Negotiating Dynamics In Chapter 11 Asset Sales

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The principal focus of Chapter 11 reorganization cases used to be reorganization plans. A debtor-in-possession ("DIP") or trustee would operate the debtor's business while seeking to restructure its capital and negotiate with creditors on terms for payment of an acceptable amount of their debt. Some assets were sold outside the ordinary course of business, but generally with the goal of paring operations down to a profitable core that could be restructured and continue to exist with new or at least additional equity and a stronger balance sheet.

Most Chapter 11 cases over the last several years have instead focused on the sale of the debtor's business, as a whole or in component parts. The reorganization plan is only the tail on the dog. It is generally a liquidating plan where an individual supervises claim allowance, liquidation of causes of action and miscellaneous assets, and distribution of whatever sale proceeds have not already been distributed to Lenders at closing. If an acceptable plan cannot be negotiated quickly and cost-effectively, the case is converted to a Chapter 7 liquidation.

Sale of estate assets outside the ordinary course of business is authorized under Bankruptcy Code § 363(b), and requires Bankruptcy Court approval after notice and a hearing. 11 U.S.C. § 363(b)(1). The seminal case interpreting that statute, *Lionel*, held that the court must be satisfied that a good business reason exists for the sale, after considering the diverse interests of the debtor, creditors and equity holders. *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983). The court listed factors to be considered: (1) the proportionate value of the asset being sold to the estate as a whole; (2) how long the case had been pending and the likelihood that a reorganization plan could be confirmed in the near future; (3) the effect of the proposed sale on the ability to confirm a plan; and (4) whether the asset was increasing or decreasing in value.

In another seminal case that year, the Fifth Circuit held that a sale outside a reorganization plan may not dictate the terms of the future plan. *In re Braniff Airways, Inc.*, 700 F.2d 935, 940 (5th Cir. 1983). More recent decisions have approved sales that effectively mandated that any plan would be a liquidating plan, when the sale did not dispose of virtually all assets and did not restrict creditors' rights to vote on a subsequent plan, and there was no release of claims against the debtor. *See, e.g. In re Cajun Elec. Power Co-Op, Inc.*, 119 F.3d 349, 355 (5th Cir. 1997).

I. The Parties and Their Interests.

The debtor-in-possession ("DIP") generally makes decisions through its management and, for a corporate debtor, its board of directors. The DIP has fiduciary duties to its creditors as well as its shareholders whenever the DIP is insolvent. The DIP is not required to be disinterested, however. While furthering creditor interests, DIP management takes into account the self-interest of the management, board members, equity (often guarantors or individuals holding personal liability on some of the debt), and professionals assisting the DIP.

In most cases there is a principal lender ("Lender"), often a financial institution, which has loaned the debtor money on an operating line of credit. The lender has usually obtained a security interest in virtually all of the debtor's assets, but does not hold a security interest in causes of action arising for the first time during the bankruptcy case.

The Unsecured Creditors Committee ("Committee"), generally including trade vendors as well as bondholders and tort and contract claimants, usually wants both payment for unsecured creditors' claims and an ongoing enterprise with which the creditors can do future business. The Committee is often the party holding authority to investigate and pursue estate defenses and causes of action against the Lender, while the debtor waives such defenses and claims under a cash collateral or DIP financing agreement. The Committee accordingly may have leverage to extract some value from Lenders when over-encumbered assets are sold, and also to support continuation of the business in the hands of better-capitalized new owners.

A prospective buyer of property from a bankruptcy estate ("Buyer") often perceives advantages to acquiring assets with the imprimatur of court approval. Not only is the seller distressed and likely to accept lower purchase prices, but the Buyer may obtain a level of insulation from successor liability unattainable outside of bankruptcy. It can "cleanse" the assets it acquires of liens, some successor liability claims, and fraudulent conveyance claims that it paid less than a fair and appropriate price. However, the Buyer also knows that the bankruptcy process entails additional costs and delays. It knows that distressed sellers may lack the wherewithal to maintain product or operating quality, and may have incentives to "cut corners." It knows there are fewer market comparables to aid in determining an appropriate bid than exist outside a bankruptcy context. And the Buyer knows there is a risk that the court might not approve its offer, even if acceptable to the DIP, because other bidders may take advantage of its due diligence and contract negotiations and make a successful overbid, in a potentially vibrant bidding environment.

Other parties in interest in the bankruptcy case have stakes at issue and positions to assert at various points in the process.

II. The Decision to Sell Instead of Reorganize

Lender: Often, the Lender is the driving force behind asset sales. The Lender may have lost confidence in the DIP's management and its ability to manage the business profitably and repay the debt. The Lender is likely concerned about prepetition deterioration in the amount or quality of its collateral, and the potential for that deterioration to continue and escalate postpetition. The Lender may be concerned that the DIP's business model is not working, and its enterprise value is declining. The Lender may see a window of opportunity to market the business and close a sale that it does not want the DIP to miss.

The Lender may have the leverage to force a sale through terminating the DIP's access to accounts receivable and other cash collateral. *See, e.g. In re Coastal Indus., Inc.*, 63 B.R. 361 (Bankr. N.D. Ohio 1986), where a motion to sell one week after filing the bankruptcy case was approved when proof of compelling reasons for such great haste were met. The banks had called their loans and the debtor's insurance was about to expire, threatening continued operations. The agreement avoided immediate layoff of employees and would facilitate collection of accounts receivable.

DIP: Management of the DIP is likely to be considerably more optimistic about the company's prospects than the Lender. In the early sale context of this paper, the DIP has been persuaded by business realities that is only hope to salvage the business for its employees, and in its best case management team members as well, is to sell the company.

Fundamentally, a sale versus reorganization turns on money and time. Who will contribute enough money to finance the business? When will that money be forthcoming? If no new value is to be had from existing equity or a white knight, and no money is to be had soon enough to prevent the Lender's exercise of remedies, the DIP probably will decide to sell.

The management and board of directors of a DIP must evaluate whether to accept an offer, even a hostile bid, by looking to the best interest of the entity and its creditors, not their own self-preservation. *See In re Bidermann Indus. U.S.A., Inc.*, 203 B.R. 547, 552 (Bankr. S.D.N.Y. 1997); *In re S.N.A. Nut Co.*, 186 B.R. 98, 102 (Bankr. N.D. Ill. 1995); *In re 995 Fifth Avenue Assoc. L.P.*, 96 B.R. 24 (Bankr. S.D.N.Y. 1989) (duty of board to deal fairly with bidders in a corporate takeover context applicable in Chapter 11). The court may be especially unsympathetic to objections by equity interest holders where the sale would result in creditors getting paid, and the owners are not willing to advance their own cash. *In re Canyon Partnership*, 55 B.R. 520, 524-25 (Bankr. S.D. Cal.1985)(objection by equity interests to sale on grounds that price was inadequate overruled where non-objecting Lender's loan was to be assumed, small unsecured creditors would be paid in full, equity infusion would be required to obtain a higher price, and equity interests not willing to advance cash.

Committee: When the DIP and Lender have committed to a sale strategy, the Committee is unlikely to alter the course. The Committee rarely has access to funds needed by the DIP – trade credit is generally insufficient – although Committee members may have contacts with potential white knight investors. If the Committee perceives grounds to force use of cash collateral and continue business operations, it may try to align with DIP management against the Lender early, and avoid a sale. More commonly, the Committee's approach is only to alter the edges of the sale strategy.

If a sale is unlikely to generate sufficient funds to pay the Lender in full, the Committee may well attempt to use whatever devices it can muster to extract value for unsecured creditors by making the Lender buy peace with the Committee. It may object to the Lender's secured claim, and assert whatever grounds pass Rule 9011 muster to challenge the claim and assert offsetting counterclaims. The Committee may object to a sale under *Lionel/Braniff* requirements. It may object to the bankruptcy case itself as having been filed in bad faith, as not benefiting unsecured creditors – a use of the Code manufactured for the Lender that does not belong in bankruptcy court.

The Committee may also assert that the urgent circumstances warranting a sale claimed by the DIP and Lender have been manufactured to pressure the court to act, or there are questions of self-dealing. An expedited sale may not be approved in such a case. *See In re Crutcher Resources Corp.*, 72 B.R. 628, 632 (Bankr. N.D. Tex. 1987) (a sale to insiders requires careful review; "blatant attempt to place pressure on the Court only serves to raise additional suspicions concerning the 'cozy' relationship between the parent and the Lenders and to suggest that this case is being orchestrated not for the benefit of unsecured creditors …, but rather for the benefit of the Lenders and the principals of the parent corporation;" no evidence on value of assets being sold other than the self serving statements of the purchasers (who were insiders); no evidence of business justification from the standpoint of the parent; notice not sufficient; approval of sale denied); *In re Beker Indus. Corp.*, 64 B.R. 900, 906 (Bankr. S.D.N.Y. 1986) ("Primary among the considerations applicable here is the notion that this case is at a crucial stage where the path the Debtor will take is to be determined;" court found at early stage of the case the type of compelling circumstances permitting such a sale were not presented), *rev'd on other grounds*, 89 B.R. 336 (S.D.N.Y. 1988); *In re Au Natural Restaurant, Inc.*, 63 B.R. 575 (Bankr. S.D.N.Y. 1986) (claimed need for expedition contradicted by record, proposed transaction not clear; installment sale would restrict payments to creditors; notice insufficient; transaction disapproved). In *In re Copy Crafters Quickprint, Inc.*, 92 B.R. 973, 983 (Bankr. N.D.N.Y. 1988), the court held that a lease entered into by the debtor postpetition as a part of a sale of the debtor's business, agreed to before the filing of the Chapter 11 petition, could not be approved *nunc pro tunc* for it would "effectively put the Court's imprimatur on the sale and confirm the Plan long before the hurdles of Chapter 11 are overcome").

Other secured creditors: Code § 363(e) provides that on request (only), of an entity having an interest in the property being used, sold or leased, the court is to prohibit or condition the transaction to provide adequate protection of that interest. It could be provided in the form of a replacement lien, cash payments or the like. The junior lienholder may also object to the sale free and clear of its liens under Code § 363(f).

III. Engaging a Broker or Investment Banker

All parties have an interest in a professional evaluation of the universe of potential purchasers, and maximizing the chance of a successful sale for the highest possible price. That includes an evaluation of selling the business as a whole or in business divisions or units, deciding which of those units to market in what order, the method of marketing to maximize bids and minimize adverse publicity, and obtaining a stalking-horse contract if possible. Investment bankers are often employed to put together a sale book and distribute it to potential strategic and financial buyers that sign confidentiality agreements, make presentations to potential buyers, and run the sale process generally. Accountants, appraisers and auctioneers are other frequent participants in sales. Any of these professionals that is engaged by the estate must meet the disinterestedness requirements of Code § 327(a).

DIP: The DIP owners and management have fiduciary duties to creditors and shareholders to ensure that the maximum price is realized for company assets. They will want the sale process to reach as many potential serious buyers as possible, a "level playing field" for information, and confirmation by professionals that they are meeting their state and bankruptcy law duties of care. By their oversight of the sale process, professionals can help to insulate the board and management from claims of unfair advantage to insider bidders. *In re Bidermann Industries U.S.A., Inc.*, 203 B.R. 547, 551 (Bankr. S.D.N.Y. 1997) ("It is astounding that the debtors have not hired an investment banker to test the marketplace for other expressions of interest."); *In re Integrated Resources, Inc.*, 147 B.R. 650, 658 (S.D.N.Y. 1992), *app. dism.*, 3 F.3d 49 (2nd Cir. 1993) (discussing board's responsibility in sale context without regard for self-interest).

The DIP wants to avoid disruption to its operations and management to the extent possible during the sale process. The DIP will seek to assuage management and employees about jobs and avoid distractions and even an exodus by proposing severance benefits and a key employee retention program, or KERP. Some members of management may be interested in bidding for the company or portions of it. Some may want to negotiate for personal benefits, such as non-compete or consulting agreements. They should not be the people analyzing competing offers. *Id.*

When bidders are competitors, the DIP will not want its proprietary information shared any more than absolutely necessary, under strict confidentiality terms insulating the people receiving the data and evaluating the purchase from the line people running the competitor's business. An investment banker can provide acceptable contract terms to meet these concerns.

The DIP will also need to work with counsel to understand and address liens and claims against assets to be sold, and the particular impact they may have on the sale. It wants to maximize confidentiality and minimize the impact of competitor access to proprietary information in case a sale to the competitor does not materialize. While sharing information with the Lender and Committee, the DIP will want to retain control over the sale process.

Lender: The Lender wants information on sale procedures, proposals and responses, so it can oversee them and ensure that appropriate efforts are being made, and that its collateral does not decline any more than necessary. If management members are involved in sale contract negotiations and due diligence, and are also prospective bidders or otherwise have incentives to discourage a particular bidder or bidders generally, the Lender will want procedures in place to confirm (1) there is no sabotage of due diligence, *e.g.* by having an investment banker participate in meetings between management and potential buyers; (2) value properly attributable to company assets are allocated to those assets, not to buy-off management; (3) costs for KERP and severance are kept in line; (4) disinterested board members are reviewing offers, and there is limited access to buyer information for potentially-bidding management and its allies.

The Lender also will want timelines and deadlines to assure that the sale process moves forward expeditiously, especially if the company is losing money and thus reducing its collateral value as time goes on.

Committee: The Committee's interests are the same as the DIP and Lender, but it is also concerned with oversight of the DIP and Lender. If the Lender is to finance the Buyer, the Committee wants to ensure that the terms vis-à-vis the estate are fair and reasonable.

Buyer: The Buyer wants sufficient information to enable it to decide whether the company assets are worth pursuing with a letter of intent, or LOI, as a stalking-horse bidder. Once it reaches that decision, the Buyer will want to maximize its advantages over other bidders, and minimize the risk of unreimbursed expenditure of due diligence and contract negotiation costs by requiring acceptable terms in a bidding procedures order.

IV. Negotiating With a Stalking-horse

<u>Price</u>

Buyer: The Buyer will offer less than its bottom-line purchase price for a stalking-horse offer, recognizing it may need to bid further at an auction. The Buyer must also recognize that values and asset amounts may change during the period before the sale closing, and will often bid on a formula instead of a flat dollar amount – *e.g.* X% of accounts receivable less than 90 days old; X% of inventory at lower of cost or market, determined on a first in-first out "FIFO" basis. The contract will need to provide for a post-closing count of assets and reconciliation.

DIP: The DIP will negotiate for the highest price and best formula it can get, taking into account the DIP's business and accounting methods, the market analysis of its professionals, and its obligation to maximize the value for the estate. The DIP will be concerned that once the Buyer prevails, it will have good incentives to construe the contract in a way that will reduce the price as much as possible. The DIP will accordingly want the method of valuing the assets to be clearly stated, and a method of resolving the disputes to be included, preferably including specific performance remedies. *In re Aerovex*, 281 B.R. 419, 424-25 (Bankr. D. Mass. 2002).

Lender: The Lender may have a minimum price, below which it is not willing to continue funding the company's operations, and/or may proceed with foreclosure after seeking stay relief, or in accordance with negotiated stay relief under a cash collateral or DIP financing order.

<u>Assets to be Sold</u>

Causes of Action

Buyer: Courts have generally allowed the sale of state law causes of action. *E.g. In re Irvin*, 950 F.2d 1318 (7th Cir. 1991) (order approving sale of damages lawsuit against debtor's employer appropriate). If an operating business is being sold, either the Buyer will want to obtain collection causes of action, or it will pay less for receivables. When equipment is purchased, the Buyer will want warranty causes of action with respect to that equipment, and so forth.

DIP: If substantially all the assets are being sold, the debtor will rely principally on the Lender and Committee to decide whether litigation should be handled through a liquidating trust or other representative under a plan, or through a sale.

Lender and Committee: The creditors will need to evaluate whether they can obtain more cash by selling causes of action at a discount, or pursuing them. They will also need to determine how litigation costs will be funded.

Commonly, while business-related claims are sold with the business, avoidance actions are retained by the estate. Fraudulent transfer claims have been held to belong to the debtor's creditors, and are not property of the estate that is included in a sale of "all the debtor's assets." *In re Cybergenics Corp.*, 226 F.3d 237, 242 (3rd Cir. 2000). Some courts have held that avoidance actions cannot be sold for pursuit on the account of the individual purchaser alone. *E.g. In re Vogel Van & Storage, Inc.*, 210 B.R. 27, 32 (N.D.N.Y. 1997). Other courts have allowed a sale of avoidance actions upon notice to all creditors that the transfer restricts them from pursuing it on their own, at least when any litigation recovery will be shared with the estate, *i.e.* litigated on the trustee/DIP's behalf. *In re P.R.T.C., Inc.*, 177 F.3d 774, 782 (9th Cir. 1999); *In re Greenberg*, 266 B.R. 45, 51 (Bankr. E.D.N.Y. 2001).

Property Restricted From Transfer Under State Law

Whatever the parties may desire, property restricted from transfer under state law generally cannot be transferred in a bankruptcy sale. *See, e.g. Integrated Solutions, Inc. v. Service Support Specialties, Inc.*, 124 F.3d 487, 495-96 (3d Cir. 1997) (where New Jersey law and public policy restricted debtor's power outside of bankruptcy to assign prejudgment tort claims, the chapter 11 trustee lacked power to assign the claims to a third party and, therefore, the purchaser of the claims lacked standing to pursue the claims); *In re Keim*, 212 B.R. 493, 497 (Bankr. D. Md. 1997) (debtor in possession cannot sell lottery proceeds in violation of Maryland statute prohibiting assignment); *In re Pintlar Corp.*, 187 B.R. 680, 682 (Bankr. D. Idaho 1995) (applicable environmental laws do not allow trustee to sell property free of license of company to dump environmental waste thereon); *See also In re Lauriat's, Inc.*, 219 B.R. 648, 649 (Bankr. D. Mass. 1998) (chapter 11 debtor in possession may not conduct store closing sales without complying with state law because 28 U.S.C. §959(b) requires a debtor in possession to manage property of the estate in accordance with state law).

Contract and Designation Rights

When a sale involves executory contracts or unexpired leases, the transfer must comply with Code § 365. This includes a requirement to cure, or provide adequate assurance that it will promptly cure, any default. Code § 365(b)(1)(A). The assignee of the contract must also provide "adequate assurance of future performance." Code § 365(f)(2).

Buyer: The Buyer may perceive value in under-market leases or other contracts it does not plan to use, but could resell. Some courts have allowed the transfer of the bankruptcy estate's designation rights. *E.g. In re Ames Department Stores, Inc.*, 287 B.R. 112, 117 (Bankr. S.D.N.Y. 2002); *In re Ernst Home Ctr., Inc.*, 209 B.R. 974 (Bankr. W.D.Wash. 1997), *appeal dismissed as moot (but with concurring opinion)*, 221 B.R. 243 (9th Cir. BAP 1998).

Contracting Party: The other party to a contract that is subject to assignment in conjunction with an asset sale will want certainty, and information about the entity that will actually be the counter-party to its contract. It will not want an indeterminate delay while the Buyer shops for a subsequent assignee of the contract rights. If the court does allow a sale with the Buyer receiving designation rights, the Contracting Party will want the order to be clear on the DIP's and Buyer's responsibility to pay rent or other contract obligations during the delay period, and the consequences if the payment is not made. *See MLC Group v. Tenet Healthcare Corp.*, 68 Fed. Appx. 322 (3rd Cir. 2003) (no claim for post-asset purchase date rent under § 365(d)(10) because parties agreed to terminate the estate's interest as part of the sale).

Lessee's Possessory Interest

Buyer: If the debtor is a lessor of an unexpired lease, Code § 365(h)(a)A)(ii) allows the lessee to remain in possession of the premises after a lease rejection. The Buyer would often prefer to acquire the property free and clear of such leasehold interests under § 363(f). Several courts have held this to be impermissible. *See, e.g., In re Taylor*, 198 B.R. 142, 164-67 (Bankr. D.S.C. 1996) (debtor-lessor cannot sell free of lessee's rights); *In re Churchill Properties III L.P.*, 197 B.R. 283, 288 (Bankr. N.D. Ill. 1996) (same). However, a recent decision authorized such a sale free of the lessee's possessory interest. *Precision Industries v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 545-46 (7th Cir. 2003). *See also In re Bedford Square Assocs., Ltd. Partnership*, 247 B.R. 140, 145-46 (Bankr. E.D. Pa. 2000)(approving sale free and clear of certain restrictive covenants in the lease but not the tenancy interests themselves pursuant to § 363(f)(4) where there was a bona fide dispute regarding the enforceability of those restrictive covenants).

These decisions do not address Code § 363(e) obligations to provide adequate protection to a person with an interest in the property being sold, which applies only if such relief is sought. According to the legislative history of section 363, in the context of a sale under section 363(f), adequate protection most often will mean that the interest of the lessee (or other third party) will attach to the proceeds from the sale (see H. Rep. No. 95-595, at 5(1977)), and the lessee will receive the value of its leasehold interest from the sale proceeds. Section 363 does not require that a lessee receive his bargain "in kind" when the debtor sells the underlying property, so long as the lessee's interest is adequately protected "in value."

Property Owned by an Affiliate:

Buyer: The Buyer may want to acquire assets used in conjunction with the assets it is acquiring, but owned by a non-debtor entity. The general rule is that the trustee/DIP can use, sell or lease property of the estate. Code § 363(b), (c). Some courts have held that the court lacks jurisdiction to do otherwise, especially in the context of objections being raised. *See In re Murchison*, 54 B.R. 721, 728 (Bankr. N.D. Tex. 1985) (the bankruptcy court does not have jurisdiction to enter any order concerning the sale of property owned by a corporation that is related to the debtor, but which has not been collapsed into the debtor as the debtor's alter ego); *In re Olszewski*, 124 B.R. 743, 746-49 (Bankr. S.D. Ohio 1991) (the trustee of an individual partner's estate cannot sell partnership property free and clear of the interests of the partnership or the non-debtor partners, under Ohio law); *accord In re Funneman*, 155 B.R. 197, 200 (Bankr. S.D. Ill. 1993). If all parties consent, however, some courts have held that the DIP can sell related assets. *See In re River Line, Inc.*, 19 B.R. 158, 164 (Bankr. M.D. Tenn. 1982) (debtor cannot use §363 to sell property it did not own, but where all parties agree that property should be sold and only dispute was manner of sale, court ordered sale under authority of § 105).

DIP, Lender and Committee: If assets related to estate property need to be included to facilitate a sale, and it would be costly and time-consuming to file additional bankruptcy cases for the property owners, the DIP and creditors may advocate a joint sale. It will be important to allocate the proceeds between estate and non-estate assets. If there are separate creditors of the affiliated entities whose assets are sold, their interests need to be taken into account. *In re Crutcher Resources Corp.*, 72 B.R. 628, 632-33 (Bankr. N.D. Tex. 1987).

Financing

Buyer: The bidder may want to limit the amount of new cash it invests, and to leverage its purchase using the value of the acquired assets, a leveraged buy-out. *Bidermann Industries*, 203 B.R. at 549; *In re Au Natural Restaurant, Inc.*, 63 B.R. 575, 577 (Bankr. S.D.N.Y. 1986)

DIP and Committee: The DIP and Committee want to maximize the return to its creditors, and to be able to distribute proceeds in a form the creditors will want. Generally that is cash, not promissory notes payable to the debtor in the future. *Au Natural*, 63 B.R. at 581. Unless the DIP is to continue in business as a reorganized debtor under a plan, it will not want carry-back financing of the purchase price.

Lender: The Lender may finance the buyer of the assets just as it financed the DIP, effectively transferring the old debt on its books to a new operator. If so, the Lender may seek financing fees. *Bidermann Industries*, 203 B.R. at 549.

Disposition of Sale Proceeds

DIP: Sales free and clear are not intended to destroy creditors' interests, and the DIP will advocate a sale on the basis that a transfer of liens to the proceeds of sale results in that relief even as to creditors that did not affirmatively seek adequate protection.

Lender: The DIP's contention that the Lender is adequately protected relies on cases assuming that the proceeds are available to pay the Lender. When the DIP proposes to use collateral proceeds to acquire other assets to which liens will be transferred, the creditor may not be adequately protected. *E.g. In re Magnus*, 50 B.R. 241 (Bankr. D.N.D. 1985) (sale of real estate for the purpose of purchasing two used silos was found not to be adequate protection); *In re Red Oak Farms, Inc.*, 36 B.R. 856 (Bankr. W.D. Mo. 1984)(proceeds of land sale to go into cattle operation with attendants risks; no indubitable equivalent).

The Lender generally wants an immediate distribution of proceeds, to avoid depletion by the DIP. Courts have held that the Lender is adequately protected by the attachment of its lien to the sale proceeds, and interest earned on those proceeds, pending distribution under a plan, however. *In re Air Beds, Inc.*, 92 B.R. 419, 424 (9th Cir. BAP 1988); *In re McCorhill Publ'g, Inc.*, 92 B.R. 74, 82 (Bankr. S.D.N.Y. 1988). The Lender can legitimately demand that the proceeds be kept in an interest-bearing account, even if it cannot seize the money immediately. *McCorhill Publ'g*, 92 B.R. at 83; *In re Conroe Forge & Mfg. Corp.*, 82 B.R. 781, 786 (Bankr. W.D. Pa. 1988) (in a liquidating Chapter

11 case where the undersecured creditor has not established that immediate payment to it of the proceeds of the sale is required for adequate protection, there will be no distribution until a plan is confirmed, but the proceeds were maintained in an interest bearing account).

<u>Warranty Issues</u>

Buyer: The Buyer will want some recourse if something should go wrong after the sale closes. The Buyer will generally understand that the DIP may not be able to respond to a breach of contract claim. But if the DIP estate will have substantial remaining assets after the sale (*e.g.* if only a division of the company is being sold), so that the estate could respond to a damages claim, the Buyer will not want to limit its ability to recover for a breach of representations or warranties.

The Buyer's principal concern is to obtain full disclosure of all information about the assets it is buying through the representations and warranties, and some assurance that operational controls are maintained so that the assets continue to have the same value through the bidding and pre-closing period. Thus, the Buyer will want at the least for the accuracy of representations and warranties to be a condition precedent to closing. And it will want a hold-back of its purchase price to cover post-closing adjustments and breach of warranty claims.

DIP: The DIP will seek to avoid any representations, warranties or indemnities that cold create a risk of additional claims that will dilute the sale proceeds available to creditors. New turnaround management or a trustee may be even more hesitant about making representations and warranties, due to lack of historical knowledge of the company and possible disarray of the books and records. The DIP will argue to the Buyer that it can rely on sale order language providing for the sale to be free and clear of claims and interests, which provides more protection than warranties. The DIP will want a provision that any representations and warranties do not survive the sale, and the only consequence of a breach is that the Buyer is not obligated to close. If the Buyer then refuses to close, the DIP may be able to pursue a specific performance suit. *See In re Aerovex*, 281 B.R. 419, 427, 437-38 (Bankr. D.Mass. 2002) (debtor granted injunctive relief for specific performance of asset purchase agreement; contract provided for such relief as a remedy for breach).

Committee: Any breach of warranty claim would likely have administrative expense status, and destroy the benefits of a sale otherwise realized by creditors. The Committee will accordingly resist representations and warranties – but if certain warranties result in materially greater proceeds for unsecured creditors, the Committee will have to weigh the chances of a breach claim carefully. If funds are to be held back in escrow to cover potential breach claims, the Committee will want the hold-back period to be as short as possible, and the requirements to collect on such a claim as narrowly and precisely drawn as possible. The Committee will want to avoid any clawback rights on the part of the Buyer.

Lender: The Lender wants the same things as the DIP and Committee. As the entity that is to receive most of the proceeds, the Lender may also be concerned that a damages claim for breach of warranties or representations will not result in a disgorgement of those proceeds.

Interim Management Pending Sale Approval

Buyer and Lender: When the DIP's operations are sliding downhill fast, or if the Buyer is another entity financed by the Lender to manage the same operations while improving the Lender's bank records, the Buyer and Lender may propose that the new management step into control even before the sale closes. The Buyer will need to recognize the risk of being outbid at the final sale, and to monitor proceedings closely. One case illustrating this point is *In re Northern Star Indus., Inc.*, 38 B.R. 1019 (E.D.N.Y. 1984). The intended purchaser expended funds and made improvements based on the lack of objections to the sale, then did not attend the sale hearing. The property was held sold to a higher bidder without notice to the improving bidder. The sale order was reversed on appeal on the basis that the original bidder should have received additional notice and had an opportunity to overbid also.

DIP: Any interim management by the Buyer will be as an agent of the DIP, the actual property owner, with resulting liability exposure. The risk is not only on the Buyer, but also on the DIP if the Buyer mismanages the business. To the extent the new management is deemed to require court approval, its engagement likely will not pass the test of disinterestedness. Code § 327(a); *see In re Weaver Potato Chip Co., Inc.*, 243 B.R. 737, 740-41 (Bankr. D. Neb. 2000).

Agreements with Management

DIP: The DIP's management may be interested in employment agreements with the Buyer, and potential equity rights. *Bidermann Industries*, 203 B.R. at 549. Alternatively, management may seek a consulting agreement and/or a non-compete agreement. *Bidermann Industries*, 203 B.R. at 549. *Id.*

The issue of good faith in connection with a sale outside the ordinary course of business focuses principally on the element of special treatment of the DIP's insiders in the sale transaction and contemporaneous transactions. *In re Industrial Valley Refrigeration & Air Conditioning Supplies, Inc.*, 77 B.R. 15, 22 (Bankr. E.D. Pa. 1987). That case held that a sale was not in good faith and not approved where the buyer, a successor to the DIP, also entered into a contemporaneous employment agreement and lease with DIP management for nearly half the amount of the proceeds being paid to the estate, and at higher prices than the DIP had paid for the lease and salary.

Committee: The Committee will want to ensure that value acquired by the Buyer is not diverted to DIP management in the form of specious/spurious consulting agreements and non-compete agreements.

V. Bidding Procedures

Break-up and Topping Fees

Buyer: As a stalking-horse bidder, the Buyer recognizes that its proposed purchase is subject to review and approval by other parties in interest and the Bankruptcy Court, and that after investing significant time and expense in completing its due diligence and negotiating its contract, it may be outbid. The Buyer will want "break-up fees" or "topping fees," or at least a commitment up front to reimburse expenses, to provide an incentive to proceed nonetheless, effectively compensating for this investment or providing some measure of protection. *In re Integrated Resources*, 147 B.R. at 657-60; *In re Diamonds Plus, Inc.*, 233 B.R. 829, 831 (Bankr. E.D. Ark. 1999). The amount of the fee should reflect a fair and reasonable percentage of the proposed purchase price, and be reasonably related to the risk, effort and expenses of the Buyer. *Integrated Resources*, 147 B.R. at 662 (1.6% of purchase price); *In re Financial News Network, Inc.*, 931 F.2d 217, 219 (2nd Cir. 1991) (2.8%); *In re Twenver, Inc.*, 149 B.R. 954, 957 (Bankr. D. Colo. 1992) (1%-2% reasonable; 10% was not).

If not approved initially, the unsuccessful stalking-horse bidder can always seek compensation later on the basis of an expense of preserving the estate under §503(b)(1)(A), or having made a substantial contribution to the estate, although the bidder may have to acquire a minimal claim first. *See In re O'Brien Environmental Energy, Inc.*, 181 F.3d 527, 535 (3d Cir. 1999); *In re DP Partners, Ltd. Partnership*, 106 F.3d 667, 672-73 (5th Cir.), *cert. denied*, 522 U.S. 815 (1997).

DIP: The DIP may need the break-up fee to entice a stalking-horse bid, and thereby establish a minimum price for the assets and help create a market for them. *Integrated Resources*, 147 B.R. at 660 (stalking-horse bid serves as a magnet to attract other bids); *see In re Ryan*, 261 B.R. 867, 870 (Bankr. E.D. Va. 2001) (bidder only got serious when another purchaser was found).

A break-up fee can also help ensure that the opening bid is not retracted by providing it is not due if the Buyer fails to proceed in good faith or abandons its proposal. *Integrated Resources*, 147 B.R. at 661. The DIP must exercise sound business judgment in determining whether to agree to a break-up fee, and in negotiating its amount, without regard to management's own desires regarding tenure or financial interests. *In re Integrated Resources*, 147 B.R. at 656 (breakup fee satisfies business judgment test if (1) the parties' relationship is not tainted by self-dealing; (2) the fee encourages instead of hampers bidding; (3) the amount is reasonable relative to the proposed purchase price); *Bidermann Industries*, 203 B.R. at 553. The DIP should come to the sale procedures hearing with evidence about (i) the process by which the stalking-horse Buyer was identified and the contract negotiated, and that it was fair and took into account the best interest of the estate; (ii) the protections for the Buyer will benefit the estate by establishing a greater marketplace for the sale; and (iii) the Buyer will not proceed without the protections; and (iv) the amount is reasonable.

Committee: Break-up fees may discourage potential bidders, especially if they are too large. *Integrated Resources*, 147 B.R. at 660. If an opening bid will be made regardless of a break-up fee, it would not serve the best interest of the estate to allow any such fee. *In re APP Plus*, 223 B.R. 870, 875 (Bankr. E.D.N.Y. 1998) (given substantial interest and offers by bidders, topping fee would not enhance bidding but break-up fee allowed). The court must not be overly deferential to the debtor's business judgment because the court must decide what is in the best interest of the estate as a whole, and maximizing revenue for the estate. *In re America West Airlines, Inc.*, 166 B.R. 908, 912 (Bankr. D. Ariz. 1994); *In re S.N.A. Nut*, 186 B.R. 981, 102-06 (Bankr. N.D. Ill. 1995) (arguments against the need for break-up fee). The Committee may also show that a break-up or topping fee is not necessary to preserve the value of the estate, because the Buyer will bid without a break-up fee or because of the disadvantage to other prospective purchasers. *O'Brien Environmental*, 181 F.3d at 535-36.

The Committee will also want to ensure that the fee amount is reasonable relative to the proposed purchase price. Because break-up fees reduce the amount of sales proceeds the estate will receive, the Committee will also want any fee limited to the minimum amount needed to induce the stalking-horse bid. The Committee will seek access for its professionals to investigate any collusion between the DIP's management and the Buyer that discourages other bidders because of insider benefits flowing from the stalking-horse arrangement. *Bidermann Industries*, 203 B.R. at 552.

The Committee may also seek to limit any Buyer compensation to expense reimbursement, and even limit such reimbursement to the extent the Buyer's due diligence is shared (*e.g.* shared environmental Phase I report), or the negotiated contract is available for others to match. The Committee may require evidence that the Buyer actually conducted due diligence from which other entities benefited before being paid a break-up fee to compensate for such expenditures. *In re Tiara Motorcoach Corp.*, 212 B.R. 133, 138 (Bankr. N.D. Ind. 1997). *See also In re Hupp Indus., Inc.*, 140 B.R. 191, 195-96 (Bankr. N.D. Ohio 1992) (fee disallowed where purchaser was to be paid regardless of outcome of sale, amount had no bearing on actual costs incurred and was more akin to liquidated damages).

Lender: The Lender's interests are aligned with the DIP and Committee. The Lender may be more sophisticated and have a better sense of the market for such fees than the Committee, however. It may recognize that terms that seem egregious to trade vendors on the Committee are simply market rates. The Lender also has the maximum economic stake in a sale, and will want to avoid Committee nitpicking that slows the sale process.

Bidding Increments and Matching Rights

Buyer: The Buyer will want the next overbid to be a substantial amount greater than its own offer, to create a threshold other bidders will be reluctant to overcome. It may also seek matching rights, so that the Buyer need not overbid itself. While courts generally reject that concept, matching rights have been approved in some cases. *In re Food Barn Stores, Inc.*, 107 F.3d 558, 567-68 (8th Cir. 1997); *In re Wintz Companies*, 230 B.R. 840 (8th Cir. BAP 1999), *aff'd*, 219 F.3d 807 (8th Cir. 2000) (buyer's right to match highest bid, or "last look" was acceptable on second round of bidding for asset); *In re Table Talk, Inc.*, 53 B.R. 937, 942 (Bankr. D. Mass. 1985).

DIP, Committee and Lender: The DIP and creditors will want the next overbid to be large enough to cover the cost of any break-up or topping fee, so that it will generate a net benefit to the estate. If the overbid is too large, however, it serves to hamper instead of enhance bidding, and they will argue it should be disapproved. *In re Twenver, Inc.*, 149 B.R. 954, 956-57 (Bankr. D. Colo. 1992); *In re Hupp Indus., Inc.*, 140 B.R. at 195-96 (arbitrary and unreasonably high increments are not justified). The DIP and creditors may also argue that a right of first refusal may likewise chill the interest of other prospective buyers from bidding. *In re Mr. Grocer, Inc.*, 77 B.R. 349, 353 (Bankr. D.N.H. 1987); *In re Joshua Slocum, Ltd.*, 99 B.R. 261, 263 (Bankr. E.D. Pa. 1989).

<u>Qualification of Bidders and Sharing of Bids</u>

All parties are interested in identifying bona fide bidders from tire-kickers, and determining their financial capability and reputation for fair and honest negotiation and following through on a purchase contract. Pre-qualification for purposes of executory contract and lease assumption may be substantially more involved, and not warranted before the sale hearing.

Buyer: The Buyer wants the most stringent and restrictive pre-qualification of bidders to reduce competition for the acquisition. It may ask that other bidders post an earnest money deposit larger than the one it posted. The Buyer will want access to advance written bids, to learn what others are willing to pay and enable it to prepare to meet those bids.

DIP: The DIP wants to weed out speculative bidders who, if successful, may outbid the stalking-horse buyer and other serious bidders, then fail to close. The DIP may seek protection by requiring a pre-auction deposit that is refundable only if the bidder is not the successful bidder at the hearing, or if successful, the failure to close is not caused by that bidder. The DIP will want to review carefully the evidence of financing, and any conditions placed on a bidder's financing commitment.

If the sale involves assumption and assignment of executory contracts or leases, determining whether other parties to those contracts will be satisfied with the bidders' adequate assurance of future performance will be important. This will take time, however, auguring for a longer notice period. It may also disqualify bidders whose competitive bids would increase the purchase price by a prevailing bidder.

When bidders are competitors, the DIP will be concerned that they will attempt to bid-up the price, with no intention of closing, but with the goal instead of making the DIP's business more costly and difficult for the true buyer. The independent judgment of an investment banker can be helpful in meeting management's concerns while proceeding to maximize bids and conduct a fair auction.

Lender and Committee: The creditors will share the concerns of the DIP, and will want their own access to the bidding qualifications and bids, to exercise their independent judgment as a check and balance to the DIP's views. If DIP management is involved in the Buyer or its bid, the Committee may take over substantial responsibility for evaluating competing bids and even negotiate the purchase contract along with disinterested participants in DIP management and the investment banker. *In re 995 Fifth Avenue Assoc.*, 96 B.R. at 25-26; *see In re Simon Transp. Services, Inc.*, 292 B.R. 207, 218 (Bankr. D. Utah 2003) (DIP must never give an insider a competitive advantage over others in matters affecting the bankruptcy estate, including asset sales).

The creditors will argue against pre-qualification of bidders as acceptable to landlords, because it could reduce the pool of prospective bidders, as well as delay and distract from the sale. They can point to reported cases where courts refused to pre-qualify bidders to expedite the sale and narrow the disputes the courts must resolve. *In re Food Barn Stores, Inc.*, 107 F.3d 558, 562-63 (8^{th} Cir. 1997) (requirement of pre-qualification needlessly diverts court time and resources to speculative issue, and would have adverse effect on bidding process by requiring trial and costly trial preparation in advance of sale; competitor bidder's participation in sale approved even though its intended use of the shopping center premises may well have violated tenant mix provisions of lease); *In re Joshua Slocum, Ltd.*, 99 B.R. 261, 263-65 (Bankr. E.D. Pa. 1989) (court refused to pre-qualify retailer bidders for leased locations; landlords submitted highest bids after competitive auction; allowing qualification process to take place only if needed after bidding allowed more expedited sale and narrower focus to qualification dispute).

<u>Non-solicitation Commitments</u>

Buyer: The Buyer wants to reduce the likelihood of being out-bid at the hearing on sale approval. It may ask for assurance that the DIP will not solicit, initiate, or encourage any other bids. The court may be persuaded that this is required to bring a prospective bidder to the table with a serious bid. *See In re Crowthers McCall Pattern, Inc.*, 114 B.R. 877, 889 (Bankr. S.D.N.Y. 1990).

DIP: The DIP cannot violate its fiduciary duties to maximize the recovery to the estate. It walks a tightrope in trying to bring in a stalking-horse bid, and yet encourage other potentially higher bids as well. Some courts have held that a non-solicitation covenant, or "no shop" flatly violates the DIP's fiduciary duties. *In re Big Rivers Elec. Corp.*, 233 B.R. 768, 785-87 (Bankr. W.D. Ky. 1999); *see In re Bidermann Industries*, 203 B.R. at 550. The DIP will at the least need an exception to any non-solicitation commitment to the extent that failing to act would violate the DIP's fiduciary duties (the "fiduciary out"). If the business has been marketed extensively, and likely prospective buyers can be informed of the stalking-horse bid and their need to contact the DIP or investment banker should they want to proceed, a "window shop" provision for responses only may suffice to meet the DIP's fiduciary duties. *See Bidermann Industries*, 203 B.R. at 552 (such a "window shop" insufficient where offers would have to be made first, and no previous efforts to obtain bidders); *Cottle v. Storer Communication, Inc.*, 849 F.2d 570 (11^{th} Cir. 1988) (lock-up in non-bankruptcy sale context met business judgment rule under the circumstances).

Lender and Committee: The creditors want to ensure that full market value is realized for the assets, maximizing the participation of bidders without losing stalking-horse bid. They will want to prevent or at least limit any non-solicitation commitments, and want to ensure that all potential bidders have been contacted and have the information they need to entice them to bid.

Adherence to the Buyer's Form of Agreement – Bundling of Assets

Buyer: The Buyer will want to force its form of agreement on other bidders, especially if it is drafted in a form that meets its unique business needs and may not be as adaptable for others. It also helps the Buyer by inhibiting bidders that would prefer to buy a different amount of assets, or pay for them in a different manner (*e.g.* with stock in the acquiring company, or notes).

DIP, Lender and Committee: The DIP and creditors prefer a single form of agreement to allow a fair comparison of overbids, but will want to encourage other bids as well. They will want any deviation from the Buyer's form of agreement specified before the hearing, and quantified to the extent possible. However, they will want to encourage other bidders to participate, and enable their effective participation, by grouping non-overlapping competitive bidders for the same collection of assets.

Notice of Sale Approval Hearing

Failure to give proper notice of a sale requires, or at least authorizes, the court to set the sale aside as void or voidable. *In re Foster*, 19 B.R. 28, 29 (Bankr. E.D. Pa. 1982) (court "shocked and appalled at the conduct of the debtor and her counsel…[f]ailure to comply with the procedure mandated by Congress requires this Court to order that the transfer be set aside…"); *In re Cedar Tide Corp.*, 859 F.2d 1127, 1133 (2d Cir. 1988) ("[t]he process of reorganization cannot be evaded by labeling a sale as being 'in the ordinary course of business;'" transfer of real property by a debtor without notice or hearing was held improper and nullified); *In re GEM de P.R., Inc.*, 79 B.R. 142 (D.P.R. 1987) (failure to obtain court approval in advance nullifies transaction), *appeal dismissed*, 860 F.2d 1072 (1^{st} Cir. 1988). Notice is the due process component of a Code § 363(b) transfer that gives parties in interest an opportunity to be heard; it is especially important when all the assets will be sold and thereby shape the plan. *In re Copy Crafters Quickprint, Inc.*, 92 B.R. 973, 983 (Bankr. N.D.N.Y. 1988).

The bankruptcy court has discretion to determine appropriate notice and hearing procedures. 11 U.S.C. § 102(1)(A), (B); *Lionel*, 722 F.2d at 1069. However, the notice of a proposed sale out of the ordinary course of business "shall" be at least 20 days by mail. Bankruptcy Rules 6004(a), 2002(c), 2002(a)(2). A sale proposed to be free and clear of liens and other interests must requested by a Rule 9014 motion, must be served on all parties who have liens or other interests in the property to be sold, and must include the date of the hearing on the motion and the time within which objections may be filed and served. Bankruptcy Rule 6004(c). The court can also order publication notice. Bankruptcy Rule 2002(l). The notice must be served on parties specified in Bankruptcy Rule 2002(a)(2), (c)(1), (i), (k) and 6004(c).

Code § 363(b)(2) modifies the requirements of the Clayton Act, 15 U.S.C. § 18a, to provide that any such notification is to be given by the trustee/DIP, and ends on the fifteenth day after receipt of the notice by the Federal Trade Commission and the Assistant attorney General in charge of the Antitrust Division of the Department of Justice, unless the period is extended under the Clayton Act or by the bankruptcy court.

The form of the notice of sale must be approved by the court. *In re Bertholet Enterprises, Inc.*, 66 B.R. 566, 567 (Bankr. D.N.H. 1986). It should designate a person for interested parties to contact to obtain a copy of the agreements evidencing the proposed transaction or to ask questions.

Buyer: The Buyer will want to give other potential bidders limited time to react to its sale offer, and reduce the likelihood of others presenting credible competing bids. On the other hand, it will also want to ensure that sufficient notice is given to extinguish all successor liability claims, and all conflicting ownership claims. *ITOFCA, Inc. v. Mega Trans Logistics, Inc.*, 322 F.3d 928, 930 (7th Cir. 2003) (once court approves sale of assets, person with notice of the sale cannot void it on grounds he is real owner of asset). The Buyer wants the maximum amount of notice given to creditors, and the shortest marketing period for other bidders, reducing their time to conduct necessary due diligence and address financing and other business integration issues.

The Buyer will be concerned about decisions holding that a sale order is void, or voidable, when creditors do not receive advance notice of the sale, including by reason of notice sent to the wrong address. *See In re Ex-Cel Concrete Co.*, 178 B.R. 198 (9th Cir. BAP 1995) (notice of sale sent to attorney for creditor not representing the creditor in the bankruptcy case, who did not provide notice to the creditor was insufficient for due process, and sale order was void), *applying In re Center Wholesale*, 759 F.2d 1440, 1448 (9th Cir. 1985) (cash collateral order with notice received day before hearing, providing that inventory sales proceeds would not be used to satisfy junior lien, was void to that extent); *In re Moberg Trucking, Inc.*, 112 B.R. 362, 363 (9th Cir. BAP 1990) (§ 363(m) mootness is not applicable where appellant attacks sale on grounds of improper notice); *In re F.A. Potts & Co.*, 86 B.R. 853 (Bankr. E.D. Pa. 1988), *aff'd*, 891 F.2d 280 (3d Cir. 1989) (failure to send notice to a creditor's most recent address of record held to violate due process and render the transaction voidable at the option of the creditor). The Seventh Circuit has refused to hold a sale void when a junior lienholder lacked notice due to an outdated address, however, and said the court may balance the equities in deciding on appropriate relief. *In re Edwards*, 962 F.2d 641 (7th Cir. 1992).

The Buyer will be particularly concerned with notice being sent to holders of liens on and interests in the property, and that notice clearly providing for the sale being free of such liens. *In re Marcus Hook Dev. Park, Inc.*, 143 B.R. 648, 660, 663 (Bankr. W.D. Pa. 1992) (notice of sale of property sent to creditor with lien on property which did not recite that property was to be sold free of liens, but which did state that additional conditions could be announced at auction, was insufficient to put creditor on notice that sale free of liens was condition which could be announced at auction; thus, sale was not free of creditor's lien); *In re Fernwood Mkts.*, 73 B.R. 616, 621 (Bankr. E.D. Pa. 1987) (failure to give proper notice authorizes setting sale aside; creditor given option to have sale totally set aside, or agree to have its lien attach to proceeds in its turn; court would not leave only one lien intact while senior liens attached to proceeds, however); *In re Farmland Industries, Inc.*, 284 B.R. 111, 117-20 (Bankr. W.D.Mo.2002) (bidding reopened to allow bid by holder of right of first refusal that did not receive sale notice).

DIP: The DIP will bear the onus of ensuring that adequate notice is given to every party entitled to notice at the correct address. Like the Buyer and the creditors, the DIP will want the sale order to be final, not void or voidable, and effective to transfer the assets free and clear of liens, claims and interests. The DIP should also take care to describe bidding options. If the sale is noticed as a whole package at one bid price, then only a portion is sold at a substantially lesser price, the notice may be held insufficient. *Potts*, 86 B.R. at 860-62 (other parties may have bid on part of assets if that option was understood).

If any insiders or affiliates are involved in the transaction, their identity, connections to the debtor, and interest in the transaction (or any contemporaneous or related transactions) should be fully disclosed. *In re Simon Transp. Services, Inc.*, 292 B.R. 207, 216 (Bankr. D. Utah 2003); *In re Wilde Horse Enterprises, Inc.*, 136 B.R. 830, 842 (Bankr. C.D. Cal. 1991). All terms of the sale, including side agreements and their value, must be fully disclosed, not merely mentioned. *Simon Transp. Services*, 292 B.R. at 217. If successor liability is to be avoided, full disclosure is even more critical in a transaction in which insiders are participating.

Lender: In addition to the DIP's and Buyer's concerns, the Lender will want to avoid any liens or claims to the sales proceeds on the grounds that particular creditors lacked notice of the sale, particularly if those liens or claims prime the Lender's claim. *In re Harold & Williams Dev. Co.*, 163 B.R. 77 (Bankr. E.D. Va. 1994)(court ordered mortgage holder to disgorge proceeds it received from debtor's sale of collateral so as to satisfy priming tax lien where taxing authority did not receive proper notice of the sale); *In re Oyster Bay Cove, Ltd.*, 161 B.R. 338, 342 (Bankr. E.D.N.Y. 1993) (unnoticed junior lienholder would have claim against proceeds, estate, or trustee/DIP, but not against purchaser); *In re Fernwood Mkts.*, 73 B.R. at 621 (creditor lacking notice given option to have sale totally set aside, or agree to have its lien attach to proceeds in its turn).

Committee: The Committee wants to ensure that all creditors have notice of the sale, but it also wants to maximize bidding. If the assets are not deteriorating rapidly, the

Committee will argue for a longer marketing period and more contact with potential bidders.

Credit Bidding

Buyer: The Buyer wants to acquire the assets with no hindrances from other bidders, including bidders who can use non-cash credit in competition with the Buyer's cash outlay. Usually the Buyer has struck a deal with the Lender, and the credit bid issues relate to junior lienholders. *Gulf States Steel of Alabama*, 285 B.R. 497, 517 (Bankr. N.D. Ala. 2002) (competing bid including § 363(k) feature rejected because bidding creditor's lien on assets was junior to creditors who would not get paid under competing bid proposal).

Lender: In some instances, the Buyer is in fact being financed by the Lender, with the secured debt being moved on the Lender's books to a new entity/management in the form of the Buyer. One opinion approving a sale via credit bid to the Lender over the objection of the equity holder described a common scenario. *In re Medical Software Solutions*, 286 B.R. 431, 442 (Bankr. D. Utah 2002). The Lender's bid included an infusion of some cash for other lienholders, contract cure payments, chapter 11 unpaid administrative expenses, and an additional sum, presumably for unsecured creditors. The court found the property had been marketed for some time, there was a narrow window of further marketability, and the price was fair and reasonable.

The Lender's ability to credit bid may turn on whether its claim is disputed, usually by the Committee. Code § 363(k). If the claim is disputed, the court may allow an offset on a temporary basis, with interest accruing on the purchase price in the event the claim is ultimately disallowed, or preserve the right to object to the claim later. *In re St. Croix Hotel Corp.*, 44 B.R. 277, 279 (D.V.I. 1984) (while objection to secured claim was pending, Lender purchased collateral at judicial sale, offset allowed temporarily, compounded interest to accrue on purchase price in event claim disallowed); *In re Miami Gen. Hosp., Inc.*, 81 B.R. 682, 687-88 (S.D. Fla. 1988) (where the proceeding has just begun, a stipulation allowing a credit bid, but preserving a later right in the trustee to object to the Lender's claim, is an appropriate remedy).

Committee: If the sale proceeds will not be sufficient to pay the Lender in full, the Committee will strive for a carve-out to give some money to unsecured creditors. *In re SPM Mfg. Corp.*, 984 F.2d 1305 (1st Cir. 1993).

Auction With or Without Reserves

DIP: The court can reject a sale where the price does not reflect the fair value of the property. When the DIP has been unable to negotiate a stalking-horse contract, and is in danger of losing its going concern value by inability to fund further operations, it may proceed with a "naked" auction sale, noticing the auction to the potentially interested bidders who refused to enter into such a contract. The auction may be in open court, or the sale may be conducted through a sealed bid process. *E.g. In re the Charter Co.*, 829 F.2d 1054, 1055 (11th Cir. 1987).

The DIP's financial advisors should evaluate the likely proceeds of a liquidation sale, and the costs of continuing the company's operations through the likely closing date for a going concern sale. They can then determine a minimum price that would need to be realized at a going concern sale to warrant not simply turning to liquidation. This reserve price would not be noticed, to avoid informing bidders of the minimum amount they would need to pay for the assets, but the DIP would need to defend it to the court.

Lender: The Lender's own financial advisors will undertake the same analysis being made by the DIP, and likely will have done so sooner, and pressed the DIP to reach that decision. The Lender's cash collateral and possibly DIP financing will be at issue as well – how long will the Lender allow losses to continue in the hope of a sale before cutting off funding, resulting in liquidation?

VI. Conducting the Auction

Determining the Best Bidder

Buyer: The Buyer may attempt to structure its bid in a manner that provides benefits other bidders find hard to match, such as retention of leases at store locations favorable to the Buyer, but less attractive to others. The Buyer may attempt to overcome higher bids by arguing the value of such benefits. *In re After Six, Inc.*, 154 B.R. 876, 883-84 (Bankr. E.D. Pa. 1993) (although court approved higher bid, it stated in dicta that lower bid might be accepted where it offered more in the way of "societal needs" such as preserving jobs).

DIP: The DIP and creditors generally look for maximum cash at minimum risk. A lower cash price may be preferable to a higher one that is paid over time, or in some form other than cash. *In re Gulf States Steel, Inc. of Alabama*, 285 B.R. 497, 516-17 (Bankr. N.D. Ala. 2002). In that case the court recognized that the trustee/DIP has discretion to determine the best bid and has a fiduciary duty to maximize the return for creditors. It held there is no abuse of that discretion when a lower bid has no contingencies that would render it less desirable, and would not take substantially longer to consummate, despite a union objection that the effect on the community, the lesser number of jobs, environmental issues and local government preferences should be taken into account. *See also In re Bakalis*, 220 B.R. 525, 533-34 (Bankr. E.D.N.Y. 1998) (court sustained the trustee's decision to accept a lower bid because the highest bid had more uncertainty with its closing conditions, more potential for business disruption and problems with regulatory approval). Indeed, the assured ability to consummate a sale, with no delays for labor or licensing requirements, may make a strategic buyer more attractive than a financial one. Note also that bids may have different tax consequences, which should be taken into account when taxation would affect the amount of proceeds available to creditors. *In re Ryan*, 261 B.R. 867, 872-75 (Bankr. E.D. Va. 2001).

Committee: The Committee shares the DIP's perspective, but if its constituents are truly "out of the money," the Committee may advocate for a higher-paying, more risky offer that will give unsecured creditors a chance at some recovery. It may use whatever leverage it has to extract some concessions from the Lender. The Committee may particularly value the assumption of executory contracts and leases, because it will result in a lesser amount of rejection-based damages claims.

Lender: The Lender wants the maximum payout on its secured claim, but as long as the sale will net it more than a liquidation, the Lender wants to be sure the sale will close – it is often willing to sacrifice some potential cash for less risk. The Lender may agree to share some of the proceeds with the Committee's constituents to buy their cooperation in supporting the Lender's proposed Buyer.

VII. Provisions in the Sale Order

<u>Free and Clear of Liens, Claims and Interests</u>

Buyer: One of the primary benefits of a bankruptcy sale to a buyer is the ability to acquire assets free and clear of existing liens, claims, encumbrances and interests. 11 U.S.C. § 363(f). Bankruptcy courts generally protect a Buyer from "current" claimants who have had notice of the bankruptcy case and are either actually participating in the bankruptcy case or have had the opportunity to participate in the case. *See, e.g., In re P.K.R. Convalescent Centers, Inc.*, 189 B.R. 90, 94 (Bankr. E.D. Va. 1995); *In re CLC Corp.*, 110 B.R. 335, 339 (Bankr. M.D. Tenn. 1990).

Courts have broadly defined the kinds of rights and interests that can be extinguished by such a sale. *In re Colarusso*, 295 B.R. 166 (1st Cir BAP 2003) (broad interpretation of "interest" in § 363(f) – adverse possession rights); *see In re Trans World Airlines, Inc.*, 322 F.3d 283, 289 (3rd Cir. 2003) (the phrase "any interest in such property" as used in section 363(f) encompasses not only *in rem* interests in property, such as liens, but also interests which are connected to or arise from the property being sold; there, employment discrimination claims); *In re Leckie Smokeless Coal Co.*, 99 F.3d 573 (4th Cir. 1996) (Coal Act successor liability); *In re WBQ Partnership*, 189 B.R. 97, 105 (Bankr. E.D. Va. 1995) (state's claim for depreciation overpayment); *In re All Am. Of Ashburn, Inc.*, 56 B.R. 186 (Bankr. N.D. Ga.), *aff'd*, 805 F.2d 1515 (11th Cir. 1986) (product liability claims); *In re White Motor Credit Corp.*, 75 B.R. 944, 948 (Bankr. N.D. Ohio 1987) (sales free and clear of successor liability not governed by § 363(f), but successor liability still preempted); *but see In re 523 E. Fifth St. Housing Preservation Dev. Fund Corp.*, 79 B.R. 568, 576 (Bankr. S.D.N.Y. 1987) (equities did not permit sale free and clear of restrictive covenant in deed).

One hurdle to selling free and clear of claims is the logistics of noticing such claimants. *See In re Savage Ind., Inc.*, 43 F.3d 714, 721-23 (1st Cir. 1994) (court affirmed bankruptcy court's denial of purchaser's request to enjoin state-law successor liability action for indemnity brought by retailer of debtor's product based on pre-sale injury because debtor and purchaser failed to provide adequate notice of sale and its effect on post-sale claims). The notice problem is truly impractical with respect to future claims, and a sale free and clear of successor liability for future claims is doubtful, at least where there is no plan providing for such claims and no opportunity for the claimant to file a proof of claim during the case. *Truck Divers Union v. Tasemkin, Inc.*, 59 F.3d 48, 50 (7th Cir. 1995) (chapter 7 case closed before successor liability claim brought; not barred by sale order); *In re Mooney Aircraft, Inc.*, 730 F.2d 367, 374-75 (5th Cir. 1984) (accident after sale and closing of bankruptcy case); *In re Fairchild Aircraft Corp.*, 184 B.R. 910, 931-32 (Bankr. W.D. Tex. 1995), *vacated on equitable grounds*, 220 B.R. 909 (Bankr. W.D. Tex. 1998 (accident occurred after sale and discharge; plan did not provide for future claims); *but see In re Christopher*, 28 F.3d 512, 519 (5th Cir. 1994) (rejecting lack of actual notice of sale as a basis for allowing successor liability when actual notice of bankruptcy case); *In re Paris Indus. Corp.*, 132 B.R. 504, 509-10 (W.D. Maine 1991) (plaintiffs not prejudiced by lack of notice because in absence of sale, they would have no claims against purchaser, and they can still file claims against debtor/seller).

It is common for the Buyer to acquire accounts receivable, as to which the account payor may assert setoff or recoupment rights. A bankruptcy sale is not free and clear of defenses to causes of action. *Folger Adam Security, Inc. v. DeMatteis/MacGregor, JV,* 209 F.3d 252, 260-61 (3d Cir. 2000) (debtor's claims against third party could not be sold free of defenses, because they are not "interests" under § 363(f)); *In re Trans World Airlines, Inc.*, 275 B.R. 712, 718-19 (Bankr. D. Del. 2002) (sale of accounts receivable was free and clear of setoff rights not exercised prepetition, which attached to proceeds only, but not free of recoupment defense); *Schneider Nat'l, Inc. v. Bridgestone/Firestone, Inc.*, 200 F.Supp. 2d 1006, 1011 (E.D. Wis. 2001) ("a defendant may only obtain a setoff following a free and clear sale if the setoff was actually obtained prior to the bankruptcy filing").

Transfer Tax Liability

Buyer, DIP, and all creditors other than taxing authorities: All the parties in interest in a bankruptcy case other than taxing authorities want an order exempting the Buyer from payment of taxes on the transfer under Code § 1146(c). The reason is obvious – for every dollar of taxes the Buyer must ultimately pay, there would be a corresponding reduction in the amount the Buyer is willing to offer for the assets. Section 1146(c) provides that "the issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax."

DIPs have seized upon the language in *In re Jacoby-Bender, Inc.*, 758 F.2d 840 (2nd Cir. 1985), intimating that where a transfer is necessary to the plan, it may be deemed a transfer "under a plan" within the meaning of section 1146(c). Some courts have espoused this view, and have ruled that even pre-confirmation transfers can be exempt from taxes pursuant to section 1146(c). *In re Linc Capital, Inc.*, 280 B.R. 640, 646-47; *In re Permar Provisions, Inc.*, 79 B.R. 530, 533-34 (Bankr. E.D.N.Y. 1987)(stating that the question is whether the sale of the property is essential to the confirmation of the plan). However, several recent cases, two at the circuit level, hold that a pre-confirmation transfer is not "under a plan confirmed" within the meaning of section 1146(c). *In re Hechinger Investment Co. of Delaware, Inc.*, 335 F.3d 243, 256 (3rd Cir. 2003); *In re NVR, L.P.*, 189 F.3d 442, 456-58 (4th Cir. 1999); *In re 310 Associates, L.P.*, 282 B.R. 295, 300 (S.D.N.Y. 2002)(holding that section 1146(c) does not exempt transfers that take place before a plan of reorganization has been drafted).

Good Faith Purchaser

Buyer: The Buyer wants a Code § 363(m) finding in the sale approval order that it has acquired the assets in good faith, so that reversal or modification on appeal will not affect the validity of the sale, whether or not the Buyer knew of the appeal, unless the sale order is stayed pending appeal. *In re Gucci*, 105 F.3d 837, 839 (2d Cir. 1997) (once sale of assets has occurred, appellate jurisdiction over unstayed sale order is limited to whether property was sold to good faith purchaser); *In re Paulson*, 276 F.3d 389, 392 (8th Cir. 2002) (sale order finality protects reasonable expectations of purchasers). A sale often includes assignment of leases and contracts, which are not within the scope of Code § 363(m). *Comco Assocs. v. Faradli Food Indus., Ltd.*, 170 B.R. 765, 770 (E.D.N.Y. 1994) (§363(m) does not apply to assignments of leases under Code §365, although an appeal of an order authorizing such assignment may be moot on other grounds).

The Buyer will want findings of fact justifying the good faith determination. Findings of fact are reversible on appeal only if they are clearly erroneous, with due regard given to the bankruptcy court's evaluation of witness credibility. Bankruptcy Rule 8013. The Buyer will want the findings to be particular and specific to this transaction, not mere generalities.

DIP: The burden is on the DIP to present evidence to support factual findings of good faith. *In re Thomas*, 287 B.R. 782 (9th Cir. BAP 2002) (bankruptcy court determines good faith in first instance as factual matter); *In re M Capital Corp.*, 290 B.R. 743, 751-52 (9th Cir. BAP 2003) (parties desiring § 363(m) protection must establish evidentiary record to enable the bankruptcy court to make necessary findings and conclusions of good faith). The *Thomas* court recognized it is hard to make fact findings of the absence of fraud or collusion, or any attempt to take grossly unfair advantage of other bidders, since such evidence is commonly not available until after the fact. *Thomas*, 287 B.R. at 785. The court may limit its finding to the generality of no reason to doubt the Buyer's good faith, unless the parties can provide more specific evidence.

Documentation Approval

Buyer: The Buyer wants the court order to require the DIP to sign necessary documentation for the transfers. Bankruptcy Rule 6004(f)(2) provides that after a sale, the trustee/DIP shall execute any instrument necessary or ordered by the court to effectuate the transfer to the purchaser. The order should provide that certain named individuals are authorized to execute the transfer documents.

DIP, Lender and Committee: If the documentation has been approved by the court, and incorporated by reference into the sale approval order, it can be enforced as a violation of a court order, as well as a breach of contract.

__Value__

Buyer: The Buyer wants to limit fraudulent conveyance exposure under Code § 550, and support the determination that it is a good faith purchaser. Apart from sale misconduct or collusion, the fact that fair value was exchanged is important on both counts. *E.g. Willemain v. Katz*, 764 F.2d 1019, 1023 (4th Cir. 1985); *In re Cable One CATV*, 169 B.R. 488, 494-97 (Bankr. D.N.H. 1994). A bankruptcy court finding that the price is not unreasonable can satisfy the value requirement, and that finding will be subject to review under the clearly erroneous standard on appeal. *In re Vanguard Oil & Serv. Co.*, 88 B.R. 576, 580 (E.D.N.Y. 1988).

DIP: The DIP's management and board want to avoid breach of fiduciary duty claims, so a finding that fair value was exchanged is important to them too.

__Allocation of Price Among Assets Being Sold__

Buyer: The Buyer will need to allocate the purchase price among different types of assets for its own tax purposes.

Lender: Some of the assets being sold may be unencumbered, and some encumbered by liens to different secured creditors. To the extent the sale price can be allocated, it may be important to the Lender and other creditors. The allocation considered reasonable by the creditors may not be in accord with the Buyer's tax advice, however. Note that Bankruptcy Rule 6004(f)(1) requires an itemized statement of property sold, categorized by the purchaser and the price, unless impracticable.

__Waiver of 10-day Stay__

Bankruptcy Rule 6004(g) provides that an order authorizing the use, sale or lease of property other than cash collateral is stayed until the expiration of 10 days after entry of the order, unless the court orders otherwise. Rule 6006(d)

If the sale order provides for no closing in the absence of a final, non-appealable order, it results in a consensual stay. *In re Victoria Station Inc.*, 88 B.R. 231, 234 (9th Cir. BAP 1988) (assignment of lease conditioned on outcome of appeal, appeal not moot), *aff'd,* 875 F.2d 1380 (9th Cir. 1989); *In re CADA Invs., Inc.*, 664 F.2d 1158, 1160 (9th Cir. 1981); *In re Brookfield Clothes, Inc.*, 31 B.R. 978, 982 (S.D.N.Y. 1983)(appeal of all asset sale not moot where agreement contained condition precedent to closing that there be a "final, non-appealable order" authorizing sale). If that closing condition precedent is to be included, the option to close despite an appeal and preserve Section 363(m) rights should be made clear.