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## The Mechanics of a § 363 Sale

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In recent years, debtors have increasingly opted to sell most of their assets pursuant to standalone § 363 sales rather than to reorganize and restructure through the chapter 11 process. This article provides a new or less experienced attorney with an overview of the § 363 process, including its benefits, drawbacks and pitfalls. To highlight different aspects of the sale process, the authors draw on a number of recent and notable bankruptcy cases that have used § 363 to sell substantial assets.

### The Benefits and Drawbacks of a § 363 Sale



Douglas E. Deutsch

Section 363 of the Bankruptcy Code governs the sales of a debtor's assets outside of the ordinary course of business. To determine whether a particular sale is outside of the ordinary course of business, courts employ two tests: a "horizontal test" and a "vertical test."<sup>1</sup> The horizontal test, sometimes known as the "industry-wide test," asks whether the transaction in question is one that businesses similar to the debtor would engage in as part of its day-to-day operations. By contrast, the vertical test asks whether this type of transaction is one that this particular debtor regularly engaged in pre-petition.

In recent years, it has become more commonplace for debtors to hold § 363

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sales with the purpose of selling *substantially all* of their assets. In this regard, many debtors are essentially "opting out" of the chapter 11 plan process in favor of what they perceive to be a quicker, more efficient process. The § 363 route may be appealing for many reasons. Perhaps an asset is rapidly decreasing in value (the so-called "wasting asset") or an estate cannot afford the administrative expenses of a prolonged restructuring. The changes to the Code made by

Second, § 363 sales can be accomplished very quickly, generally taking between two to three months to complete, but a sale can be completed in a much shorter timeframe.

One of the most notable examples was the liquidation of Lehman Brothers Holdings Inc. in 2008. At the time, Lehman was the fourth-largest investment bank in the U.S., with pre-petition assets of approximately \$639 billion. The scale and pace of Lehman's initial § 363 sale was unprecedented, with Lehman selling its fabled brokerage division to Barclays within five days of its initial bankruptcy filing.

## Building Blocks

the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 also undoubtedly made certain types of bankruptcy reorganizations far more difficult. Regardless of the particulars in any given case, the occurrence of § 363 sales seeking to sell most or all of a debtor's assets has risen sharply in recent years. There is little evidence that this trend will reverse itself soon.

To understand the increasing popularity of large § 363 sales, one must understand their principal benefits. First, a debtor may have sufficient capital to operate for only a short time or a lender may decide that it will provide a debtor with some short-term financing but no long-term capital (lenders have recently been unwilling to extend financing to debtors whose ability to restructure successfully is in question). The promise of a § 363 sale may satisfy the debtor's lenders.

Third, § 363(f) permits debtors to sell their assets "free and clear" of existing liens and interests. Combined with § 363(m), which essentially moots the ability to appeal a sale, these provisions provide a degree of finality to the sale that is very appealing to prospective purchasers. As discussed below, this benefit has come under some attack recently in at least one circuit.

Finally, § 363 also provides the opportunity to easily assign favorable unexpired leases and executory contracts to the buyer. This allows the parties to maintain one of the signature benefits of the chapter 11 process without having to satisfy all of chapter 11's reorganization requirements.<sup>2</sup>

<sup>2</sup> As a condition to assuming executory contracts and unexpired leases, bankruptcy courts require the buyer to cure all defaults and provide adequate assurance of future performance. See 11 U.S.C. §§ 363(l), 365(b)(1)(A). The buyer may be unable to assume contracts where, under applicable nonbankruptcy law, the nondebtor party would be excused from accepting performance from an assignee. See 11 U.S.C. § 365(c)(1)(A).

<sup>1</sup> See, e.g., *In re Roth American Inc.*, 975 F.2d 949, 952-53 (3d Cir. 1992); *In re Crystal Apparel Inc.*, 207 B.R. 406, 409 (Bankr. S.D.N.Y. 1997).

Section 363 is not without its drawbacks (otherwise, there might not be any chapter 11 reorganizations). For instance, while the temptation exists to use the expedited § 363 process to alter creditor rights or provide releases beyond the typical provisions provided to a buyer of assets, such actions might lead to a court invalidating the sale as what has become known as a “*sub rosa* plan.” This is an important concept that arises in many cases where substantial debtor assets are sold.

Because Congress has provided a comprehensive scheme for altering rights and resolving claims in the chapter 11 process, courts are wary of any effort to “short circuit” the reorganization process by simply resorting to a § 363 sale. This was the main concern in *Pension Benefit Guaranty Corp. v. Braniff Airways Inc.*,<sup>3</sup> one of the earliest cases to wrestle with a § 363 sale of essentially all of a debtor’s assets. Braniff Airways, the debtor, sought approval of a sale that, among other things, would have transferred ownership of its cash, airplanes and terminal leases, significantly restructured the rights of its creditors and provided for profit participation in the new company. The court, in holding that this was essentially a back-door reorganization effort and denying approval of the sale, stated that “[i]n any future attempts to specify the terms whereby a reorganization plan is to be adopted, the parties and the district court must scale the hurdles erected in Chapter 11.”<sup>4</sup> This decision, as well as several that followed it, highlights that while a § 363 sale can be an incredibly useful tool, debtors should not seek to accomplish more than § 363 was rightfully intended. These decisions are discussed further below.

### **Bidding Procedures**

The first step of a § 363 sale is often for the debtor to identify a “stalking horse” bidder, which is the initial bidder who assumes the lead in establishing a floor price for the debtor’s assets. Besides establishing the floor price and ensuring that the assets will be sold, the stalking horse negotiates a form asset-purchase agreement, which can be shopped around to other potential bidders.

Where a stalking horse is not the successful bidder, the it will generally be entitled to a “break-up fee,” which is a specified amount to be paid to the stalk-

ing-horse in the event that the it is not the winning bidder. A bankruptcy court will apply either a “business judgment” test<sup>5</sup> or a “necessary to preserve the value of the estate” test<sup>6</sup> to determine whether to approve a proposed break-up fee. Under the former test, break-up fees are presumably valid, and the court simply asks whether there was a reasonable basis for the break-up fee and whether it was established in good faith and with due care. Under the latter test, by contrast, the court must find that the break-up fee actually benefited the estate by inducing or preserving the initial bid. Ordinarily, courts will approve a break-up fee that is between 2 and 4 percent of the proposed purchase price.<sup>7</sup>

Stalking-horse break-up fees, general sale procedures and other sale matters will be negotiated among the debtors and the stalking horse, and will be incorporated into a bidding-procedures motion and related proposed orders. The sale procedures will provide, among other things, the auction time and place, required notice of the auction, a deadline for qualified bidders to submit bids and a deadline for sale objections. The purpose of drafting the bidding procedures is to ensure a fair and competitive bidding process.

Once a stalking horse has been found and the bidding procedures have been approved by the court, qualified bidders are able to submit bids for the assets. A qualified bidder is a potential buyer who submits an irrevocable offer that is greater than the price proposed by the stalking horse. To place a bid, a qualified bidder must typically submit an asset-purchase agreement (assuming that the asset is of the type that requires such an agreement), which is usually a marked-up version of the stalking horse’s asset-purchase agreement. To minimize the occurrence of default by the winning bidder, a qualified bidder will often be asked to submit evidence of sufficient financing and possibly pay a good-faith deposit.

### **Auction and Final Approval**

In the event there is more than one qualified bidder for the debtor’s assets, an auction is held. The debtor selects what it considers to be the “highest and best” offer (generally with purchase price as the most important factor) and, in many cases, consults with the credi-

tors’ committee to determine a winner, then a final court hearing is held to approve the sale.

Clarity and disclosure of the bidding procedures is essential to ensure an orderly sale process that maximizes asset value. All interested bidders need to be informed as to the sale “currency” to be used and any limitations thereon. This lesson was on dramatic display in the *Polaroid* case<sup>8</sup> where the process opened with a stalking-horse bid of \$42 million. Two bidders each bid partially in cash and partially in equity in a reorganized Polaroid entity. However, although the reorganized entity was structured differently by each of the bidders, each point of equity was valued by the debtors (for bidding purposes anyway) at the same price. After numerous bids and following two instances where the debtor believed a winner had been selected, a final winner was declared by the debtor. This bid was valued by the debtors at just over \$88 million, which was \$600,000 more than the runner-up bid. At this point, the creditors’ committee announced to the bankruptcy court that it believed that the equity in the runner-up bidder was actually worth more than the difference in bids because the runner-up had created a more valuable reorganized Polaroid. In summary, the equity bid by each of the two bidders was believed to be a different currencies that had to be treated differently. The court, acknowledging that the committee members would be the future equityholders, listened to the committee’s view and declared the runner-up the winner. This remarkable series of events underscores how important it is that the bidding procedures set forward a clear and understood bidding process.

### **Recent § 363 Developments**

Although a detailed review of all the recent § 363 cases that might be of interest is beyond the scope of this article, a review of several of the most interesting cases of late is appropriate. We begin with the most controversial of these cases from the past two years.

In *Clear Channel Outdoor Inc. v. Knupfer (In re PW, LLC)*,<sup>9</sup> a senior lender credit-bid for its real estate collateral and a junior lienholder objected to the sale. The issue became whether a bankruptcy court could order a sale of assets free and clear of the liens of dissenting junior lienholders. The court approved the sale, and the case was appealed to the Ninth

<sup>3</sup> 700 F.2d 935 (5th Cir. 1983).

<sup>4</sup> *Id.* at 940.

<sup>5</sup> *In re Integrated Resources Inc.*, 147 B.R. 650 (S.D.N.Y. 1992).

<sup>6</sup> *In re Reliant Energy Channelview LP*, 594 F.3d 200, 206 (3d Cir. 2010).

<sup>7</sup> See Marshall Huebner and Rajesh James, “Duties and Obligations of Officers and Directors in § 363 Sales,” *Am. Bankr. Inst. J.*, December/January 2010, at 36.

<sup>8</sup> See *In re Polaroid*, No. 08-46617 (Bankr. D. Minn. 2008).

<sup>9</sup> 391 B.R. 25 (9th Cir. B.A.P. 2008).

Circuit Bankruptcy Appellate Panel (BAP). No stay of the effectiveness of the bankruptcy court's order was granted, and the sale was closed. Nonetheless, on appeal, the BAP found that (1) the closing of the sale did not moot the appeal under § 363(m), and (2) the bankruptcy court erred in stripping the junior lienholder of its lien under § 363(f). On the first issue, the court held that § 363(m)'s mootness applied to sales under § 363(a) and (b), but not to lien-stripping under § 363(f). On the second issue, the court reasoned that cramdown of the junior lienholder in a hypothetical plan scenario was not the type of proceeding to which § 363(f)(5) was applicable. Because the facts were not fully developed, the case was ultimately remanded to the lower court.<sup>10</sup>

The BAP's decision in *Clear Channel* has been seriously criticized by commentators. The more recent Sixth Circuit BAP case of *In re Nashville Senior Living LLC* rejected *Clear Channel* and adopted a more expansive view of mootness under § 363(m). The court referred to *Clear Channel*'s holding as "an aberration in well-settled bankruptcy jurisprudence."<sup>11</sup> However, *Clear Channel* still carries considerable weight in the Ninth Circuit and its reasoning will be considered by courts outside the Sixth Circuit. It certainly must be considered in the bringing a § 363 sale motion, at least outside the Sixth Circuit.

As noted, sale "currency" is often an issue in § 363 cases. Whereas the sale currency at issue in the *Polaroid* case was the form of equity, the currency at issue in two of the most written about cases of the past two years was the ability to use credit. In both *Pacific Lumber*<sup>12</sup> and *Philadelphia Newspaper*,<sup>13</sup> the respective courts raised the question of whether a pre-petition lender had an absolute right to credit-bid the face value of its pre-petition claim in an asset sale if the sale was accomplished as part of a reorganization plan under § 1129 (as compared to a sale pursuant to a § 363(k) process). Both courts answered "no" because the statute's clear language did not incorporate § 363(k) in all circumstances.<sup>14</sup> If you are involved in a case

where credit-bidding is possible, these cases must be considered.

Although the recent cases of *Lehman*, *Chrysler* and *General Motors* might lead one to question whether bankruptcy courts are being true to the spirit of *Braniff* and its progeny, a recent case from the Southern District of Texas proves that § 363 sales are not the proper tool for all situations. In *In re Gulf Coast Oil Corp.*,<sup>15</sup> the court refused to approve the final sale because the debtors did not demonstrate a "substantial business reason" for holding a § 363 sale rather than a sale under a liquidating chapter 11 plan. The court identified several factors that a bankruptcy judge should look for before approving a § 363 sale, including: (1) the necessity for a speedy resolution; (2) whether there is a business justification for a stand-alone § 363 sale; (3) the likelihood of competitive bids; (4) the type of protections the buyer is seeking; and (5) who is benefiting from the sale. The court reiterated the core holding of *Braniff*, explaining that a sale is "merely a transfer of assets for value, possibly including provisions for adequate protection," and that a sale risks invalidation if it goes further and attempts to affect creditors' rights in a significant way. In this case, because the debtors were trying to supplement the sale with both a release and the elimination of successor liability, the court decided that chapter 11 would have been the more appropriate vehicle for the debtors' liquidation. "Congress provided a process by which these benefits could be obtained," said the court, and it requires the bargaining, voting and court approval of a chapter 11 plan. ■

**Editor's Note:** For more detailed information on § 363 sales, purchase *A Comparison Shopping Guide for 363 Sales*, from the ABI bookstore at [bookstore.abi.org](http://bookstore.abi.org), and visit ABI's Asset Sales Databank website at [363.abi.org](http://363.abi.org).

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<sup>10</sup> For a more detailed analysis of *Clear Channel*, see Joel H. Levitin, et al., "Ninth Circuit BAP Dresses Down Lienstripping: Could This be the Last Dance for 363 Sales?," *Am. Bankr. Inst. J.*, October 2008, at 51.

<sup>11</sup> *Official Comm. of Unsecured Creditors v. Anderson Senior Living Prop. LLC (In re Nashville Senior Living LLC)*, 407 B.R. 222, 231 (6th Cir. B.A.P. 2009).

<sup>12</sup> *Bank of New York Trust Co. NA v. Official Unsecured Creditors' Committee (In re Pacific Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009).

<sup>13</sup> *In re Philadelphia Newspapers LLC*, 599 F.3d 298 (3d Cir. 2010).

<sup>14</sup> See Eric Anderson and Joshua Lewis, "The Philadelphia Story: Third Circuit Denies Lenders' Credit-Bid Rights," *Am. Bankr. Inst. J.*, May 2010, at 14, 61.

<sup>15</sup> 404 B.R. 407 (Bankr. S.D. Tex. 2009).