363 Sales: An Update on Best Practices and Recent Developments

Mark D. Collins
Zachary I. Shapiro
Richards, Layton & Finger, P.A.
Wilmington, Delaware

I. Introduction

Typically, in a section 363[1] sale, a potential purchaser of a debtor's assets will be required to participate in an auction and sale process to determine which bidder has submitted the highest and/or best bid for the assets. Assuming the transaction is approved by the bankruptcy court and ultimately consummated, the successful purchaser will walk away with the assets and a federal court order providing that such assets are free and clear of all prior liens, claims and encumbrances. This paper discusses the auction process, including several commonly found sale procedure provisions, as well as case law developments regarding the ability of a sale order to shield a purchaser from successor liability.

II. The 363 Sale Process

Most asset sales in large bankruptcy cases begin with the selection of a "stalking horse" purchaser. Typically, at the outset of any sale process, including any sale process that is initiated prior to the petition date (*i.e.*, the date that the debtor files its voluntary petition), the debtor will engage various professionals, including an investment banker and counsel, to negotiate with third parties that are potentially interested in purchasing the debtor's assets and, in the case of a going-concern sale, acquiring the ongoing operations of the debtor's business. Thus, it is not uncommon for the pre-petition marketing process to resemble an auction that concludes with the selection of a stalking horse purchaser, the execution of an asset purchase agreement with such purchaser and the filing of the debtor's bankruptcy petition. As part of the asset purchase agreement, the stalking horse purchaser agrees to purchase the debtor's assets subject to higher and better bids and subject to approval by the bankruptcy court. In essence, the stalking horse purchaser provides a backstop and certainty of sale. While the debtor could choose to sell its

[1] *See* 11 U.S.C. § 363(b)(1) (providing that the debtor "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate"). Unless otherwise indicated, any section references herein are to sections of title 11 of the United States Code (the "Bankruptcy Code").

assets through an auction process without the benefit of a stalking horse purchaser, entering bankruptcy and/or the sale process with a "bird in the hand" informs the marketplace that the debtor's assets are at least worth the purchase price set forth in the stalking horse asset purchase agreement and, in the case of a going concern sale, potentially prevents protective and other adverse actions by the debtor's creditors, customers and suppliers by signaling to such parties that the debtor's business has a plan to exit bankruptcy and the go forward funding to be successful in the future.

After the debtor (who likely will consult with other key parties, such as its lenders) selects the stalking horse purchaser, the debtor will seek bankruptcy court approval of its proposed sale procedures which will, among other things, govern the bidding process, the sale timeline and the conduct and rules of the auction, with the purchase price set forth in the stalking horse purchase agreement serving as the floor price. After the auction is concluded or, if there are no competing bids, cancelled, the debtor will then seek court approval of the transaction at the sale hearing, which is typically one or two days after the conclusion of the auction. Assuming the bankruptcy court enters the sale order, the parties will proceed to closing the transaction.

III. Bid Procedures and Bid Protections

One of the key documents in any section 363 sale process is the sale procedures order, which contains, typically as an exhibit thereto, the bid procedures that will govern the conduct of the sale. The motion to approve bid procedures typically will also seek the bankruptcy court's authority to provide certain bid protections to a stalking horse purchaser. The negotiation and documentation of bid procedures and bid protections often involve a delicate balancing between protecting the stalking horse purchaser and crafting a process that does not chill bidding. It becomes even more delicate when the secured creditor is serving as the stalking horse purchaser

through a credit bid, as the secured creditor is wearing two hats-- both as a potential purchaser and the party that is funding the bankruptcy case. Moreover, as a result of the leverage that a stalking horse purchaser may have over the debtor, it is not uncommon for the stalking horse purchaser to demand that the debtor include provisions that may unduly favor the stalking horse bidder and, thereby, affect the debtor's ability to later conduct a full, fair and open auction process. Nevertheless, with such limited options, the debtor typically will proceed with the sale process and the stalking horse bidder and leave to other parties in the case (*e.g.*, the Office of the United States Trustee, the Official Committee of Unsecured Creditors or the bankruptcy court itself) the ability to later re-negotiate or modify some of the more onerous provisions.

The following is a non-exhaustive list of common bid procedures and stalking horse bid protections and some of the issues that often arise in seeking their approval by the bankruptcy court.

A. Expense Reimbursement

Stalking horse purchasers will typically require the debtor to pay the fees and expenses it incurs in negotiating the stalking horse asset purchase agreement, conducting due diligence and attending court hearings. Once approved by the court, expense reimbursement obligations become administrative expenses of the debtor's estate and are payable if the stalking horse purchaser is not the winning bidder or, in certain circumstances, if the debtor breaches the stalking horse asset purchase agreement. As a general matter, expense reimbursement obligations will be approved so long as the obligation is reasonable. In order to ensure that expense reimbursement obligations are reasonable, such obligations typically are capped at a

fixed amount and limited to actual and necessary expenses incurred by the stalking horse purchaser in such capacity.[2]

B. Break-up Fees

In addition to expense reimbursement obligations, a stalking horse purchaser will often require the debtor to compensate it in the event that it does not ultimately purchase the assets. Such compensation typically equates to a set percentage of the cash portion of the purchase price contained in the stalking horse asset purchase agreement. [3] Similar to expense reimbursement obligations, break-up fees are commonly payable to the stalking horse purchaser if the debtor fails to consummate the sale to such purchaser due to the debtor's breach of the stalking horse asset purchase agreement or a third party wins the auction for the assets. The rationale for break-up fees is two-fold. First, when a stalking horse purchaser invests its time and money engaging in due diligence and then ultimately enters into an asset purchase agreement, it is foregoing other opportunities to enter into other transactions. In other words, the break-up fee is compensating the stalking horse purchaser for lost opportunity costs. Second, and primarily, the stalking horse bid provides a direct benefit to the debtor's estate by serving as the baseline bid, which gives confidence to the marketplace that a purchaser, after presumably performing extensive diligence,

[2] In certain circumstances, courts have approved what may be considered extraordinary expense reimbursement obligations, including the purchaser's costs relating to Hart-Scott Rodino review. *See, e.g.*, *In re Verasun Energy Corp.*, No. 08-12606 (Bankr. D. Del. Feb. 19, 2009) (BLS) (approving expense reimbursement obligation comprised of attorneys' fees, investment bankers' fees, and other fees and expenses relating to Hart-Scott Rodino review); *In re Dura Automotive Systems, Inc.*, No. 06-11202 (Bankr. D. Del. Aug. 15, 2007) (KJC) (same).

[3] Non-cash components of the purchase price, including assumed liabilities, are generally not considered when determining the amount of the break-up fee in a section 363 sale. *See In re Tama Beef Packing Inc*., 312 B.R. 192, 196 (Bankr. N.D. Iowa 2004) (noting that "[n]o Court in any circuit adds actual expenses or additional liabilities assumed as part of the purchase price" for purposes of calculating a break-up fee). Further, in the event of a credit bid pursuant to section 363(k) (see *infra* for a discussion of credit bits), such bidder will, as a general matter, be entitled to expense reimbursement but typically will not be entitled to a break-up fee unless such bidder's bid also contains a cash component. *See, e.g.*, *In re iGPS Company LLC*, No. 13-11459 (Bankr. D. Del. July 3, 2013) (KG) (approving payment of actual and necessary expense reimbursement obligation up to $400,000 to stalking horse bidder whose $49 million bid consisted of a $48 million credit bid and $1 million in cash (plus the assumption of certain assumed liabilities)); *but see In re HSS Holding, LLC*, No. 13-12740 (Bankr. D. Del. Nov. 7, 2013) (BLS) (approving payment $1.145 million break-up fee to stalking horse bidder whose bid contained no cash-component and consisted almost entirely of a credit bid).

is willing to pay *at least* the purchase price set forth in the stalking horse asset purchase agreement. Opponents of break-up fees will argue that such fees are unnecessary, as those who are interested in purchasing the assets will bid regardless of whether they get a break-up fee and break-up fees reduce the funds available to the debtor's estate. While courts have not set a cap on break-up fees, the generally accepted range of break-up fees is between 2% and 4% of the cash portion of the purchase price. Importantly, there is no universal standard for approval of break-up fees, which, as is discussed in greater detail *infra*, has resulted in some uncertainty in this area. However, in the very least, debtors and buyers should be aware of these parameters when negotiating the amount of any break-up fee.[4]

Courts in the Second Circuit employ a "fair and reasonable" standard in determining whether to approve a break-up fee, which is a variation on the business judgment rule.[5] However, courts in the Third Circuit have applied a stricter standard as set forth in the *O' Brien* case.[6] In *O'Brien*, the Third Circuit Court of Appeals held that while bidding incentives are measured against a business judgment standard in non-bankruptcy transactions, the administrative expense provisions in section 503(b) govern whether such incentives should be approved in the bankruptcy context.[7] Therefore, to be approved, bidding incentives, such as break-up fees, must be necessary for the preservation of the debtor's estate.[8] A significant finding in the *O'Brien* case was that the stalking horse purchaser did not make receiving the break-up fee a condition to consummating the sale. Thus, in the Third Circuit, a stalking horse

[4] Please refer to Exhibit A for a chart that lists recently approved break-up fees and expense reimbursement obligations in the United States Bankruptcy Court for the District of Delaware.

[5] *In re Metaldyne Corp.*, 409 B.R. 661 (Bankr. S.D.N.Y. 2009); *In re Ray Realty Fulton Inc.*, 2009 WL 2600760 (Bankr. E.D.N.Y. Aug 21, 2009); *In re 995 Fifth Avenue Assocs.*, L.P., 96 B.R. 24 (Bankr. S.D.N.Y. 1989).

[6] *Calpine Corp. v. O'Brien Envt'l. Energy Inc. (In re O'Brien Envt'l. Energy Inc.)*, 181 F.3d 527 (3d Cir. 1999).

[7] *Id. at* 534 (citation omitted).

[8] *Id.*at 532.

purchaser that wishes to have its requested break-up fee approved should, at a minimum, make court approval of such break-up fee a condition to consummating the sale.[9]

In *Reliant*, the Third Circuit Court of Appeals revisited the issue of when break-up fees are permissible.[10] In this case, the stalking horse asset purchase agreement provided for a $15 million break-up fee (which equated to 3% of the purchase price). The bankruptcy court did not approve the break-up fee because it found that such fee was not necessary to preserve the value of the estate. The Third Circuit Court of Appeals, in affirming the bankruptcy court's decision, reaffirmed the standard set forth in *O'Brien* and held that section 503(b), and not the business judgment rule, is the applicable standard in determining whether break-up fees should be approved.[11] Again, a key fact was that the stalking horse asset purchase agreement did not include a provision that allowed the stalking horse purchaser to terminate the stalking horse asset purchase agreement if the break-up fee was not approved.[12]

Certain courts outside of the Second and Third Circuits have adopted other approaches. For example, in *Sea Island*,[13] the court adopted a hybrid standard (which was first set forth in *American West Airlines*[14]), which provides that the court must determine whether the transaction will further the interests of the debtor and its key stakeholders.

One issue that came up recently is whether the stalking horse purchaser should be denied its bid protections when it engages in conduct that, while not expressly prohibited by the bid

[9] Of course, even if approval of the break-up fee is such a condition, that does not prevent the stalking horse purchaser from waiving the condition in order to consummate the sale in the event that the break-up is not approved.

[10] *In re Kelson Channelview LLC v. Reliant Energy Channelview LP (In re Reliant Energy Channelview LP)*, 594 F.3d 200 (3d Cir. 2010).

[11] *Id.* at 208-09.

[12] *Id*. at 207.

[13] *Sea Island Coastal Props. LLC v. Official Comm. of Unsecured Creditors (In re Sea Island Co.)*, 2010 WL 4393269 (Bankr. S.D. Ga. Sept. 15, 2010).

[14] 166 B.R. 908 (Bankr. Ariz. 1994).

procedures, potentially harms the estate.[15] In *A123*, the stalking horse purchaser was outbid at the auction by a foreign company. The winning bidder, as a result of its nation of origin, was required to obtain governmental approval in order to consummate the sale. At the sale hearing, the Official Committee of Unsecured Creditors argued that the stalking horse purchaser should not be entitled to its bid protections (which were previously approved by the court) because it allegedly engaged a lobbying firm to attempt to prevent the winning bidder from obtaining the necessary governmental approvals to consummate the sale. Of course, if this lobbying firm was successful, the stalking horse bidder, as the second highest bidder, would have been the ultimate purchaser and the estate would have lost the benefit of whatever additional value was generated by the winning bidder's bid. As a result, the Official Committee of Unsecured Creditors argued that this conduct, while not explicitly prohibited by the bidding procedures, was intended to harm the estate and, as such, should preclude the stalking horse purchaser from receiving the benefits of its previously-approved bid protections. Ultimately, this dispute settled. However, *A123* suggests that debtors should, in certain circumstances, consider including provisions in their bid procedures that provide that the stalking horse purchaser will not be entitled to the benefit of its bid protections if it attempts to harm the estate by interfering in any way with the debtor's ability to consummate the sale to another party.

C. Topping Fees

A topping fee is paid to a stalking horse purchaser only if another bidder is the winning bidder and successful purchaser. Unlike a break-up fee, a topping fee is not paid to the stalking horse purchaser if the stalking horse purchaser is the winning bidder but the debtor breaches the stalking horse asset purchase agreement or is otherwise unable to close the sale. A topping fee

[15] *In re A123 Systems Inc.*, No. 12-12859 (Bankr. D. Del. Dec. 11, 2012) (KJC).

may be paid to the stalking horse purchaser in lieu of a break-up fee or, as is more commonly seen, be a component of the break-up fee. The amount of a topping fee is typically a percentage of the difference between the purchase price of the winning bid and the purchase price of the stalking horse bid. As a result, the stalking horse purchaser is arguably incentivized to initially bid less on the assets with the hope that other bidders will drive the purchase price up thereby entitling it to a larger topping fee. There are few published decisions that discuss topping fees. However, these few decisions analyze the permissibility of topping fees under the standards applicable to break-up fees.[16]

D. Minimum Overbids and Bid Increments

If the debtor receives no "Qualified Bids" (see *infra* for a discussion of "Qualified Bids") other than the stalking horse purchaser's bid,[17] the stalking horse purchaser purchases the assets for the price set forth in the stalking horse asset purchase agreement and the auction, if any, is cancelled.[18] However, if the debtor receives additional Qualified Bids, an auction takes place where the assets are sold to the highest or otherwise best bidder. A key protection that a stalking horse purchaser often negotiates for is a minimum overbid requirement, which provides that, in order to participate in the auction, a potential bidder must be willing to bid an amount that is a specific amount higher than the purchase price set forth in the stalking horse asset purchase agreement. A typical overbid requirement is the purchase price under the stalking horse asset purchase agreement plus the break-up fee, the expense reimbursement and an additional amount

[16] *In re App Plus, Inc.*, 223 B.R. 870 (Bankr. E.D.N.Y. 1998) (acknowledging 'dearth of cases' regarding topping fees and using break-up fee precedent to analyze permissibility of topping fee); *In re Twenver, Inc.*, 149 B.R. 954 (Bankr. D. Colo. 1992) (using break-up fee precedent to analyze permissibility of topping fee); *In re Bidermann Indus.*, 203 B.R. 547 (Bankr. S.D.N.Y. 1997) (same).

[17] Typically the bidding procedures provide that the stalking horse purchaser's bid is deemed to be a Qualified Bid.

[18] In such a circumstance, the bidding procedures often require the debtor to file and serve a notice that provides that the stalking horse purchaser is the winning bidder and that the auction is cancelled.

(such as 10% of the purchase price).[19] At this amount, if a bidder other than the stalking horse purchaser is the winning bidder, the estate will receive some measurable benefit. To illustrate, without such protection, if the stalking horse asset purchase agreement provides for a $1 million purchase price, a third party could participate in the auction by bidding only $1 million and $1. Assuming this bid is the winning bid, after paying the expense reimbursement and break-up fee, the estate would be worse off than if it just sold the assets to the stalking horse purchaser. By having a meaningful overbid requirement, the debtor is able to maximize value to the estate, while providing the stalking horse purchaser with a slight advantage over other bidders, thereby compensating the stalking horse purchaser for its time and effort in negotiating and entering into a stalking horse asset purchase agreement. Further, once the auction begins, bidding procedures often include minimum bidding increments to ensure that the leading bidder is only outbid by a materially better bid and for the convenience of the bidders and other parties attending the auction.

E. Deposits

It is fairly commonplace for the stalking horse purchaser, as part of the stalking horse asset purchase agreement, to provide a cash deposit equating to a meaningful percentage of the purchase price. While this percentage varies, purchase price deposits in this context are commonly 10% of the purchase price. Additionally, the bid procedures typically require potential bidders to provide a cash deposit along with their bid. Such deposits are intended to

[19] As compared to other bid protections, minimum overbids are a fairly unchallenged. As such, there is not an abundance of case law that addresses minimum overbids. *See In re Greater Miami Neighborhoods*, 2008 WL 4397425, at *2 (Bankr. S.D. Fla. Sept. 26, 2008) (noting that the overbid requirement must be intended to compensate the debtor for the expense and effort of running an auction process); *In re Hupp Indus., Inc.*, 140 B.R. 191, 195-96 (Bankr. N.D. Ohio 1992) (noting that arbitrary and unreasonably high bidding increments are not justified).

streamline the auction process by preventing parties that are not seriously interested in purchasing the assets or have other ulterior motives from participating in the auction.

F. Bid Packages and Qualified Bids

As indicated *supra*, to help ensure an orderly auction process, bidding procedures often provide that only "Qualified Bidders" may participate in the auction. Typically, to be considered a Qualified Bidder, a potential bidder must submit a "bid package" by a date certain, and assuming the bid meets the bid requirements, will be deemed a "Qualified Bid" by the debtor following consultation with other key parties (who are commonly referred to as "Consultation Parties"). A bid package commonly includes a commitment to pay above a minimum purchase price (*i.e.*, the initial overbid amount), a minimum deposit, a list of the assets to be purchased, an asset purchase agreement marked against the stalking horse asset purchase agreement to show the bidder's requested changes, a list of the executory contracts to be assumed and assigned and documentary evidence that the bidder can perform under such contracts and has the financial wherewithal to close the sale. Of these components of the bid package, perhaps the most important component to the debtor is whether the potential bidder has the financial wherewithal to close the sale. While the debtor is typically familiar and comfortable with the financial health of the stalking horse purchaser, the debtor may know very little about the financial condition of other parties who would like to become Qualified Bidders and participate in the auction. By requiring potential bidders to provide financial information in their bid packages, the debtor is able to make a determination as to whether the potential bidder has the ability to close the transaction. This information is helpful with respect to the ability of the debtor to assign executory contracts and leases of non-residential real property in connection with the sale, as purchasers who are assuming such executory contracts and leases must demonstrate adequate assurance of future performance pursuant to section 365(b)(1)(C).

In addition, as one might expect, potential purchasers are often competitors of the debtor and, as such, may only be attempting to use the bidding process to gain a competitive advantage by accessing sensitive commercial information regarding the debtor that it could not ordinarily obtain. To guard against this, bidding procedures typically require parties to enter into confidentiality agreements prior to gaining access to any diligence materials. To further guard against this possibility, bidding procedures may contain provisions that provide the debtor with additional discretion in determining whether a bidder is a Qualified Bidder or the ability to limit the type and nature of due diligence information that must be provided to potential purchasers that are also competitors of the debtor.

Another issue that may arise is whether the bid procedures should provide the stalking horse purchaser with the right to receive the bid packages of proposed bidders at the same time the debtor receives such bids (and before such bids are deemed to be Qualified Bids). As a general matter, providing the stalking horse purchaser with copies of all of the bids prior to the debtor's determination of whether such bids are Qualified Bids serves little purpose because the stalking horse purchaser will only compete against (and should thus only be concerned with) other Qualified Bids. Therefore, it is more common to require that all Qualified Bids be shared with the stalking horse purchaser and, to ensure that the stalking horse purchaser does not have an unfair advantage over the other Qualified Bidders, with the other Qualified Bidders.

G. Marketing and Due Diligence Period

Prior to executing the stalking horse asset purchase agreement, presumably the stalking horse purchaser has completed all necessary due diligence with respect to the transaction. However, issues often arise regarding the length of the post-petition marketing and due diligence period that third parties may need in order to make a determination regarding whether to submit a bid and ultimately attend the auction. In calculating this period of time, a debtor needs to

balance its desire to lengthen and extend such period, which could result in higher and better bids for the benefit of the estate, with the stalking horse purchaser's desire to complete a quick sale in order to help eliminate bidding competition. The length of the sale process and the related marketing and due diligence period may also be influenced by the debtor's financial condition. For example, the debtor may only be allotted enough cash collateral and/or financing to carry it safely through an extremely quick sale process. Further, the financing order may include sale-related milestones that the debtor must meet and, if it fails to do so, an event of default will be triggered under the financing agreement.

H. Competing Bids and Contingencies

Another common issue is whether parties submitting bid packages may include certain contingencies to their obligation to consummate the sale, including, by way of example, financing or due diligence contingencies. Significantly, such contingencies provide the potential bidder with the ability to withdraw its bid prior to closing. Of course, these contingencies will be reflected in the marked up asset purchase agreement that is included in the bid package. As such, the debtor will be able to consider such contingencies when determining which bid is the highest and best bid.

Recently, however, bid procedures are requiring bids to have no contingencies that are not already included in the stalking horse asset purchase agreement. Such a requirement assists the debtor in comparing bids by allowing it to compare bids on an "apples to apples" basis.

I. "No-shop" provisions

In out-of-court transactions, it is common for potential purchasers to receive the benefit of "no-shop" provisions, which provide that the seller is not permitted to solicit or encourage third parties to bid on the particular assets to be purchased. However, in the bankruptcy context, such a provision is problematic because it chills bidding and, consequently, potentially

suppresses the value that the debtor may receive as a result of the auction process. With that said, no-shop provisions which extend from the date that the stalking horse asset purchase agreement is executed through the date that the bidding procedures order is entered have become fairly common. This limited no shop provision provides the stalking horse purchaser with added comfort that the bidding procedures and protections it bargained for will be honored by the debtor during this interim time period. Although no-shop provisions restrict the debtor from actively soliciting offers, such provisions do not typically restrict the debtor from receiving unsolicited offers. Thus, in the event that a debtor receives an unsolicited offer during this interim period that it deems higher and better than the stalking horse purchaser's bid, the debtor may consider accepting this competing bid prior to the sale procedures hearing. In any event, a debtor should always seek to include a "fiduciary out" provision in the asset purchase agreement, which allows the debtor, consistent with its fiduciary duties, to terminate such agreement if an alternative and materially better restructuring opportunity is available to the debtor.

J. Re-opening the Auction

On occasion, despite the very detailed step-by-step process for submitting bids and competing at the auction, all as set forth in the bid procedures order, parties may appear in court at the sale hearing and try to re-open the bidding when, after the conclusion of the auction, either a disgruntled bidder or an entirely new bidder offers a materially higher purchase price for the debtor's assets. When this happens the court is tasked with a difficult decision: should it honor the process it previously approved or re-open the bidding to maximize value to the debtor's estate.

In *Corporate Assets*, the Seventh Circuit Court of Appeals affirmed the decisions of the lower courts that re-opened bidding when, a day after the auction, the second place bidder increased its bid and the debtors, in consultation with its secured creditors, decided to re-open the

auction.[20] In this case, the bidder that won at the first auction won again at the re-opened auction but argued at the sale hearing and on appeal that the second auction was invalid under the court-approved bid procedures. In affirming the lower courts' decisions to re-open the auction, the court of appeals noted that the extent to which a court has discretion to re-open an auction depends on the degree to which the sale is final.[21] In other words, once the sale order is entered, there are a narrow set of circumstances under which a court may re-open bidding *(e.g.*, fraud or a grossly inadequate purchase price). However, under the facts presented in *Corporate Assets* (*i.e.*, prior to the sale hearing and thus entry of the sale order), a court has broad discretion to re-open the auction and the bankruptcy court did not abuse its discretion in doing so.[22]

Recently, the Delaware bankruptcy court in *Allied Systems* authorized the debtors to re-open the auction when, after bidding closed, one of the bidders increased its bid by what the debtors considered to be a material amount.[23] In permitting the re-opening of the auction, the court, in a transcript ruling, gave deference to the debtor's determination that, in order to fulfill its fiduciary duties and to maximize value to the estate, it needed to re-open the auction.[24]

On the other hand, there are a few reported decisions in which courts have determined not to re-open the bidding, thereby indicating that the sanctity of the bidding procedures outweighs any potential additional value to the estate. For example, in *In re Bigler, LP*, the court refused to reopen the bidding after an auction had concluded, holding that "when the bid procedures are clear; the bid procedures are not complex; the parties are sophisticated; there is no collusion or

[20] *Corp. Assets, Inc. v. Paloian*, 368 F.3d 761, 767 (7th Cir. 2004).

[21] *Id.* at 768.

[22] *Id.*

[23] *In re Allied Systems Holdings, Inc.*, No. 12-11564 (Bankr. D. Del. Sept. 9, 2013) (CSS).

[24] *See Transcript of Proceedings, In re Allied Systems Holdings, Inc.*, No. 12-11564, at 26:2-6 (Bankr. D. Del. Sept. 9, 2013) (CSS).

fraud; and the auction price is not grossly inadequate—the highest priority should be placed on maintaining the integrity of the system."[25]

K. Credit Bidding

Pursuant to section 363(k), a secured creditor is provided with the ability to "credit bid" the allowed amount of its secured claim, thereby allowing it to serve as a bidder at an auction without having to use cash.[26] In order to protect this ability, secured creditors may require the bid procedures or the financing order to expressly provide for such ability and their right to participate in the auction should they choose to credit bid.

Of note, it is becoming more common for the credit bid of a secured creditor to be the stalking horse bid in a section 363 sale. It is also becoming more common for distressed investors to purchase secured debt at a discount to par amount and then exercise their ability to credit bid the face amount of such debt. This "loan-to-own" strategy can be very effective. However, the bankruptcy court in *In re Fisker Automotive Holdings, Inc.* reminded us that this strategy is not without some risk.[27] In *Fisker*, the stalking horse purchaser purchased a loan, with a face value of $168.5 million, for $25 million about one month before the debtor filed for bankruptcy. The stalking horse purchaser then sought to credit bid its secured claim for $75 million. The Official Committee of Unsecured Creditors objected to the proposed credit bid because it believed such bid would chill bidding. The court analyzed the stalking horse purchaser's right to credit bid and whether that right should be limited. The court concluded that

[25] 443 B.R. 101, 117 (Bankr. S.D. Tex. 2010); *see also In re Cloverleaf Enters. Inc.*, 2011 WL 873145 (Bankr. D. Md. Mar. 11, 2011) (citing *In re Bigler*).

[26] Section 363(k) provides that "[a]t a sale under [section 363(b)] of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases the property, such holder may offset such claim against the purchase price of such property." 11 U.S.C. § 363(k).

[27] 2014 WL 210593 (Bankr. D. Del. Jan. 17, 2014).

the stalking horse purchaser had the right to credit bid but, relying on its ability to limit such right for "cause" as set forth in section 363(k), capped the amount of the credit bid to $25 million for two primary reasons. First, according to the court, the evidence established that if the stalking horse purchaser was permitted to credit bid the full amount of its claim, "bidding would be frozen."[28] Second, the court found that the stalking horse purchaser had insisted on an "unfair process, *i.e.*, a hurried process" for the sale that neither the debtor nor such purchaser could justify.[29] While this ruling is currently being appealed, it will nonetheless give distressed investors pause and may be used as precedent to limit the ability of such investors to credit bid the full amount of their secured debt when the sale timeline is severely truncated.

IV. Free and Clear Sales and Successor Liability

Under section 363(f), a debtor, under certain circumstances, may sell its assets "free and clear of any interest in such property of an entity other than the estate."[30]

A. Successor Liability Generally

The general rule is that a purchaser of assets for fair consideration does not become liable for the seller's liabilities, even when the sale transaction includes substantially all of the assets of the seller.[31] The exceptions to this general rule are as follows:

(1) where the purchaser agrees to assume such debts or other liabilities;

(2) where the transaction amounts to a *de facto* consolidation or merger of the seller and purchaser;

(3) where the purchasing corporation is merely a continuation of the selling corporation; or

---

[28] *Id*. at *5.

[29] *Id.* at *6.

[30] *See* 11 U.S.C. § 363(f).

[31] *See Kemos, Inc. v. Bader*, 545 F.2d 913, 915 (5th Cir. 1977*); Cargo Partner AG v. Albatrans*, Inc., 352 F.3d 41, 45 (2d Cir. 2003); *Conn v. Fales Div. of Mathewson Corp.*, 835 F.2d 145, 146 (6th Cir. 1987).

(4) where the transaction is entered into fraudulently in order to escape liability for such debts.[32]

Although the specific contours of each exception vary from state to state, a purchaser should be comforted in knowing that it will be shielded from any successor liability *unless* one of the-above listed exceptions applies, regardless of whether the asset sale is conducted pursuant to section 363, a state court proceeding or otherwise. If, on the other hand, such a purchaser is aware that one of these exceptions may apply, it should consider the risk that potential successor liability claims may survive the sale and, as is discussed *infra*, take affirmative steps to mitigate this risk.

B. The Intersection of Section 363(f) and Successor Liability

As discussed *supra*, section 363(f) provides that the debtor, to the extent set forth in such section, "may sell property . . . free and clear of any interest in such property of an entity other than the estate . . . ." The phrase "interest in such property" is not defined by the Bankruptcy Code, and courts have reached different conclusions regarding whether section 363(f) alone is sufficient to shield a purchaser (*i.e.*, a successor) from the obligations of the seller (*i.e.*, a predecessor) under state and federal law (*i.e.*, successor liability).

In broadly interpreting the phrase "interest in property", the Third Circuit Court of Appeals determined that employment discrimination claims and certain rights under an employee benefit program qualified as "interests in property" under section 363(f), thereby defeating the successor liability claims of those claimants.[33] However, the Sixth Circuit Court of Appeals limited the scope of "interest in property" when it held that a debtor's experience rating, for the purposes of the Michigan Employment Security Act, was not an "interest" within the meaning of

[32] *Fales Div. of Mathewson Corp.*, 835 F.2d at 146.

[33] *See In re Trans World Airlines*, Inc., 322 F.3d 283 (3d Cir. 2003).

section 363(f) and, consequently, the debtor's rating survived the sale of substantially all of its assets. [34] In a more recent district court decision in the Sixth Circuit, the court suggests that where claims are more particularly identified in a sale order, section 363(f) could be used to shield successor liability.[35] In fact, this same reasoning was used by a district court in the Seventh Circuit to shield a purchaser from successor liability.[36] As such, in order to reduce the risk associated with successor liability, the sale order should include, among other things, the following:

(1) factual findings expressly absolving the purchaser of successor liability;

(2) language indicating the purchaser's reliance on the determination that it will not be subject to successor liability;

(3) specific reference to the various claims or obligations of concern from which the purchaser seeks to take the assets free and clear (in additional to the general reference to liens, claims and encumbrances);

(4) language enjoining any holder of a claim, lien, or interest from taking any action against the purchaser relating to such claims, liens, or interests;

(5) language specifically identifying the liabilities being assumed by the purchaser and those not being assumed by the purchaser;

(6) an express factual finding that the purchaser is a "good faith" purchaser; and

(7) language specifically reserving the bankruptcy court's jurisdiction to enforce the sale order.

A prospective purchaser should, however, be aware that, at least with respect to future claims, such purchaser still may be subject to successor liability even if the sale order includes

[34] *See generally In re Wolverine Radio Co.*, 930 F.2d 1132 (6th Cir. 1991).

[35] *See Mickowski v. Visi-Trak Worldwide*, LLC, 321 F. Supp. 2d 878, 885 (N.D. Ohio 2003) (sale of assets pursuant to section 363 does not preclude successor liability claim of unsecured creditor against buyer absent bankruptcy court order expressly stating that sale was free and clear of unsecured claims).

[36] *See generally Faulkner v. Bethlehem Steel/Intern. Steel Group*, 2005 WL 1172748 (N.D. Ind. 2005) (order expressly provided that the sale of the debtor's assets to the buyer vested such buyer with all right, title, and interest in those assets free and clear of any other interests, claims or liens, including any claims arising under successor liability).

all of the above provisions. For example, the United States District Court for the Southern District of New York, in *In re Grumman Olson Industries, Inc.*, cautioned sellers that principles of due process may override provisions in sale orders that purport to insulate a purchaser from successor liability.[37] In *Grumman*, the purchaser bought certain of the debtor's assets through a section 363 sale approved by the bankruptcy court in 2003. More than five years later, plaintiffs were injured in an automobile crash involving a truck that allegedly contained defective parts that were manufactured by the debtor. Such plaintiffs commenced a personal injury action against the purchaser. In response to this action, the purchaser commenced an adversary proceeding which sought declaratory and injunctive relief barring the plaintiffs from continuing such action because the sale order expressly insulated the purchaser from successor liability. Despite the clear and unambiguous language in the sale order, the district court, in an appeal from the bankruptcy court, affirmed the bankruptcy court's ruling and dismissed the purchaser's adversary proceeding "[b]ecause parties holding future claims cannot possibly be identified and, thus, cannot be provided notice of the bankruptcy . . . ."[38] Further, the district court reasoned that to "whatever extent maximizing the value of the estate is an important policy of the Bankruptcy Code, it is no more fundamental than giving claimants proper notice and the opportunity to be heard before their rights are affected, to say nothing of constitutional requirements of due process."[39] As such, even if the sale order expressly shields the purchaser from successor liability claims and even expressly shields the purchaser from specifically enumerated claims, notions of due process may abrogate the effect of such provisions. Therefore, a cautious purchaser, in order to help ensure that it is shielded from possible successor liability claims,

[37] 467 B.R. 694 (S.D.N.Y. 2012).

[38] *Id.* at 707.

[39] *Id.* at 710.

should, in addition to providing notice of the sale hearing and the entry of the sale order to all creditors, publish the sale notice in areas where potential claimants may be found. Such widespread publication of the sale notice may aid in defending due process challenges that may arise in the future.