notice of the sale and a hearing to approve any sale outside of the debtor's ordinary course of business. Federal Rule of Bankruptcy Procedure 2002 provides that the debtor and creditors are entitled to 20 days' notice by mail of a proposed sale of the bankruptcy estate's assets other than those sold in the ordinary course of business, unless the court for cause shortens the notice time or directs some other method of notice, such as publication.[9] Additional parties who should receive notice include the U.S. Trustee, any official committee of unsecured creditors or its counsel, and equity security holders.[10] Any limitations on notice must be approved by the bankruptcy court prior to notice being sent, otherwise due process concerns are implicated that can jeopardize the effectiveness of any order approving the sale.

Standards for Approval of a Sale

Cases diverge on the "standard" for approving bankruptcy sales based on the jurisdiction in which the debtor's case falls, although most generally accept a business judgment test and grant broad authority to courts to approve sales. A small minority of courts holds that the sale of all or substantially all of a debtor's assets outside of the ordinary course of business violates the reorganization principles of Chapter 11 bankruptcy,[11] or that an emergency must be shown to warrant a pre-confirmation sale.[12] Although initial opinions by circuit courts of appeals on the issue of sales of all or substantially all of a debtor's assets took a conservative tone, as discussed below, approval of these types of sales is now commonplace, as evidenced by the recent high-profile sales of Chrysler and General Motors.

The Law: The Big Three Cases

The definition of a sub rosa plan is a "secret" or "covert" plan of reorganization or a de facto plan of reorganization that is effectuated without meeting the technical requirement of the Bankruptcy Code. The seminal decision on sub rosa plans was made in the case of *Pension Benefit Guar. Corp v. Braniff Airways*.[13] In its decision in this case, the Fifth Circuit, although not expressly ruling on whether debtors could sell all or substantially all of their assets pursuant to § 363, did hold that "the debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets."[14]

The Second Circuit has developed an "exception" to the *Braniff* ruling. *In In re Lionel Corp.*,[15] the Second Circuit Court of Appeals discussed extensively the history of § 363 and noted that, in connection with approving bankruptcy sales, although "a bankruptcy judge must not be shackled with unnecessarily rigid rules when exercising the undoubtedly broad administrative power granted him under the Code, … we also reject the view that § 363(b) grants the bankruptcy judge carte blanche." The *Lionel* court held that the bankruptcy court must find, based on the evidentiary record, that a good business reason exists to allow a sale. "In fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike." The court went on to list the following nonexclusive factors for the bankruptcy court to consider:

- the proportionate value of the asset to the estate as a whole;
- the amount of elapsed time since the filing;
- the likelihood that a plan of reorganization will be proposed and confirmed in the near future;
- the effect of the proposed disposition on future plans of reorganization;
- the proceeds to be obtained from the disposition vis-à-vis any appraisals of the property and which of the alternatives of use, sale, or lease the proposal envisions; and
- whether the asset is increasing or decreasing in value—the proverbial ice cube melting in the sun.

The *Lionel* court considered the last factor as the most important.

In *In re Continental Airlines Inc*., the Fifth Circuit revisited the issue of sub rosa plans. In considering the factors listed in the *Lionel* decision, the court in the *Continental Airlines* case held that the objecting party bears the burden of proving which Chapter 11 protection is denied and that the bankruptcy court could "fashion appropriate protective measures modeled on those which would attend a reorganization plan." As such, in *Continental Airlines*, the Fifth Circuit Court attempted to strike a balance between due process concerns and plan confirmation standards and the fundamental necessity, in certain circumstances, of a sale.

The Practical Pros and Cons of Bankruptcy Sales

One of the first practical problems with sale motions is the debtor's own dilatory conduct in the case being a potential bar to legitimate business justification. One bankruptcy judge, in an unpublished opinion, accurately and succinctly summed up modern bankruptcy sales as follows:

> The problem with the "melting ice cube" argument is that it is easy enough for the debtor to unplug the freezer prior to bankruptcy. Historically, the best preparation for a successful Chapter 11 reorganization was to file early, husband resources and arrange post-petition financing to give the debtor the best possible chance to continue its business in Chapter 11. Modernly, it is a better tactic to wait until the last minute and then file with no ability to survive in Chapter 11. This compels the court to find the urgency and sound business reason necessary to approve the sale. Unless the bankruptcy judge is willing to show exceptional judicial courage, he or she must approve the sale. While nominally "presiding" over

the case, the judge is reduced to a figurehead without any meaningful discretion and might as well leave his or her signature stamp with the debtor's counsel and go on vacation or shift attention to consumer cases where the law may still mean something.[16]

Another practical problem with sale motions is the purchaser's stated intention to run for the hills if his or her demands are not met in connection with the sale. Creditors frequently have trouble swallowing this position whole. However, in addressing objections filed by bondholders to the business justifications for the expedient sale of substantially all of GM's assets in *In re General Motors Corp.*,[17] Judge Gerber stated the following:

> [T]he [] Bondholders Committee states that it was not inclined to second guess GM's view that it had to proceed with a 363 sale, given GM's lack of alternatives, but that the [c]ourt should step in to tell everyone that a 363 sale was unacceptable. The premise underlying this contention was that the U.S. Government's [that is, the purchaser's] July 10 deadline was just posturing, and that the Court should assume that the U.S. Government cares so much about GM's survival that the U.S. Government would never let GM die. …
>
> GM's counsel noted in summation that the [] Bondholder's Committee was expecting this Court to play Russian Roulette, and the comparison was apt. So that the [] Bondholder's Committee could throw GM into a plan negotiation process, the [c]ourt would have to gamble on the notion that the U.S. Government didn't mean it when it said that it would take that gamble. This is hardly the first time that this [c]ourt has seen creditors risk doomsday consequences to increase their incremental recoveries, and this [c]ourt—which is focused on preserving and maximizing value, allowing suppliers to survive, and helping employees keep their jobs—is not of a mind to jeopardize all of these goals.

One of the benefits of an immediate sale motion is the ability to prevent depreciation in the value of the business as an ongoing concern. Typically, sale scenarios involve a limited amount of post-petition lending to the debtor, sometimes coupled with operating losses during the bankruptcy, which make up the proverbial "sinking ship." A bankruptcy sale in this context allows the estate to preserve the going concern of the business, thereby maximizing the value upon the sale of the business for the benefit of all creditors.

One final practical problem in the sale motion process involves rapidly depreciating assets—such as volatile equity interests in a subsidiary, perishable goods sitting on a loading dock, and the like. Bankruptcy sales in these contexts allow the bankruptcy estate to stabilize the value of the assets by liquidating them immediately for cash, other negotiable assets, or a reduction in the liabilities of the estate—all of which benefit creditors by putting a stop gap on the value erosion pending confirmation of a plan.

Conclusion

In summary, sales under § 363 of the Bankruptcy Code are essential and provide a process by which a business can be sold quickly as an ongoing concern in order to pay creditors its maximum value. However, by necessity, these sales move quickly, involving many portions of the Bankruptcy Code. Given the current economic climate, many lawyers in all specialties may find themselves on some side of a § 363 sale, representing a potential purchaser, debtor, or creditor. As such, it is good practice to know the general § 363 sale traps and pitfalls. Even though each case is factually different depending on the debtor's current cash position, industry, and the potential future performance of the business, one commonality runs through all § 363 sales: the process is akin to a roller-coaster ride with scant brakes, barreling toward a conclusion. **TFL**

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Endnotes

[1]Only in the event that an individual's debts are above certain amounts.

[2]11 U.S.C. § 363(c).

[3]11 U.S.C. § 363(b).

[4]11 U.S.C. § 363(e).

[5]11 U.S.C. § 363(f).

[6]11 U.S.C. § 363(m).

[7]Consider the potential motivation of a debtor's major supplier or distributor as a stalking horse bidder. Such a party may be happier to be outbid if it only sought to purchase the assets to save its own business model.

[8]11 U.S.C. § 363(k).

[9]Fed. R. Bankr. P. 2002(a)(2).

[10]Fed. R. Bankr. P. 2002(d), (i), and (k).

[11]*In re D. M. Christian Co.*, 7 B.R. 561 (Bankr. N.D. W. Va. 1980).

[12]*In re White Motor Credit Corp.*, 14 B.R. 584, 590 (Bankr. N.D. Ohio 1981).

[13]*Pension Benefit Guar. Corp. v. Braniff Airways Inc.* (*In re Braniff Airways Inc.*), 700 F.2d 935 (5th Cir. 1983).

[14]700 F.2d at 940.

[15]*Comm. of Equity Sec. Holders v. Lionel Corp.* (*In re Lionel Corp.*), 722 F.2d 1063 (2d Cir. 1983).

[16]*In re Humboldt Creamery LLC*, 2009 Bankr. LEXIS 2470 at *4–5 (Bankr. N.D. Calif. Aug. 14, 2009).

[17]*In re General Motors Corp.*, 409 B.R. 24 (Bankr. S.D.N.Y. 2009).