SUB ROSA PLANS, SUCCESSOR LIABILITY, GIFTING TO AVOID STATUTORY PRIORITIES AND OTHER SECTION 363 SALE ISSUES

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I. INTRODUCTION

Section 363 sales in the context of Chapter 11 reorganization cases the have become common place. In fact, one could argue that it is the preferred, or at least predominate, tool used in the Chapter 11 toolbox. But with the recent decisions in Chrysler and General Motors, this widely used and accepted strategy has garnered greater attention. Has the use of Section 363 gone too far? Has the envelope been pushed beyond legitimate limits? Much of the discussion has focused on the sub rosa plan doctrine.

II. SOUND BUSINESS JUSTIFICATION STANDARD

To understand the sub rosa issue, one starts with the basic standard for consideration of the sale of assets outside the ordinary course of business. The standards governing § 363 sales outside a plan of reorganization were addressed by the Court of Appeals for the Second Circuit in *Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.)*.[1] In *Lionel*, the debtor moved to sell its most important asset—an 82 percent equity stake in Dale Electronics, Inc. for $50 million. The motion was granted by the bankruptcy court based on (1) the creditors' committee's insistence upon using cash from the sale to fund the debtor's reorganization and (2) the bankruptcy judge's opinion that reorganization would be delayed a year or longer by rejection of the proposal. The equity committee, joined by the Securities and Exchange Commission (SEC), appealed the order and argued that, absent an emergency, such a sale was impermissible prior to approval of a plan, because it deprived the equity holders of important safeguards that the Bankruptcy Code imposes as part of the plan confirmation process (i.e., factual disclosure, solicitation, and voting) and divested the debtor of a dominant and profitable asset that could be the cornerstone for a sound plan.

The Second Circuit adopted a "middle ground" position. Noting the absence of statutory safeguards in § 363(b), such as the "cause shown" terminology used in the Bankruptcy Act, the *Lionel* court recognized that "a literal reading of section 363(b) would unnecessarily violate the congressional scheme for corporate reorganizations."[2] This led the court to adopt a rule "requir[ing] that a judge determining a § 363(b) application expressly find from the evidence

[1] 722 F.2d 1063 (2d Cir. 1983).

[2] *Id.* at 1066.

presented before him at the hearing [that there was] a good business reason to grant such an application."[3] Factors relevant to this inquiry included:

- 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;
- The alternatives of use, sale, or lease envisioned by the proposal; and
- The increase or decrease of the asset's value.[4]

Applying these standards to the facts of the case, the Second Circuit reversed the approval of the sale, holding that the potential for delay did not provide a sound business reason for resort to § 363(b) and failed to address the equities germane to chapter 11.[5]

In the years since *Lionel*, the "good business reason" rule, or its functional equivalents, became the prevailing § 363(b) standard. The Court of Appeals for the Sixth Circuit expressly adopted the reasoning employed in *Lionel* and "conclude[d] that a bankruptcy court can authorize a sale of all a chapter 11 debtor's assets under § 363(b)(1) when a sound business purpose dictates such action."[6] Facts supporting the bankruptcy court's approval of the sale included (1) the trustee could not operate the business at a profit, (2) the business could not meet its payroll and other operating expenses, (3) the business could lose its valuable FCC licenses, and (4) the party refused to submit a competing purchase offer.[7] Later, in a case involving the proposed lease of commercial aircraft by a chapter 11 debtor,[8] the Court of Appeals for the Fifth Circuit also followed *Lionel* and held that "for the debtor-in-possession or trustee to satisfy its fiduciary duty to the debtor, creditors, and equity holders, there must be some articulated

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[3] *Id.* at 1071; *see also* Licensing by Paolo, Inc. v. Sinatra (*In re* Gucci), 126 F.3d 380, 387 (2nd Cir. 1997) ("Section 363 of the Bankruptcy Code authorizes the use, sale or lease of property of the estate in the course of a corporate reorganization under Chapter 11. A sale of a substantial part of a Chapter 11 estate other than in the ordinary course of business may be conducted if a good business reason exists to support it.").

[4] Lionel, 722 F.2d at 1071.

[5] *Id.*

[6] Stephens Indus., Inc. v. McClung, 789 F.2d 386, 390 (6th Cir. 1986).

[7] *Id.* In a similar case citing *McClung* the sale of all personal property, including an FCC broadcasting license, was approved because sound business reasons existed, including (1) the risk that the FCC might revoke the license and thereby decrease the value of the assets; (2) the price was fair; and (3) the fact that the radio station in question was located in a small town and other offers were unlikely. *In re* Charter Broadcast Group, Ltd., 1994 WL 586983, Case No. 94-61386, at *2 (Bankr. N.D. Ohio Oct. 3, 1994).

[8] *In re* Continental Air Lines, Inc., 780 F.2d 1223 (5th Cir. 1986).

business justification for using, selling, or leasing the property outside the ordinary course of business."[9]

A. Factors in Granting Approval

The primary concerns raised by preconfirmation sales of the debtor's assets are reflected in the types of business justification that have been approved by the courts. With respect to a proposed sale of all of the debtor's assets in a chapter 11 case, objecting parties frequently claim that a chapter 7 liquidation will be faster and cost less.[10] Accordingly, courts may favor a § 363(b) sale as the best liquidation procedure.[11] Courts are also likely to favor pre-plan liquidations when necessary to preserve the "going concern" value of the assets[12] or if the debtor is more likely to obtain a better sales price than a chapter 7 trustee.[13]

An important issue in any sale is the court's perception of the fairness of the sale process and the effect of the sale on both procedural and substantive rights of creditors and shareholders.

Following are some factors considered in granting approval:

1. The sale is negotiated at arm's length and is appropriately documented.
2. Creditors and committees have been actively involved in the sale process and have had an opportunity to explore other alternatives.
3. The assets have been properly marketed and the sale price represents a fair price for the assets. Notice of sale is given to other potential bidders.

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[9] *Id.* at 1226. In addition to requiring a business justification, the *Continental* court mandated compliance with §§ 363(d) and 363(e) of the Code, when applicable, and recommended the use of "appropriate protective measures" to ensure that a § 363(b) transaction did not "sidestep the protection creditors have when it comes time to confirm a plan of reorganization." *Id.* at 1227-28.

[10] Indeed, a ground frequently cited in support of a § 363(b) sale—continuing losses—expressly supports the conversion to chapter 7. *See* Code § 1112(b)(1). *See also* Honorable William T. Bodoh, et al., *The Parameters of the Non-Plan Liquidating Chapter Eleven: Refining the Lionel Standard*; 9 BANKR. DEV. J. 1, 9 (1992).

[11] *See In re* Cummins Utility, L.P., 279 B.R. 195, 198 (Bankr. N.D. Tex. 2002); *In re* All American of Ashburn, Inc., 40 B.R. 104, 108-09 (Bankr. N.D. Ga. 1984); *In re* Alves Photo, 6 B.R. 690, 693-94 (Bankr. D. Mass. 1980).

[12] *See, e.g.*, McClung, 789 F.2d at 390; In re Torch Offshore, Inc., 327 B.R. 254, 258 (E.D. La. 2005); *In re* Medical Software Solutions, 286 B.R. 431, 441 (Bankr. D. Utah 2002); Cummins, 279 B.R. at 198; *In re* Trans World Airlines, Inc., 2001 WL 1820326, at *14 (Bankr. D. Del. April 2, 2001); *In re* Idaho Photocopy & Supply, Inc., 1994 WL 553065, Case No. 94-01756, at *1 (Bankr. D. Idaho 1994); *In re* GF Corp., 115 B.R. 579, 586 (Bankr. N.D. Ohio 1990); *In re* Naron & Wagner Chartered, 88 B.R. 85, 90 (Bankr. D. Md. 1988); Coastal Indus., Inc. v. IRS (*In re* Coastal Indus., Inc.), 63 B.R. 361, 368 (Bankr. N.D. Ohio 1986). *See also* Bodoh, *supra* note 31, at 10-12.

[13] *See* Cummins, 279 B.R. at 198; Bodoh, *supra* note 31, at 12-13 (discussing Hunt Energy Co. v. United States (*In re* Hunt Energy Co.), 48 B.R. 472 (Bankr. N.D. Ohio 1985)).

4. The debtor has filed an outline of a plan and some disclosure indicating the probable distribution of sale proceeds, or the debtor has actually filed a liquidation plan and disclosure statement for distribution of sale proceeds and any remaining assets.

5. Proper notice is given pursuant to the Code and Rules so that creditors and other parties have a reasonable opportunity to object.

6. The debtor files an appropriate application setting forth the business justification for the sale and at the hearing provides competent evidence in support of the alleged business justification.

7. If the sale is justified as an "emergency," the emergency should not be caused by the delay of the debtor and the buyer. For example, a request to shorten notice of a hearing may not be well received if the need for an expedited hearing was caused solely by arbitrary deadlines imposed by the purchaser.

8. Inadequate capital or other resources, such as inability to borrow sufficient funds to fill orders or sustain the business, threatens the going-concern value of the debtor's business.

9. Employee unrest, departures, and labor actions have had a demonstrable effect on profitability and make reorganization unlikely.

B. Factors in Denying Approval

The most utilized argument against substantial preconfirmation asset sales is that they inappropriately circumvent the statutory procedures of chapter 11, which generally provide creditors with a greater opportunity to analyze the debtor's proposed actions and which provide repeated occasions for various parties in interest to influence the composition of the ultimate plan of reorganization. This concern has encouraged a number of courts to "closely scrutinize" nonplan liquidations and to impose a "heightened burden" on the proponent.[14] Factors typically considered to satisfy this standard are as follows:

1. Whether accurate and reasonable notice has been given to all creditors and parties in interest;

2. Whether there is a sound business reason for the sale without a disclosure statement and plan;

3. Whether the purchase price is fair and reasonable; and

[14] *In re* Channel One Communications, Inc., 117 B.R. 493, 496 (Bankr. E.D. Mo. 1990). *See also* Medical Software, 286 B.R. at 445; .

4. Whether the proposed sale does not unfairly benefit insiders or proprietary purchasers or unfairly favor a creditor or class of creditors.[15]

Other factors considered by courts denying approval of all asset sales include:

- Inadequate notice to creditors and interest holders, including failure to provide affidavits supporting request for expedited, pre-plan relief;
- Inadequate description of the property to be sold and inadequate marketing;
- Involvement of insiders and management, including post sale employment agreements;
- Evidence of impropriety, such as sweetheart employment contracts with management or participation by management in the purchase;
- Approval of sale is sought after the debtor's exclusive time to file a plan has expired;
- Failure of debtor to have a plan and disclosure statement on file or disclose to creditors the functionally equivalent information;
- A manufactured "emergency" as opposed to factually demonstrated deterioration of assets or other specific reasons showing danger of imminent decline in value of assets;
- Absence of evidence and testimony providing a business reason for the sale;
- Opposition of creditors' committee to sale and existence of alternatives, including a creditor plan or appointment of a liquidating trustee; and
- The sale is a "creeping plan," meaning that the sale, use of assets, and payment of the purchase consideration is distributed in the asset sale agreement in a way that dictates material provisions of any subsequent plan. For example, a sale that assumes leases and pays employees in full may unfairly benefit lessors and employees while giving other unsecured creditors a diminished recovery.

In addition, some courts prefer sales pursuant to a plan and impose a heightened burden of cause on any asset sale, reflecting the court's concern with the procedural framework of the Code.

Whether under the *Lionel* test or the more comprehensive "heightened burden" analysis, courts have approved § 363(b) asset sales when the debtor-in-possession or trustee has shown (1) objective and tangible reasons for consummating a sale outside the typical chapter 11 confirmation process,[16] (2) an adequate sale price that is the product of good faith negotiations or

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[15] *In re* Equity Management Systems, 149 B.R. 120, 124 (Bankr. S.D. Iowa 1993). *See also* Medical Software, 286 B.R. at 439-40; *In re* Idaho Photocopy & Supply, Inc., 1994 WL 553065, Case No. 94-01756, at *1 (Bankr. D. Idaho 1994); *In re* Delaware & Hudson Ry. Co., 124 B.R. 169,176 (D. Del. 1991); *In re* Titusville Country Club, 128 B.R. 396, 399 (Bankr. W.D. Pa. 1991); *In re* George Walsh Chevrolet, Inc., 118 B.R. 99, 102 (Bankr. E.D. Mo. 1990); *In re* Industrial Valley Refrigeration and Air Conditioning Supplies, Inc., 77 B.R. 15, 21 (Bankr. E.D. Pa. 1987).

[16] *See, e.g.*, GBL Holding Co., Inc. v. Blackburn/Travis/Cole, Ltd. (*In re* State Park Building Group, Ltd.), 331 B.R. 251, 254 (N.D. Tex. 2005) (prompt sale would maximize value of property, generate enough revenue to satisfy creditors, and allow payment of mortgage and tax liability to avoid foreclosure); *In re* Cadkey Corp., 317 B.R. 19, 23 (D. Mass. 2004) (immediate sale of assets was preferable due to declining sales, withholding of payments by customers, employee attrition, and likelihood that company's value would further decrease); Trans

bidding at arm's length,[17] and (3) sufficient notice to third parties with respect to the terms of the proposed transaction.[18] On the other hand, proposed asset sales have been denied when the facts have revealed (1) insufficient or dubious reasons for concluding a preconfirmation transaction,[19] (2) a flawed or inadequate pre-sale procedure,[20] or (3) an improper or bad faith motive behind the sale effort.[21]

World Airlines, 2001 WL 1820326, at *14 (rejection of the sale motion would have resulted in an immediate and precipitous decline in the financial affairs of TWA); Delaware & Hudson, 124 B.R. at 177 (debtor would be in "liquidation mode" if required to follow confirmation procedures); *In re* Weatherly Frozen Food Group, Inc., 149 B.R. 480, 483 (Bankr. N.D. Ohio 1992) (imminent contract negotiations and need to inspect plant for repairs and maintenance); Titusville Country Club, 128 B.R. at 400 (deterioration of golf course and need for maintenance); *In re* Ionosphere Clubs, Inc., 100 B.R. 670, 676 (Bankr. S.D.N.Y. 1989) ("Eastern has demonstrated that it needs a substantial amount of cash for viability within the very near future."); *In re* Boogaart of Fla., Inc., 17 B.R. 480, 483 (Bankr. S.D. Fla. 1981) (rapidly depreciating assets). *Cf.* Equity Management, 149 B.R. at 124 (execution of long-term leases necessary due to depreciating assets and need for income).

[17] *See, e.g.*, *In re* Searles Castle Enter., Inc., 17 B.R. 440, 441-42 (B.A.P. 1st Cir. 1982); Torch Offshore, 327 B.R. at 258; Cadkey, 317 B.R. at 23-4 (D. Mass. 2004); *In re* Gulf States Steel, Inc. of Alabama, 285 B.R. 497, 515 (Bankr. N.D. Ala. 2002); Delaware & Hudson, 124 B.R. at 177; Weatherly Frozen Food, 149 B.R. at 480; Titusville, 128 B.R. at 399-400; *In re* Oneida Lake Dev., Inc., 114 B.R. 352, 357 (Bankr. N.D.N.Y. 1990); Circus Time, Inc. v. Oxford Bank and Trust, U.S. (*In re* Circus Time, Inc.), 5 B.R. 1, 2-3 (Bankr. D. Me. 1979).

[18] *See, e.g.*, Medical Software, 286 B.R. at 442 ("[T]he Court heard extensive testimony regarding the attempts to distribute notice to all possible parties . . ."); Delaware & Hudson, 124 B.R. at 180; *In re* Engineering Prod. Co., Inc., 121 B.R. 246, 249 (Bankr. E.D. Wis. 1990). *Cf. In re* Naron & Wagner Chartered, 88 B.R. 85, 88 (Bankr. D. Md. 1988) ("[A]ppropriate notice should be a functional substitute for the adequate information which would be contained in a disclosure statement concerning the proposed transaction.").

[19] *See, e.g.*, *In re* Encore Healthcare Associates, 312 B.R. 52, 57 (Bankr. E.D. Pa. 2004) (proposed sale would benefit only the secured creditor and would do nothing to advance the chapter 11 reorganization of debtor); *In re* Plabell Rubber Prods., Inc., 149 B.R. 475, 479 (Bankr. N.D. Ohio 1992) (urgency of sale to one of several potential bidders not demonstrated); *In re* Sovereign Estates, Ltd., 104 B.R. 702, 704 (Bankr. E.D. Pa. 1989) (sales price would be enhanced if subdivision approval was obtained before any attempted sale); *In re* Fremont Battery Co., 73 B.R. 277, 279 (Bankr. N.D. Ohio 1987) (proposed sale would benefit only one creditor); *In re* Au Natural Restaurant, Inc., 63 B.R. 575, 580 (Bankr. S.D.N.Y. 1986) ("Au Natural has not explained why the transaction could not have been made a part of a liquidating chapter 11 plan, and has failed to convince this court that it should allow the debtor to circumvent the safeguards of chapter 11 because of some overriding business justification."). *See also* Committee of Equity Security Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1069-71 (2d Cir. 1983).

[20] *See, e.g.*, *In re* Country Manor of Kenton, Inc., 172 B.R. 217, 220-21 (Bankr. N.D. Ohio 1994) (property had not been advertised nor put on real estate market and proposed purchase price was less than half the scheduled value); Plabell Rubber Prods., 149 B.R. at 479; *In re* George Walsh Chevrolet, Inc., 118 B.R. 99, 102 (Bankr. E.D. Mo. 1990); Sovereign Estates, 104 B.R. at 704. *Cf. In re* Jillian's Entm't Holdings, 327 B.R. 616, 618 (Bankr. W.D. Ky. 2005) (in post-confirmation sale of business, court, applying *Lionel*, concluded that an auction, rather than the proposed sale, would be in the best interest of the estate).

[21] *See, e.g.*, Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 2005 WL 3071471, at *18 (S.D.N.Y. Nov. 16, 2005) (sales order constituted improper attempt to determine or preempt plan issues to the advantage of junior creditor); Mission Iowa Wind Co. v. Enron Corp. (*In re* Enron Corp.), 291 B.R. 39, 43 (S.D.N.Y. 2003) (allocation of sales proceeds issue remanded to address the possibility of self-dealing by parent company); Plabell Rubber Prods., 149 B.R. at 479-80 (unfair advantage to ESOP and questionable role of debtor's vice president); *In re* Industrial Valley Refrigeration and Air Conditioning Supplies, Inc., 77 B.R. 15, 22-23 (Bankr. E.D. Pa 1987) (unfair subsidies to insiders); *In re* Crutcher Resources Corp., 72 B.R. 628, 632 (Bankr. N.D. Tex.

III. Sub Rosa Plan

Even the most thoroughly prepared and objectively supported § 363(b) sale cannot be approved if the transaction attempts to structure the rights and claims of interested parties, the so-called "creeping plan." In *In re Braniff Airways, Inc.*,[22] the Court of Appeals for the Fifth Circuit, on an expedited appeal, considered a proposed agreement between the debtor Braniff, and Pacific Southwest Airlines, Inc. (PSA). The "PSA Agreement" provided that (1) Braniff would purchase "scrip," which would be allocated in its reorganization pursuant to the PSA Agreement, (2) secured creditors would be required to vote a portion of their deficiency claims in favor of a reorganization plan approved by the unsecured creditors' committee, and (3) the claims of all parties against Braniff, its secured creditors, and its officers and directors would be released.

Objecting creditors raised the traditional argument that § 363(b) is not applicable to sales or other dispositions of all the assets of a debtor and that such a transaction must be effected pursuant to the voting, disclosure, and confirmation requirements of the Code. Braniff responded by citing both Code and pre-Code case law approving preconfirmation asset liquidations. In reversing the district court's order approving the PSA Agreement, the Fifth Circuit stated:

> We need not express an opinion on this controversy because we are convinced that the PSA transaction is much more than the "use, sale or lease" of Braniff's property authorized by § 363(b). . . . The PSA transaction would also require significant restructuring of the rights of Braniff creditors. Appellants raise a blizzard of objections to each of these elements of the deal. It is not necessary, however, to decide whether each individual component of the PSA transaction is or is not authorized by § 363 because the entire transaction was treated by both courts below as an integrated whole. Since certain portions of the transaction are clearly outside the scope of § 363, the district court was without power under that section to approve it. Its order must be reversed.[23]

1987) ("[T]he parent and the lenders are attempting to rush this [consolidated] case so that there will not be appropriate time for an examination of each of the subsidiaries.").

In *In re Abbotts Dairies of Pa., Inc.*, 788 F.2d 143, 149 (3d Cir. 1986), the Third Circuit held that when a bankruptcy court authorizes a sale of assets pursuant to § 363(b), it is required to make a finding with respect to the good faith of the purchaser; *see also In re* Stroud Ford, Inc., 163 B.R. 730, 733 (Bankr. M.D. Pa. 1993) (sale denied because proposed purchaser had colluded with higher bidders by buying out their objection and thereby prevented estate from receiving adequate compensation). *But see In re* Zinke, 97 B.R. 155, 156 (Bankr. E.D.N.Y. 1989) ("While [Abbotts Dairies] does impose an independent duty on bankruptcy courts in the Third Circuit to make an explicit 'good faith' finding prior to authorizing a sale or lease of property in the debtor's estate, that duty has not been imposed by the Second Circuit or the United States Supreme Court."); *see also In re* Thomas, 287 B.R. 782, 785 (B.A.P. 9th Cir. 2002) (actual finding of "good faith" not required for approval of a sale under § 363(b) since genuinely probative evidence of "good faith" is generally not reasonably available at the time a bankruptcy court approves a sale).

[22] 700 F.2d 935 (5th Cir. 1983).

[23] *Id.* at 939.

The *Braniff* court concluded its opinion with the following warning: "In any future attempts to specify the terms whereby a reorganization is to be adopted, the parties and the district court must scale the hurdles erected in chapter 11."[24] Therefore, while sales of all or substantially all the debtor's assets prior to administration of a chapter 11 plan have been approved in a variety of circumstances, a sales transaction that purports to accomplish a de facto reorganization exceeds the limitations of § 363.[25]

Subsequent decisions by the Fifth Circuit have clarified *Braniff's* narrow application to only those situations where there is truly an attempt to circumvent the Chapter 11 reorganization process.[26]

A. Chrysler and General Motors

The credit crisis that reached its zenith in the fall of 2008 had a devastating effect on the domestic auto industry. So pervasive was the fallout that the federal government came to the rescue of both Chrysler and General Motors. The resulting bankruptcy filings and Section 363 sales conducted by each has focused attention on the propriety of sales of substantially all assets and the sub rosa plan issue.

1. Chrysler. In the case of Chrysler, the U.S. Treasury through the Troubled Asset Relief Program ("TARP") loaned Chrysler $4 billion. Later, after Chrysler reached agreement to

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[24] *Id.* at 940 (citing Code §§ 1125, 1126, 1129(a)(7), and 1129(b)(2)(B)).

[25] *See also* Westpoint Stevens, 2005 WL 3071471, at *18 ("The Sale Order . . . clearly constituted an attempt to determine or preempt plan issues in the context of the Section 363(b) sale and was improper to that extent."); *In re* CGE Shattuck, LLC, 254 B.R. 5, 13 (Bankr. D. N.H. 2000) ("The Court will not approve the terms of the [commitment] and [disclosure] and permit [creditor] to end run the provisions and purposes of Chapter 11 of the Bankruptcy Code."); *In re* American Dev. Corp., 95 B.R. 735, 738 (Bankr. C.D. Cal. 1989) ("I do not believe § 363 was intended to apply to the capitalization of a subsidiary by debtor."); Fremont Battery, 73 B.R. at 279 ("The court may not, then, authorize Debtor's proposed sale as its result contemplates restructuring the Debtor-creditor relationship and exceeds the scope of § 363.").

[26] *See In re* Babcock & Wilcox Co., 250 F.3d 955, 960 (5th Cir. 2001) (The court found that the financing agreement at issue did not constitute a sub rosa reorganization because it did not have the effect of dictating the terms of any future reorganization plan, stating that "*Braniff* stands merely for the proposition that the provisions of § 363 permitting a trustee to use, sell, or lease the assets do not allow a debtor to gut the bankruptcy estate before reorganization or to change the fundamental nature of the estate's assets in such a way that limits a future reorganization plan."); Official Comm. of Unsecured Creditors v. Cajun Electric Power Coop., 119 F.3d 349 (5th Cir. 1997) (Settlement between Chapter 11 debtor-electrical power cooperative and its two largest creditors was not a prohibited sub rosa plan of reorganization, because the settlement did not dispose all claims against debtor, restrict creditors' rights to vote as they deemed fit on the proposed plan, or dispose of virtually all of debtor's assets). Most recently, Bankruptcy Judge Wesley W. Steen, in *In re Gulf Coast Oil Corporation, et al.,* Case No. 08-50213 (jointly administered as Case No. 08-50215), United States Bankruptcy Court, Southern Dist. Texas, refused to approve the sale of substantially all assets of the debtors finding that several significant confirmation requirements had not been satisfied, including: that only administrative claims that the purchaser agreed to pay would be paid; and because some unsecured creditors could be paid while others would not be paid, the Court could not conclude that creditors with equal rights would be treated alike.

sell its assets to Fiat, the government agreed to provide DIP financing in the amount of $4.96 billion and an exit facility of $6 billion to fund New Chrysler's operations. New Chrysler purchased substantially all assets of old Chrysler for $2 billion—far less than the $6.9 billion owed to Chrysler's prepetition senior secured creditors.[27] The purchase was free and clear of all liens and debts of old Chrysler. At the end of the day, New Chrysler was owned by the U.S. and Canadian governments, Fiat and 55% by VEBA, a trust established for the benefit of retirees.

In the hearing to consider the sale, testimony revealed that Chrysler had sought a sale partner for two years prior to the bankruptcy filing—and the proposal from Fiat was the only viable proposal obtained. Chrysler's situation was critical, having ceased operations in order to conserve resources. Third, the $2 billion purchase price represented fair value since unrebutted testimony indicated that the liquidation value of Chrysler was between zero and $1.2 billion. Fourth, all of the sale price was going to the senior secured lenders. Finally, no one—not even the senior secured lenders submitted a bid to challenge Fiat.

Parties objecting to the sale, led by Indiana Pension Funds asserted that the sale amounted to a sub rosa plan. Chief among the complaints was that the sale resulted in VEBA – an unsecured creditor—owning a significant amount of New Chrysler, even though secured debt was not being paid in full. In essence, the objectors argued that the sale violated the absolute priority rule. In his opinion (*In re Chrysler LLC, et al.,* 405 B.R. 84), Judge Gonzalez noted that the sale terms made no attempt to allocate sale proceeds away from secured creditors nor did it attempt to dictate the terms of a plan of reorganization. Further, Judge Gonzalez correctly pointed out that Section 365 allows a debtor in possession to assume and assign or reject executory contracts. Thus, it was not impermissible for Chrysler to assume and assign or reject contracts that New Chrysler believed would benefit future operations. The fact that parties to assumed contracts received cure payments while parties to rejected contracts received lesser payments on their unsecured claims did not turn the sale into a sub rosa plan. Finally, Judge Gonzalez found that neither the U.S. Treasury, VEBA nor the UAW received distributions from the sale on account of their prepetition claims. Rather, their "distributions" or post-sale interests were the result of arms length negotiations with the purchaser—New Chrysler.

The Second Circuit affirmed the Bankruptcy Court opinion in *In re Chrysler LLC,* 576 F.3d 108 (2nd Cir. 2009). In addressing the sub rosa issue, the Second Circuit stated:

> The term "*sub rosa*" is something of a misnomer. It bespeaks a covert or secret activity, whereas secrecy has nothing to do with a Section 363 transaction. Transactions blessed by the bankruptcy courts are openly presented, considered, approved, and implemented. *Braniff* seems to have used *"sub rosa"* to describe transactions that treat the requirements of the Bankruptcy Code as something to be evaded or subverted. But even in that sense, the term is unhelpful. The sale of assets is permissible under Section 363(b); and it is elementary that the more assets sold that way, the less will be left for a plan of reorganization, or for liquidation. But

[27] New Chrysler also assumed specified liabilities.

> the size of the transaction, and the residuum of corporate assets, is, under our precedent, just one consideration for the exercise of discretion by the bankruptcy judge(s), along with an open-ended list of other salient factors. *(Citation omitted)*

576 F.3d 108, 117.

After noting that a 363 sale may effectuate a reorganization without being the kind of plan rejected in *Braniff,* the Second Circuit noted the following in footnote 9:

> The transaction at hand is as good an illustration as any. "Old Chrysler" will simply transfer the $2 billion in proceeds to the first lien lenders, and then liquidate. The first lien lenders themselves will suffer a deficiency of some $4.9 billion, and everyone else will likely receive nothing from the liquidation. Thus the Sale has inevitable and enormous influence on any eventual plan of reorganization or liquidation. But it is not a *"sub rosa* plan" in the *Braniff* sense because it does not specifically "dictate" or "arrange" *ex ante*, by contract, the terms of any subsequent plan.

With respect to the argument that the sale violated the absolute priority rule, as pointed out by Professor Ralph Brubaker in his insightful article: "The Chrysler and GM Sales: Section 363 Plans of Reorganization?",[28] the absolute priority rule only protects dissenting classes of creditors. Since the senior secured lending group of which Indiana Pension Funds was a part voted in favor of the plan, the absolute priority rule is not implicated. Further, the absolute priority rules' prohibition against a junior class of creditors receiving any distribution when a senior dissenting class has not been paid in full, applies to unsecured as opposed to secured creditors.

2. General Motors. Unlike Chrysler, General Motors' debt structure consisted largely of unsecured bondholders owed $27 billion. Prior to its bankruptcy filing, the U.S. Treasury provided financing to General Motors of $13.4 billion, which loans were secured by first and second liens on General Motor's collateral. A condition of the loan required General Motors to submit a viability plan. When that plan was rejected, General Motors' condition became even more precarious because the government loan would shortly become due. Ultimately, the government provided an additional $6 billion in financing. General Motors filed Chapter 11 on June 1. In the bankruptcy proceeding, the U.S. and Canadian governments provided DIP financing of $42.4 billion. The DIP financing was conditioned upon the approval of a 363 sale transaction.

The sale of General Motors assets was accomplished through the formation of a New GM. New GM was owned 60.8% by the U.S. Treasury, 11.7% by the Canadian government, 17.5% by a newly formed VEBA for the benefit of retirees and 10% by Old GM for the benefit of Old GM creditors. No cash consideration was paid to accomplish the sale. Instead, in exchange for the common stock of New GM, the U.S. and Canadian governments assigned to

[28] Published in Bankruptcy Law Letter, Vol. 29, No. 9 (September 2009).

New GM their rights to credit bid their secured pre-petition and post petition claims. New GM assumed certain liabilities including prepetition nongovernmental secured debt. In addition, certain contracts were assumed and assigned to New GM, including a revised collective bargaining agreement with the UAW. Unlike Chrysler, unsecured creditors of Old GM would receive the benefit of a portion of the "purchase price"—the 10% common stock in New GM.

As in Chrysler, objectors to the General Motors sale asserted that the sale amounted to a sub rosa plan. In his decision, Judge Gerber characterized the objectors as basing their objections "on things the Purchaser intends to do". Specifically, the chief complaints were that substantially all executory contracts with suppliers were being assumed and assigned, that offers of employment were being made to all nonunionized employees and employees represented by the UAW, and that a new collective bargaining agreement was being assigned which included the duty to contribute to a new VEBA to fund retiree health benefits.

In finding that the sale did not amount to a sub rosa plan, Judge Gerber noted that nothing in Section 363 prohibits a purchaser from choosing to assume some but not other contracts. The resulting disparate treatment does not rise to the level of a sub rosa plan. In addition, Judge Gerber noted that the sale terms did not seek to allocate or dictate the distribution of sale proceeds. Finally, none of consideration received by the U.S. Treasury, VEBA or the UAW was on account of prepetition claims.

B. Successor Liability and Future Claims

An issue raised in both the Chrysler and General Motors cases was the extent to which the 363 sales orders could limit any liability of New Chrysler and New GM for consumer, tort, environmental and other claims that existed as of the petition date against Old Chrysler and Old GM. Further, could future claims, those where the injured party is not yet aware of the injury, be extinguished.

1. Claims Sought to Be Extinguished

a. arose prior to the closing date
b. relate to vehicles produced prior to the closing date
c. could have been asserted against the debtors prior to the closing date and that relate to the purchased assets.

2. Claimants Asserting Objection

a. plaintiffs with existing product liability claims
b. plaintiffs with existing asbestos related claims
c. claims asserted by lawyers on behalf of presently unknown claimants who may have claims in the future related to Old Chrysler's production of vehicles.

3. Interpretation of Section 363(f) "any interest in property" language

a. are personal injury claims "interests in property"
b. *In re Trans World Airlines, Inc.,* 322 F.3d 283 (3d Cir. 2003)

4. Asbestos Claims and Application of Section 524(g)

5. Future Claims

a. due process issue
b. scope of authority of Bankruptcy Court to extinguish future claims

IV. GIFTING PLANS—DO THEY VIOLATE THE ABSOLUTE PRIORITY RULE?

Is it permissible for one creditor to allocate a portion of the value it is entitled to in a chapter 11 case to another creditor? When a chapter 11 debtor seeks to sell assets under § 363 of the Code and its DIP lender or senior secured lenders are undersecured, structuring an adequate arrangement to allow general unsecured creditors to see any recovery post-sale may be one of the most challenging tasks for the parties involved. New authority has emerged in recent years approving arrangements in § 363 sales for carving out or setting aside certain sale proceeds of the DIP or senior secured lenders. However, these carve-outs or "gifts" have generated controversy and litigation when they bypass or fail to satisfy the claims of priority and/or administrative claims.

A. If it is Yours, Is It Okay To Give Your Money Away?

Courts approving collateral carve-outs have agreed that the carve-outs do not constitute property of the estate and are not prohibited by the distribution and priority schemes provided for in the Code. In *Official Unsecured Creditors' Committee v. Stern (In re SPM Manufacturing Co.)*, 984 F.2d 1305 (1st Cir. 1993), a secured lender entered into an agreement with the committee which allowed the committee to share in any proceeds ultimately received by the secured lender. After the sale of the assets, the case was converted to chapter 7. After the conversion of the case, the committee and the secured lender filed a motion for distribution of the sale proceeds to the secured lender, who would pay a portion of the proceeds to the committee's counsel for the benefit of the unsecured creditors. The debtor's former management objected, arguing that the payment of the unsecured creditors ahead of priority tax claims violated the chapter 7 priority scheme. Ultimately, the First Circuit Court of Appeals held that because the secured creditor was not paid in full, the proceeds received by the secured creditor were not property of the estate and were not subject to chapter 7's priority scheme. *Id.*, at 1312.

Although *SPM* was a chapter 7 case, it had an immediate impact on chapter 11 cases. In *In re World Health Alternatives*, 344 B.R. 291 (Bankr. D.Del. 2006), the debtors sought the approval of a 363 sale to a stalking-horse bidder, which was also the debtor's prepetition secured lender and DIP lender. After the auction resulted in no higher or better bids, the creditors' committee negotiated a proposed settlement, pursuant to which the committee would withdraw its objection to the sale in exchange for the DIP lender waiving its deficiency claim and paying a carve out which would be either distributed to general unsecured creditors or used to investigate and prosecute causes of action. The carve-out was for the "exclusive benefit of the debtors' general unsecured creditors." *Id.*, at 294. The trustee objected, asserting that the proposed "gift" violated § 1129 of the Code. The court held that the payout was carved out of the secured creditor's lien, not estate property. *Id.*, at 297. Moreover, the requirements of § 1129 were not implicated since the settlement agreement did not arise in the context of a chapter 11 plan. *Id.*, at

298. However, the court continued by stating that even if the absolute priority rule did apply to settlements outside of a chapter 11 plan setting, the rule would not prohibit the carve-out set forth in the settlement at issue from being approved. *Id.*, at 298. *See also In re TSIC Inc.,* 363 B.R. 71, 75 (Bankr. D.Del. 2008) (the absolute priority rule is "not violated in substance or spirit" by a carve-out of non-estate funds by a non-creditor, stalking-horse entity, to be made exclusively for the benefit of general unsecured creditors, even if senior claimants will not be paid first with such funds).

B. But The Money May Not Be Yours To Give Away.

In contrast, some courts have refused to approve gifting carve-outs, holding that such gifts violate the absolute-priority rule in § 1129. *On-Site Sourcing Inc.*, 2009 WL 1789331 (Bankr. E.D.Va. 2009) analyzed the contention and split of authority regarding this issue prior to refusing to approve a gifting carve-out.

In *On-Site*, the debtor filed first-day motions to approve DIP financing and a stalking-horse bidder, which was the debtor's DIP and prepetition secured lender. The prepetition unsecured debt totaled approximately $35 million, and under the proposed DIP financing, approximately $40 million would be advanced, which would be used, in part, to pay off the existing prepetition secured debt. Under the sale terms, the stalking-horse bidder proposed to purchase the assets for $28 million. No other bidders submitted competing bids at the auction.

The unsecured creditors' committee initially opposed the sale, but ultimately negotiated a resolution with the debtor and the stalking-horse bidder/DIP lender. Essentially, in exchange for the committee's support of the sale, (1) the DIP lender's deficiency claim would be deemed waived; (2) the stalking-horse bidder would exclude from the purchased assets (a) the debtor's interest in certain tax refunds, (b) 100% of chapter 5 causes of action against the debtor's insiders (except three key employees that the bidder intended to retain) and (c) 35% of all other chapter 5 causes of action; (3) the stalking-horse bidder would carve out and fund the sum of $132,500, plus one-half interest in the debtor's tax refunds to a trust created for the exclusive benefit of the debtor's general, unsecured creditors; and (4) the immediate payment of the committee's professionals $225,000.00 carve-out.

The trustee opposed certain terms of the resolution. The court approved the sale, but disallowed the releases for the three key employees and the general unsecured creditors trust created from the stalking-horse's gifting of $132,500 and one-half interest in the debtor's tax refund. *On-Site*, at 7-8. The court opined that the proposed releases of the debtor's three key insiders "furthered a sub rosa plan of reorganization" and that the parties failed to show an adequate business reason to justify the releases. *Id.*, at 7. The court considered the committee's argument that the proceeds in question were a gifting from the DIP lender to the debtor's unsecured creditors as "disingenuous;" it disagreed with the committee's assertion that the proceeds were a distribution of the DIP lender's property and the DIP lender was entitled to do what it wanted with the proceeds. *Id.*, at 7-8.

Citing § 541 of the Bankruptcy Code, the court held that the "proceeds from the sale of property of the estate are property of the estate," regardless of whether the property sold is subject to an encumbrance. *Id.*, at 7. Moreover, the facts of the case contradicted the

committee's argument. Upon confirmation of the sale, the DIP lender released its lien on the remaining property of the estate and forgave its deficiency. Thus, the money paid by the bidder remained property of the estate as proceeds from the sale of property of the estate, free and clear of the DIP lender's lien. *Id.*

Further, the court held that the proposed carve-out to the unsecured creditor trust would "effectively evade the carefully-crafted scheme of the Chapter 11 plan confirmation process." *Id.*, at 8. The court stated that the carve-out and unsecured creditor trust provisions were "contrary to the scheme of distribution envisioned in both a Chapter 7 and Chapter 11 liquidation," since they would ensure that general unsecured creditors were paid ahead of priority and administrative creditors. *Id.* Specifically, § 1129 (a)(7), (a)(8) and (a)(9) would be infringed upon and/or circumvented by the proposed carve-out and gifting provisions of the sale since the general unsecured creditors would receive distributions at the expense of higher, impaired claims such as priority claims and administrative claims that would not be paid in full. *Id.* Section 1129(a)(7) requires that an impaired class of claims accept the plan or receive as much as they would have received in a chapter 7 distribution. Similarly, § 1129(a)(9) requires that all administrative claimants be paid in full unless the holder of a particular claim has agreed to a different treatment. Absent consent, these provisions are not satisfied unless the priority and administrative claims are paid in full before the general unsecured creditors receive any distribution. While consent by an impaired class of creditors to a certain treatment in a chapter 11 plan may be an alternative means to satisfy the requirements of § 1129, the court recognized that the *On-Site* sale process was quick and it was not apparent that the adversely-affected parties had any meaningful notice of the sale terms.[29] *Id.,* at 10.

The court concluded that the carve-out and unsecured creditor trust proposed by the debtor and the committee would essentially deprive administrative and priority creditors of their rights under § 1129(a)(7) and (a)(9), as well as their rights under § 1125 to adequate information to make an informed decision with respect to a plan of reorganization and their rights to object to such a plan under § 1126. *Id.,* at 10. Finally, the court also held that despite the committee's success in negotiating a $132,500 increase in the sale price to fund the trust, it would be "unfair to successfully increase an inadequate sale price to a fair sale price, but then keep that benefit for one's own constituency at the expense of other, more senior classes of creditors." *Id.*

C. Is This The End of The Line For Gifting Carve-Outs?

It is uncertain if the constraints placed on carve-outs of sale proceeds for general unsecured creditors in 363 sales by *On-Site* will signal a shift in other jurisdictions that confront the issue in future cases. Courts continue to have significant differences in opinion as to whether such carve-outs involve property of the estate or are otherwise subject to the absolute-priority rule and other plan-confirmation requirements in § 1129. In jurisdictions adopting the *On-Site* analysis, debtors will most likely be limited to either tailoring any carve-out of sale proceeds to ensure that contemplated distributions satisfy the absolute-priority rule, which may result in no

[29] In its decision, the court commented on the speed with which the sale process and the DIP financing were embarked upon and approved; it specifically noted that the debtor filed its 363 sale motion and its DIP financing shortly after midnight of the first day of its chapter 11 filing and an expedited hearing on the motions was conducted a day later.

distributions for general unsecured creditors or seeking approval of the gifting carve-out as part of a plan that satisfies the § 1129 requirements.

There is a related line of authority consistent with the concept that carve-outs in 363 sales are not only permissible, but possibly necessary for approval of the sale in some circumstances where the DIP or secured lender is undersecured. *See In re Fremont Battery Co.*, 73 B.R. 277, 279 (Bankr. N.D. Ohio 1987) (finding no sound business purpose to approve sale as required under § 363 since sale would not benefit unsecured creditors as whole); *In re Encore Healthcare Assoc.*, 312 B.R. 52, 57 (Bankr. E.D. Pa. 2004) (Lionel's sound business-purpose test for approval of 363 sale must be met in order for sale to be approved, and proposed sale would not be approved where it would result in no sale proceeds being allocated for benefit of unsecured creditors); *In re Golf LLC*, 322 B.R. 874, 878 (Bankr. D. Neb. 2004) (recognizing that there is no reason to approve 363 sale unless some equity, after payment of secured creditors, will be left behind for benefit of estate and unsecured creditors). This line of authority holds that in order for a debtor to meet the sound business purpose and justification standard generally required for approval of a 363 sale, it must demonstrate that some portion of the sale proceeds or value are benefitting the unsecured creditors. The *On-Site* decision could negate or limit the effectiveness of a sale objection on such basis unless the objecting party essentially concedes from the outset that the proceeds or value to be left behind for creditors would be distributed in compliance with § 1129.

The *On-Site* court expressed a great deal of concern about the speed of the sale process and the possible lack of meaningful notice to priority creditors of the effect of the gifting carve-out on their claims. Rapid-fire 363 sales are frequently justified as necessary in order to prevent further diminution of the value of the debtor's assets or enterprise. However, in jurisdictions favorable to the *On-Site* decision, pursuing a 363 sale with a gifting carve-out without providing meaningful time and opportunity for review by priority creditors may be more likely to result in disapproval of the sale or, at a minimum, a delay in the approval of the sale, which may cause the decline in asset value that the sale proponents sought to avoid.