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Section 363 Bankruptcy Sales: Key Considerations in the Auction Process, Private Sales, Due Diligence and Operations

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Section 363 Bankruptcy Sales

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Agenda

- Our “Case” Study
- Section 363 Generally
- Pre-bankruptcy Planning
- Bidding Procedures
- Executory Contracts
- 363 Sales Pursuant to a Plan; Advantages and Disadvantages
- Stock vs. Asset Deals
- Employees
- MAE Clauses
- Credit Bidding
- Getting Money Into the “Right” Hands; Gifting
- Successor Liability
- Reopening the Auction
- The Future of 363 Sales

“Case” Study

To help set a stage for our discussion, we are going to use the fictional bankruptcy sale of substantially all of the assets of “C&J’s Brick Oven Pizza,” a chain with 60 restaurants in seven northeastern and mid-Atlantic states. C&J’s has been around for more than 30 years serving great Italian food made with the freshest ingredients.

Like many casual dining restaurant chains, C&J’s has been affected by a prolonged negative operating trend in an ever increasing competitive price environment. Consumers have more options than ever for spending discretionary income, and their preferences continue to shift towards other available alternatives. Since 2015, C&J’s has experienced a year-over-year decline in sales and revenue.

C&J’s has taken several steps in the year leading up to bankruptcy to enhance revenue and cut costs. C&J’s brought in a new executive chef, initiated a wine pairing menu, and reduced headcount. They also hired a real estate company to help them renegotiate their leases. However, it was not enough, and C&J’s has filed a voluntary chapter 11 petition with the intent to sell its assets in a 363 sale.

Section 363 of the Bankruptcy Code

- Section 363 of the Bankruptcy Code authorizes debtors, such as C&J, to sell their assets to a buyer free and clear of almost all liens, claims and encumbrances
- Section 363(f) of the Bankruptcy Code provides

  The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—

  (1) applicable non-bankruptcy law permits sale of such property free and clear of such interest;

  (2) such entity consents;

  (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

  (4) such interest is in bona fide dispute; or

  (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest
- Note that the requirements are in the disjunctive, so proving any of the 5 will satisfy the bankruptcy court
- Sections (f)(3) and (f)(5) are the provisions most frequently litigated

Section 363(f)(3)

- Section 363(f)(3) permits the sale if the sale price exceeds the “value” of the liens on the assets. Bankruptcy courts are split on whether the sale price must exceed the “face value” of the liens on the assets (see *Clear Channel Outdoor Inc. v. Knupfer (In re PW LLC)*, 391 B.R. 25, 41 (9th Cir. BAP 2008); *Terrace Chalet Apartments, Ltd.*, 159 B.R. 821 (N.D. Ill. 1993) (to be sold free and clear under subsection (f)(3), sale price must exceed interest holder’s total debt), or whether the price must simply exceed the “economic value” of the liens determined by the assets’ fair market value (see *In re Beker Indus. Corp.*, 63 B.R. 474, 475-78 (Bankr. S.D.N.Y. 1986). The approach used can make a difference if, as often is the case, the property is over-encumbered

Section 363(f)(5)

- Section 363(f)(5) permits the sale if the interest-holder could be compelled to accept a money satisfaction in a legal or equitable proceeding. If the lienholder can be forced to accept a payment in exchange for its interest, then the debtor may replace the lien with cash or some form of adequate protection. Lienholders may argue that they can only be compelled to accept cash in complete satisfaction of their lien. *Clear Channel Outdoor Inc. v Knupfer (In re PW LLC)*, 391 B.R. 25, 41 (9th Cir. BAP 2008)

Business Judgment

- Requires showing of “good business reason” (see *In re Lionel*, 722 F.2d 1063 (2d Cir. 1983))
  - Proportionate value of asset being sold to value of estate as a whole
  - Duration/pendency of case and likelihood of reorganization
  - Effect of sale on ability to confirm a plan
- Whether asset is decreasing or increasing in value (i.e., the “melting ice cube”)

Pre-Bankruptcy Planning

- Marketing
  - Typically, a debtor, such as C&J, will hire an investment banker to find potential purchasers for its assets. These purchasers generally fall into two categories: <u>financial buyers</u> (e.g., private equity funds that want to buy assets to enhance their value and sell them for a profit), or <u>strategic buyers</u> (e.g., competitors)
  - How much marketing is done pre-bankruptcy will determine how quickly a sale can be accomplished in bankruptcy. If there has been a **robust** marketing process pre-bankruptcy, then a debtor is more likely to get to a quick sale than if buyers are only learning of the opportunity to purchase the debtor's assets after it files
  - The goal of all debtors that opt to sell their assets in a bankruptcy sale is to maximize the value of their assets for the benefit of their creditors and other stakeholders

Pre-Bankruptcy Planning

- Set up the data room
  - Investment bankers usually will establish a "data room," a protected online virtual room with diligence materials for buyers to consider
  - Debtors may be sensitive to sharing economic information or trade secrets with competitors, so parties seeking access to the room must sign a non-disclosure agreement
- Find a Stalking Horse
  - Debtors oftentimes will look for a so-called stalking horse bidder—a prospective buyer that is willing to make a bid prior to an auction or some other sale process—to demonstrate to the market that there is interest in the debtor's assets and set a "floor price"
  - Debtors may enter into stalking horse agreements pre-bankruptcy and post-bankruptcy, but it is better if a debtor can identify a purchaser prior to filing

Advantages of Being a Stalking Horse

- Stalking horse bidders get an early seat at the table and can have input into the structure of the sale process
- Negotiate the form of asset purchase agreement. Negotiation occurs before other constituencies appear, such as a creditors' committee or parties to executory contracts
- Get more time to diligence the debtor, and engage with debtor's management
- Help to establish bidding procedures: sale timing, minimum bids, minimum overbids, bid protections, and what will constitute a qualified bid
- Potentially obtain bid protections, such as expense reimbursement and break-up fee. Stalking horse bidders who obtain a break-up fee may also negotiate to bid that fee in the auction. In this way, a stalking horse bidder can increase its bid without reaching into its pocket
- Guarantee of right to purchase the assets if no one else shows up to the auction. Given that stalking horse purchasers assume that there will be additional bidders, they may set their price lower than they believe the assets are worth. Thus, if no one shows up, the stalking horse may get the assets on the cheap!

Disadvantages of Being a Stalking Horse

- The chief risk is if the buyer is purchasing assets in a fluctuating market. If the price goes up, the stalking horse will need to bid more, but if the price goes down, the stalking horse is locked in with its bid and may end up paying more than the assets are worth. This risk can be mitigated with a quick sale, which stalking horse bidders almost always seek
- The bidding procedures and any bid protections may be challenged by other parties in interest once the case files
- Debtors oftentimes look to stalking horse bidders for debtor-in-possession financing. Note, this may be a blessing in disguise. As discussed below, holders of secured debt can “credit bid” that debt at the auction
- It may be difficult to get the attention of debtor’s management if the business is floundering
- Finally, stalking horse bidders should have an exit strategy if the case goes sideways during the sale process and converts to a liquidation

Pre-Bankruptcy Planning

- Negotiate the Asset Purchase Agreement
  - Let's assume that C&J's investment banker is successful in obtaining several bids, and C&J selects a financial buyer named "Blue Diamond" as their stalking horse bidder. Elements of the APA that Blue Diamond's attorneys will negotiate with C&J's attorneys include the following:
    - Qualified bid requirements
    - Overbid protection
    - Work fee/expense reimbursement
    - Bidder deposits
    - Break-up fee
    - No-shop clause
    - Consideration
    - Regulatory approvals (e.g., transfer of liquor licenses)
    - Treatment of executory contracts
    - Reps and warranties
    - Covenants
    - Hold-back

Auction or No Auction?

Let’s assume that Blue Diamond wants to purchase the assets in a private sale, rather than a public auction where it may be required to compete with other bidders. In fact, Blue Diamond tells C&J that it will include a premium if the sale can be accomplished privately through bankruptcy

Section 363(b)(1) of the Bankruptcy Code does not distinguish between public and private sales. The Bankruptcy Rules provide that “[a]ll sales not in the ordinary course of business shall be by private or by public auction.” Fed. R. Bankr. P. 6004(f)(1)

In fact, the Uniform Commercial Code encourages private sales on the theory that a sale of collateral through typical distribution channels for such type of property is likely to generate greater proceeds than a public auction. See Official Comment to UCC Section 9-610, Para. 2

Private Sales of Substantial Assets are Hard to Accomplish in Bankruptcy

Practically speaking though, private sales are difficult to achieve in bankruptcy.

First, both private and public sales require a motion seeking bankruptcy court approval of the sale. The motion must set forth the terms of the sale, a proposed hearing date for approval of the sale and a deadline by which any objections to the sale must be filed.

While no auction process is contemplated in a private sale, interested parties may *still* submit competing bids for the assets by “objecting” or otherwise responding to the sale by the objection deadline creating, in essence, in a de facto auction for the assets.

Typically, debtors and bankruptcy courts prefer public auctions to private sales because, among other things, public auctions provide better protection against subsequent claims that the debtor failed to maximize value for the benefit of its creditors.

One of the most famous “private” sales was the sale of Lehman Brother’s assets to Barclay’s. In *Lehman*, although the sale was not actually titled as a private sale, the sale occurred without an auction process being proposed by the debtors or implemented by the court. In approving the sale on an extremely expedited time frame without any competitive bidding, the bankruptcy court noted that the sale had been approved under a unique set of extraordinary circumstances, in an emergency situation, and because it was clear that Barclays was the only interested buyer. Accordingly, the court made clear that the process implemented in that case would not have precedential value.

The Bankruptcy Case

- Bidding procedures and when to file
  - C&J's chapter 11 attorney prepares the typical panoply of first day motions. While C&J are anxious to move for approval of the sale to Blue Diamond, their attorney tells them they must wait to file the bid procedures motion
  - While bankruptcy courts may approve bidding procedures on the first day of a case in which the debtor is the proverbial "melting ice cube," courts are reluctant to approve these motions until after the creditors' committee is formed. In fact, the Federal Rules of Bankruptcy Procedure provide that "[e]xcept to the extent that relief is necessary to avoid immediate and irreparable harm, the court shall not, within 20 days after the filing of the petition, grant relief regarding…a motion to use, sell, lease, or otherwise incur an obligation regarding property of the estate…." Fed. R. Bankr. P. 6003(b)

The Bankruptcy Case

- C&J's chapter 11 attorney files the bidding procedures motion, which is heard at the so-called "second day hearing." The motion requests bankruptcy court approval of the sale procedures, which will control the manner in which bids are solicited and the auction is held. C&J's bidding procedures motion contains the following:
  - Sale notification by publication
  - "As is, where is." Assets sold without any representations or warranties
  - Requirement that bidders submit bids at least 7 days prior to the auction
  - Requirement that bidders use the same form of APA used by Blue Diamond, the stalking horse, and submit a version marked to show changes to the Blue Diamond's bid
  - Requires the bidders to deposit a portion (e.g., 10%) of the sale price in cash
  - Requires that the initial overbid exceed the stalking horse bid by a certain amount (in order to cover the break-up fee, expense reimbursement and some incremental value to the debtor), and requiring that subsequent bids exceed the previous high bid by a certain dollar amount

The Bankruptcy Case

- Requires C&J to share the bids with their secured lenders and MarCo, their private equity sponsor, neither of whom are bidding in the auction
- Requires bidders to deliver financial information demonstrating their ability to close the sale
- Bid is irrevocable for some time. Provides for C&J to select a back-up bidder if the winning bidder fails to close. Note the back-up bidder’s deposit will be kept until after the sale to the winning bidder closes
- Procedures for addressing adequate assurance of future performance in connection with the assumption of executory contracts

Executory Contracts

- C&J has hundreds of contracts with vendors in several different states. Blue Diamond (or any bidder) will need to determine which contracts it wants to assume, and which it would like C&J to reject
  - Assumption and Assignment. Section 365 authorizes assumption or rejection of executory contracts and unexpired leases prior to confirmation
    - Requires exercise of "business judgment"
  - Executory contracts – some performance, other than payment, remains due as of the petition date, on both sides

Assuming Executory Contracts

- Assumption
  - After assumption, any breach will give rise to an administrative expense claim
  - Requires defaults to be cured and adequate assurance of future performance under the contract or lease (Section 365(d))
  - Consider where a newly formed special purpose vehicle is used to purchase assets. How can it demonstrate adequate assurance of future performance?

Rejecting Executory Contracts

- Rejection
  - Treated as a breach of contract/lease as of immediately prior to the petition date (but any obligations arising post-petition will be treated as administrative expense claims)
  - Rejection claims are general unsecured claims
  - Real property lease rejection damages are limited
- "Ipso Facto" clauses generally not enforceable (i.e., contract provision triggering automatic termination upon filing of bankruptcy)

Executory Contracts—Unexpired Leases

- Non-residential real property leases (11 U.S.C. § 365(d)(4))
  - Must be assumed or rejected by the earlier of 120 days after date of order for relief; or
  - The date of entry of order confirming the plan
- Court may extend the 120 period (once only) for up to 90 days for cause; any extensions thereafter must have consent of lessor
- Anti-assignment clauses generally not enforceable
  - Exception for personal service contracts
  - Exception for state or other federal anti-assignment statutes or case law (i.e., certain licenses of intellectual property)
- Special protection for shopping center leases

363 Sales Pursuant to a Plan; Advantages and Disadvantages

- Section 1146(a) of the Bankruptcy Code provides that "[t]he issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of [Chapter 11], may not be taxed under any law imposing a stamp tax or similar tax." Typical "stamp tax" is paid upon recordation of a property transfer at a statue or municipal recording office. See In re MVR, LP, 189 F.3d 442, 447-48 (4th Cir. 1999) (where four states, based on 1146, refunded more than $1 million in taxes on transfers of real property). Thus, stamp taxes can add up!
- If a sale is made before a Chapter 11 plan is confirmed, but made in preparation for and anticipation of such a plan, does it qualify for the § 1146 exemption?

363 Sales Pursuant to a Plan; Advantages and Disadvantages

- *Florida Department of Revenue v. Piccadilly Cafeterias*, 128 S.Ct 2326 (S. Ct. 2008). After filing for Chapter 11 relief, Piccadilly Cafeterias sold virtually all of its assets for $80 million in such a Section 363 sale. The sale was effected as part of a "global settlement" with creditors and constituted the centerpiece of Piccadilly's Chapter 11 plan. Part of the sale involved Florida real estate and, as a result, would normally have required payment of state taxes. In approving the sale and, eventually, the Chapter 11 plan, the bankruptcy court rejected Florida's assertion that Piccadilly owed state taxes on the sales and instead granted summary judgment in Piccadilly's favor
- The Supreme Court held that § § 1146(a)'s exemption applies only to transfer made pursuant to confirmed plans of reorganization. Thus, Sellers must pay stamp taxes in 363 sales

Stock vs. Asset Deals

- Considerations
  - Net operating losses
  - Collective Bargaining Agreements
  - Intellectual property concerns
  - Regulatory approval concerns
  - Inability to discharge liabilities

Employees

- Retention
- Assumption of employee-related liabilities
- Executives—non-competes
- WARN Act (Federal and State)
- Wages, salaries, PTO and other accrued benefits

Material Adverse Effect ("MAE") Clauses

- Buyers want optionality. If the assets or business goes sideways during the sale process, they want the opportunity to walk. Buyers will want a fairly broad MAE Clause
  - "Material Adverse Effect" means a "Material Adverse Effect" on (i) the operations, business assets or properties or condition (financial or otherwise) of the Sellers (other than those resulting solely from the commencement of the Chapter 11 Cases), (ii) the ability of the Sellers to perform any of its obligations under this Agreement, (iii) the legality, validity or enforceability of this Agreement, (iv) the rights and remedies of the Buyer under this Agreement, or (v) the validity, perfection or priority of the Buyer's rights, claims, and interests on account of the Termination Fee

Material Adverse Effect ("MAE") Clauses

- Sellers want certainty. They want to know the sale with the stalking horse bidder will close even if no one shows up. Sellers will want a fairly narrow MAE Clause
  - "Material Adverse Effect" means any event, occurrence, fact, condition or change that is materially adverse to (a) the business, results of operations, financial condition or assets of the Business, taken as a whole, or (b) the ability of Seller to consummate the transactions contemplated hereby (other than those resulting solely from the commencement of the Chapter 11 Cases); provided, however, that "Material Adverse Effect" shall not include any event, occurrence, fact, condition or change, directly or indirectly, arising out of or attributable to: (i) general economic or political conditions; (ii) conditions generally affecting the industries in which the Business operates; (iii) any changes in financial, banking or securities markets in general, including any disruption thereof and any decline in the price of any security or any market index or any change in prevailing interest rates; (iv) acts of war (whether or not declared), armed hostilities or terrorism, or the escalation or worsening thereof; (v) any action required or permitted by this Agreement or any action taken (or omitted to be taken) with the written consent of or at the written request of Buyer; (vi) any matter of which Buyer is aware on the Agreement Date; (vii) any changes in applicable Laws or accounting rules (including GAAP) or the enforcement, implementation, or interpretation thereof; (viii) the announcement, pendency or completion of the transactions contemplated by this Agreement, including losses or threatened losses of employees, customers, suppliers, distributors or others having relationships with Seller and the Business; (ix) any natural or man-made disaster or acts of God; or (x) any failure by the Business to meet any internal or published projections, forecasts or revenue or earnings predictions

The Auction

- Auction location
- Going into the auction
  - What is the Debtor thinking?
  - What are the Bidders thinking?
  - What is the Committee thinking?
  - What is the Secured Lender thinking?
  - What is the Judge thinking?
- Bid strategies and evaluation
  - Economic vs. non-economic consideration

Credit Bidding

- Credit Bidding. What is it? A “credit bid” allows a secured creditor to offset all or a portion of the purchase price by the amount of its secured claim, a right expressly provided for in section 363(k) of the Bankruptcy Code

What Can a Secured Creditor Credit Bid?

- May a secured creditor bid the **face amount** of its debt, or is its credit bid capped at the **economic value** of the underlying collateral?
  - **Face Amount**: *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Systems Corp.)*, 432 F.3d 448 (3d. Cir. 2006) (secured creditor entitled to credit bid its entire secured claim); *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (B.A.P. 9th Cir. 2008) (held language of section 363(f)(3) refers to the aggregate face amount of all liens secured by the property, rather than their economic value); *Criimi Mae Servs. Ltd. P'ship v. WDH Howell LLC (In re WDH Howell LLC)*, 298 B.R. 527 (D.N.J. 2003) (same)
  - **Economic Value**: *In re Bay Circle Properties, LLC*, 2017 Bankr. LEXIS 438 (Bankr. N.D. Ga. Feb. 14, 2017), (sale of real property free and clear under section 363(f)(3) was permitted because the sale price met or exceeded the economic value of the liens encumbering the property, even though the price did not exceed the face amount of the liens); *In re Boston Generating LLC*, 440 B.R. 302 (Bankr. S.D.N.Y. 2010)

Supreme Court Weighs in on Credit Bidding Under a Plan

- *RadLAX Gateway Hotels, LLC et al., v. Amalgamated Bank (In re River Road Hotel Partners, LLC)*, 132 S. Ct. 2065 (2012). Resolved a split between the Third Circuit (*In re Philadelphia Newspapers*, 599 F.3d 298 (3d Cir. 2010)) and Seventh Circuit (*River Road Hotel Partners, LLC v. Amalgamated Bank*, 651 F.3d 642 (7th Cir. 2011)), and confirmed that a secured lender has an absolute right to credit bid its debt in a sale free and clear of its liens being conducted under a Chapter 11 reorganization plan

> The ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price. It enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan.
>
> *- J. Scalia*

Limiting Credit Bidding

- Section 363(k), however, affords courts flexibility in permitting the use of credit bid currency. A bankruptcy court may limit a secured creditor's ability to credit bid if it finds that there is "cause," or orders otherwise
- Prior to 2014, the bankruptcy courts had generally limited "cause" to situations in which a secured creditor had engaged in egregious misconduct (i.e., such as collusion) and were largely unsympathetic to arguments that credit bidding should be precluded because it would chill the bidding process

Capping Credit Bidding

- A creditors' committee may be concerned that a lender with a significant secured claim may chill bidders participating in an auction because the credit bidder can bid by offsetting its secured claim against its debt, rather than putting up new cash
- A committee's concern can be even greater in situations where the bidder has purchased a secured claim for less than its face amount (e.g., a creditor may have purchased a secured claim in the secondary market for pennies on the dollar, and then seek to bid the face amount of its claim at auction)

2014: A Bad Year for Credit Bidding

- *In re Free Lance-Star Publishing Co. of Fredericksburg, Va.*, 512 B.R. 798 (Bankr. E.D. Va. 2014). In *Free Lance-Star*, the secured creditor purchased an existing loan to the debtor. The debtor commenced a Section 363 Sale process, and the secured creditor credit bid its secured claim. The debtor and the creditors' committee objected. The bankruptcy court entered an order limiting the secured creditor's right to credit bid to $13.9 million, and concluded that

> [t]he confluence of (i) [the secured creditor's] less than fully secured lien status; (ii) [the secured creditor's] overly zealous loan to own strategy; and (iii) the negative impact of [the secured creditor's] misconduct has had on the auction process has created the perfect storm, requiring curtailment of [the secured creditor's] credit bid rights.

2014: A Bad Year for Credit Bidding

- *In re Fisker Automotive Holdings, Inc. et al.*, 510 B.R. 55 (Bankr. D. Del. 2014). In *Fisker*, the bankruptcy court limited a secured creditor's right to credit bid its $169 million secured claim to the $25 million that the secured creditor paid for its claim. The bankruptcy court held cause existed to limit the secured creditor's rights due to (a) the desire not to chill bidding at the Section 363 Sale and (b) concerns raised by unsecured creditors regarding the extent and validity of the secured creditor's liens on certain assets being sold
  - Appealed to the District Court. The District Court found that the Bankruptcy Court's controversial ruling was supported by the "plain text of 363(k)" which permits a bankruptcy court to limit credit bidding for "cause"
  - The District Court also dismissed the secured creditor's argument that it would be without a remedy if the auction occurred while its credit bid was capped at $25 million. The District Court noted that the secured creditor could credit bid $25 million and continue bidding with cash. In that context, the secured creditor could receive either a cash return of the difference between a full credit bid and the $25 million cap on its credit bid were the Bankruptcy Court to conclude it was so entitled. If a third-party bidder won the auction, the secured creditor would receive its entitlement from the sale proceeds

Credit Bidding

- *In re Aéropostale, Inc.*, 555 B.R. 369 (Bankr. S.D.N.Y 2016). In *Aéropostale*, the Debtors sought to sell substantially all of their assets pursuant to a chapter 11 plan of reorganization
- The Debtors sought to disqualify Sycamore Partners, its secured lender, from credit bidding at the proposed sale
- In addition to making a $150 million secured loan to Aéropostale, Sycamore (i) had required that Aéropostale enter into a sourcing agreement with a Sycamore affiliate, (ii) through an affiliate, purchased 8 percent of Aéropostale's common stock, and (iii) purchased preferred stock that represented 5 percent of Aéropostale's common
- The bankruptcy court permitted Sycamore to credit bid the full amount of its claim. The court held that the potential chilling effect of a credit bid, in and of itself, is not sufficient for a court to find cause to preclude or limit a credit bid under Section 363(k) of the Bankruptcy Code, in contrast to the *Free Lance-Star* and *Fisker* decisions
- Note that each case was decided in a different circuit

Getting the Money Into the “Right” Hands; Gifting

- Suppose that instead of Blue Diamond purchasing C&J’s assets, C&J’s secured lender decided to buy them. Let’s further suppose that, prior to bankruptcy, C&J and the lender realized that the sale would result in significant capital gains tax for C&J’s estate, and that this tax would be entitled to administrative expense priority. If the government had this administrative expense claim, it would be impossible to get any money to unsecured creditors (all the vendors who sell C&J dough and cheese). What can C&J do?
- Generally, the Bankruptcy Code contemplates that secured creditors are to be paid from their collateral, that administrative and priority creditors are to be paid in full before unsecured creditors and that unsecured creditors are to be paid in full before a distribution to existing equity holders

Getting the Money Into the "Right" Hands; Gifting

- Gifting. In effect, the "gifting" concept allows a senior class to share its distributions with a junior class without regard to the hierarchical scheme established in the Bankruptcy Code. Note that generally, "gifting" has been limited in the Second and Third Circuits by virtue of the *DBSD* and *In re Armstrong World Industries Inc.*, 432 F.3d 507 (3d Cir. 2005) (gifting of estate property by senior creditors to junior creditors pursuant to contested plan of reorganization violated the Bankruptcy Code's priority scheme) decisions. As a result of these Circuit Court cases, at least in the Second and Third Circuits, a plan which proposes to skip a senior class and pay distributions to a more junior class will face confirmation hurdles when the "skipped" senior class rejects the plan
- There are workarounds…

Getting the Money Into the “Right” Hands; Gifting

- Consensual Gifting. If no one objects, it’s generally fine
- Settlements – Utilizing Fed. R. Bankr. P. 9019
  - *In re ICL Holding Co., Inc., et al.*, 14-2709 (3d Cir. Sept. 14, 2015). In *ICL Holding*, the Third Circuit held that, in the context of a settlement, an asset purchaser’s payments into segregated accounts for the benefit of general unsecured creditors and professionals employed by the debtor (i.e., the seller) and its creditors’ committee, made in connection with the purchase of all of the debtor’s assets, are not property of the debtor’s estate or available for distribution to creditors—even when some of the segregated accounts were listed as consideration in the governing asset purchase agreement

Getting the Money Into the "Right" Hands; Gifting

- *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017). Supreme Court overruled a Third Circuit decision that authorized distributions to general unsecured creditors while "skipping" priority claimants in the context of a structured dismissal. The Supreme Court, however, was very careful not to rock the boat too much. General takeaways from the Supreme Court's Jevic decision are
  - Structured dismissals are still an option
  - Priority skipping settlements are still an option (provided they are not done in a structured dismissal. Supreme Court expressly endorsed the Second Circuit's decision in *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452 (2d Cir. 2007)
  - Other forms of priority skipping remain viable (e.g., critical vendor orders, wage orders, and roll-ups)

Getting the Money Into the "Right" Hands; Gifting

- Assumption of liabilities. Section 363(b) sale structures may envision "gifts" or payments to certain creditors in a case without regard to discrimination principles or the absolute priority rule. In many cases, purchasers assume certain unsecured claims and leave behind others. A purchaser is free to pick and choose claims it wishes to pay as part of its Asset Purchase Agreement
- Third-Party Agreements Outside of Bankruptcy. The Second Circuit in *DBSD* specifically did not address whether a secured creditor can enter into a private agreement outside of a plan with a junior class in order to provide such class with a gift of its property. *DBSD*, 634 B.R. at 95. ("we need not decide whether the Code would allow the existing shareholder and Senior Noteholders to agree to transfer shares outside of the plan"). Any agreement would need to be fully disclosed to the court. It's not clear whether a court would approve
- Claim Purchases. A senior creditor may purchase a junior claim. May only be useful in smaller cases
- Purchasing Avoidance Actions. Not uncommon for a purchase to acquire the debtor's preference and fraudulent conveyance actions to "bury them" (i.e., so as to avoid the residual estate bringing actions against vendors and other counterparties with whom the purchaser wants to do business)

Buying Liability

- Generally, a buyer of assets is not liable for the seller's debts or liabilities unless it agrees to assume them (which is why excluded liability clauses in APAs are critical)
- There are two general exceptions (i) fraudulent transfer risk, and (ii) successor liability/product line exception

Successor Liability

- Buyers may obtain some protection against successor liability claims, unless the sale amounts to (a) a de facto merger, or (b) a mere continuation of the predecessor
  - De Facto Merger: Continuity of enterprise and ownership, seller liquidates, buyer assumes obligations of seller ordinarily necessary for the uninterrupted continuation of normal business operations
  - Mere Continuation: Continuity of ownership, same officers and directors, and inadequate consideration
  - Product Line Exception: When the buyer continues a product line, the buyer is liable for products in that line that the seller produced before the sale. Focus is on the product and strict liability principles, rather than buyer and seller
- GM Ignition MDL Ignition Switch Litigation

Beware Collective Bargaining Agreements

- Some cases hold or imply that a sale cannot occur free and clear of a debtor's CBA obligations unless that CBA is first rejected under Section 1113. *See In re Maxwell Newspapers, Inc.*, 981 F.2d 85, 90 (2d Cir. 1992) ("debtor may sell the assets of the business unencumbered by a CBA if that agreement has been rejected pursuant to section 1113"); *See In re Sound Shore Med. Ctr.,* No. 13-22840 (Bankr. S.D.N.Y.) (Hrg. Tr. Sep. 18, 2013) [ECF No. 340] ("a debtor may not breach a [CBA] in an asset purchase agreement just as it may not breach a [CBA] and any other agreement or any other act it takes unless it has first obtained permission under Section 1113 to do so either on an interim or final basis…. [§] 1113 is not a condition to a right to sell under Section 363 but … if, in fact, the sale agreement would violate the CBA, then it appears to be … that [§] 1113 would prohibit the sale unless, of course, the agreement was rejected."); *In re Journal Register Co.*, 488 B.R. 835, 840 (Bankr. S.D.N.Y. 2013) ("A debtor cannot bypass § 1113 and obtain a *de facto* rejection of its collective bargaining agreement simply by refusing to perform it. Although the obligation to comply with the successor clause is only one duty among many under a collective bargaining agreement, a debtor's intentional breach of a material provision of the collective bargaining agreement is tantamount to a rejection, or alternatively, a unilateral alteration of its provisions in violation of Bankruptcy Code § 1113(f). Thus, as a general proposition, a sale under Bankruptcy Code § 363 cannot circumvent the condition imposed under a successor clause absent compliance with § 1113")

CBAs and Successor Liability

- Other courts have held that so long as the sale does not breach a successor liability provision in a CBA, the sale need not comply with any other provision in a CBA. See *In re After Six, Inc.*, 1993 WL 160385, at *3 (Bankr. E.D. Pa. May 13, 1993) ("The language of 11 U.S.C. § 1113(f) aids the Unions' cause only if the collective bargaining agreements provide for successor liability. Otherwise, a successor to the Debtor is only obliged to bargain with the Unions, not to adhere to the terms of the collective bargaining agreement itself.") (citations omitted)
- Expired CBAs may affect the analysis. See *In re Hostess Brands, Inc.*, 477 B.R. 378, 382 (Bankr. S.D.N.Y. 2012) ("rejection of the collective bargaining agreement pursuant to Section 1113(b) and (c) is a moot issue if the agreement expires by its own terms and before the bankruptcy court has a hearing on rejection") (citation omitted)

Reopening the Auction

- What happens if a higher bid comes in after the auction is completed?
- A Debtor or committee may move to reopen the auction, or the bankruptcy court itself has discretion to reopen the auction. *Corporate Assets, Inc. v. Paloian*, 386 F.3d 761 (7th Cir. 2004) (court reopened auction where losing bidder did not have the same information as other bidders did and the bid procedures in that case specifically reserved to the debtors the right to reject any bid prior to the sale hearing)
- Generally, a losing bidder does not have standing to move to reopen an auction (although, the bidder could buy a claim to obtain standing, and equity holders have standing to be heard too)

Tests Courts Apply When Considering to Reopen the Auction

- Bankruptcy courts may apply one or more of the following tests to evaluate a proposed sale when a higher bid has been received after the auction
  - Compare the amount of the sales price against the competing bid
  - Consider whether the auction procedures provided for a level playing field
  - Consider the flexibility of the bidding procedures and the expectations of the parties
- The downside of reopening the auction is that it impairs the finality of the auction process. The upside is a higher price
- **Takeaway**: Know whether the bid procedures provide that the sale is final, or do the procedures simply state that the seller agrees to submit the winning bid to the bankruptcy court for approval? The more discretion in the bid procedures, the more likely the court is to authorize the re-opening of the auction

The Future of Section 363 sales

- The American Bankruptcy Institute Commission to Study the Reform of Chapter 11 issued a report containing numerous recommendations to reform Chapter 11 of the Bankruptcy Code (26 BBLR 1688, 12/11/14). The report recommended
  - Additional requirements for 363 sales (e.g., no 363 sales for the first 60 days after the debtor files, sales followed by a plan would no longer be permitted, etc.)
  - Provide more leverage to debtors and committees by requiring all administrative expense claims incurred through the closing date to be paid in full
  - Expressly exclude certain successor liability from the "free and clear" sale, including (i) successorship liability for purposes of federal labor law, and (ii) certain obligations that are deemed to ''run with the land'' under applicable nonbankruptcy law

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