

Section 363 Issues—Acquiring Troubled Companies and Assets (Part 1)

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All section references are to the Bankruptcy Code (“Code”) unless otherwise indicated.

A. Introduction

1. In his article, *The Case Against Breakup Fees in Bankruptcy*, 66 Am. Bankr. L.J. 349 (1992), Bruce A. Markell cautioned that purchasing assets from a bankruptcy debtor was not like purchasing eggs at a supermarket. “Consumers pay posted prices for eggs without question because they know that shopping around or haggling with the grocer will not yield significant price reductions or quality increases.” *Id.* at 350. In contrast, no organized market exists to sell bankruptcy assets. Potential buyers cannot simply visit an adjoining supermarket to compare prices; instead they must often spend considerable time and resources to determine an appropriate bid for assets. And that’s just the beginning.

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2. The purchase of assets from a bankruptcy estate is subject to review and approval by the bankruptcy judge, after notice and hearing. After all, the judge has a duty to maximize the recovery on assets of the estate for the benefit of all parties in interest in the case. Thus, a potential buyer must always be concerned that its offer, even after receiving the blessing of the debtor, might not garner the approval of other bankruptcy constituencies, including the bankruptcy judge. Moreover, a buyer must worry that a new potential buyer will emerge, basing much of its pricing on the first bidder's due diligence and pending offer.
3. An additional concern for a potential asset buyer in a bankruptcy case is whether the sale of assets will be free and clear of claims, including potential tort liabilities. In this regard, section 363(f), which allows a purchaser to acquire assets free and clear of existing "interests" may provide a safe harbor for the purchaser. However, the protection of section 363(f) is not without limitation.
4. What protections and incentives can properly be provided to stimulate bidding on assets in a bankruptcy case? How can transactions be structured to best protect purchasers from unwanted successor liability? This outline explores these issues and provides insight into the most recent case developments. (An issue commonly associated with asset purchases is claims trading. For a review of claims trading issues, see Chaim J. Fortgang and Thomas Moers Mayer, *Trading Claims: Participations and Disputed Claims*, 15 *Cardozo L. Rev.* 733 (1993); Harold S. Novikoff, *Update on Recent Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, SE71 ALI-ABA Course of Study Materials: Chapter 11 Business Reorganizations (Volume 1) 197 (February 24, 2000).)

B. Sales of Assets

1. *Generally.* Section 363(b) requires court approval of transactions outside the debtor's ordinary course of business. A determination of what is in the ordinary course of business normally requires both a horizontal analysis and a vertical analysis. See *Medical Malpractice Ins. Ass'n v. Hirsch (In re Lavigne)*, 114 F.3d 379, 384-85 (2d Cir. 1997). A horizontal analysis compares the transaction in question to transactions that similarly situated businesses normally enter into. See *id.* The primary focus of the test then is external—examining the business vis-a-vis other businesses. See *In re Crystal Apparel, Inc.*, 220 B.R. 816, 831 (Bankr. S.D.N.Y. 1998). In contrast, under the vertical analysis, the debtor measures "ordinariness" by asking what a creditor would expect a normal oper-

ator in that business to do. See *In re Lavigne*, 114 F.3d at 384-85; *In re Crystal Apparel, Inc.*, 220 B.R. at 831. If the transaction is consistent with a creditor's assumed expectations, the transaction is "ordinary." See *In re Lavigne*, 114 F.3d at 384-85; *In re Crystal Apparel, Inc.*, 220 B.R. at 831. Two recent cases addressing this issue are *In re HMM Motor Services, Inc.*, 259 B.R. 440, 449 (Bankr. S.D. Ga. 2000) and *In re Honey Creek Entertainment, Inc.*, 246 B.R. 671, 689 (Bankr. E.D. Okla. 2000). By its terms, the statute allows the debtor, after notice and hearing, to sell substantial property of the estate outside the ordinary course of business. See *In re W.A. Mallory Co., Inc.*, 214 B.R. 834, 836 (Bankr. E.D. Va. 1997); but see *In re Lyons Transportation Lines, Inc.*, 123 B.R. 526, 533-35 (Bankr. W.D. Pa. 1991) (finding that substantial liquidation of assets can only take place in a chapter 7 filing). Parties in interest may object to a section 363(b) sale. The most common objections posed by creditors include concerns over the proposed purchase price; whether there is, or could be, a higher and better offer than the one for which approval is sought; or if the proposed price is too low.

- a. One of the first circuit cases to examine section 363 transactions is also considered the seminal case on the sale of assets. In *Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2d Cir. 1983), the debtor proposed to sell its most valuable asset—an 82 percent interest in a separate corporation that had not filed for bankruptcy—before it proposed a plan of reorganization. The bankruptcy court approved the sale and the district court affirmed. On appeal, the Second Circuit reversed, concluding that before a sale of assets outside the ordinary course of business could be approved, the bankruptcy court must be satisfied that a good business reason for authorizing the sale of assets had been demonstrated. "In fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike." *Id.* at 1071. The *Lionel* court found no justification for the proposed sale of substantial assets other than the appeasement of an anxious party.
- b. Although recognizing that bankruptcy judges should not be "shackled with unnecessarily rigid rules when exercising the undoubtedly broad administrative power granted him under the Code," *id.* at 1069, and that a "bankruptcy judge must have substantial freedom to tailor his orders to meet differing circumstances," *id.*; the Second Circuit went on to reject the view "that §363(b) grants the bankruptcy judge *carte blanche*" in all sale sit-

uations. Doing so, they explained, would obviate one of the primary purposes—adequate disclosure.

- c. Although the *Lionel* court stated that a “good business reason” for approval of a sale was all that was required, it listed several factors to be considered in each case:
 - i. The proportionate value of the asset being sold to the estate as a whole;
 - ii. How long the case had been pending and the likelihood that a plan of reorganization could be confirmed in the near future;
 - iii. The effect of the proposed sale on the ability to confirm a plan; and
 - iv. Whether the asset is increasing or decreasing in value. *Id.* at 1071.
- d. You could, of course, wonder whether such instructions were necessary when the business judgment rule presumptively suggests that the court is relying on the wisdom of the party making the decision, at least so long as the following elements are present:
 - i. A business decision;
 - ii. Disinterestedness;
 - iii. Due care;
 - iv. Good faith;
 - v. According to some authorities, no abuse of discretion or waste or corporate assets. *In re Integrated Resources Inc.*, 147 B.R. 650, 656 (S.D.N.Y. 1992) *appeal dismissed*, 3 F.3d 49 (2d Cir. 1993).
- e. In application, the *Lionel* approach—termed the “business judgment” approach—simply engrafted traditional non-bankruptcy, corporate requirements onto a bankruptcy framework. Despite criticisms for so doing, *see infra*, the approach has been widely adopted. *See, e.g., Licensing by Paolo, Inc., v. Sinatra (In re Gucci)*, 126 F.3d 380, 387 (2d Cir. 1997) (“A sale of a substantial part of a Chapter 11 estate other than in the ordinary course of business may be conducted if a good business reason exists to support it.”); *Bartel v. Shugrue (In re Ionosphere Clubs, Inc.)*, 184 B.R. 648, 653 (S.D.N.Y.

1995); *In re Allegheny Intern., Inc.*, 117 B.R. 171, 176-77 (W.D. Pa. 1990); *In re Engineering Products Co., Inc.*, 121 B.R. 246, 249 (Bankr. E.D. Wis. 1990); *In re Channel One Communication, Inc.*, 117 B.R. 493, 496 (Bankr. E.D. Mo. 1990) (“A debtor-in-possession may sell substantially all of its assets under 11 U.S.C. §363(b)(1) so long as the court can ‘expressly find from the evidence presented before [it] at the hearing a good business reason to grant such an application.’”). Note that in addition to satisfying the requirements of section 363(b), a proposed sale is also subject to the requirements of 11 U.S.C. §363(d) and (e). *Institutional Creditors of Continental Airlines v. Continental Airlines, Inc. (In re Continental Airlines, Inc.)*, 780 F.2d at 1223, 1226 (5th Cir. 1986); see also *In re Brileya*, 108 B.R. 444, 446 (Bankr. D. Vt. 1989). Section 363(d) limits the use, sale or lease of estate property “only to the extent not inconsistent with any relief granted under section 362(c), 362(d), 362(e) or 362(f).” Section 363(e) provides that on the request of an entity having an interest in property used or proposed to be used, “the court, with or without a hearing, shall prohibit or condition such use...as is necessary to provide adequate protection of such interest.” Adequate protection, in turn, as defined by 11 U.S.C. §361, may be cash payments, additional or replacement liens, or such other relief as to provide “the indubitable equivalent of such entity’s interest in such property.”

- f. In summary, the business judgment rule “is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” *In re Integrated Resources, Inc.*, 147 B.R. at 656 (citing cases).
2. *Sub Rosa Plans*. Some courts have expressed concerns over whether a sale of substantially all of the debtor’s assets can be accomplished by motion under section 363 or whether such a sale can only be accomplished pursuant to a plan of reorganization. Depending upon the structure of the proposed sale transaction, an objection may be raised that the sale constitutes an impermissible *sub rosa* plan of reorganization. Because so much time has passed, it hardly seems beneficial to review the case most frequently cited in connection with this sinisterly named practice the Fifth Circuit berated in *Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935 (5th Cir. 1983)—creation of a *sub rosa* plan. (“*Sub rosa*” is defined as “[c]onfidential; secret; not for publication.” *Black’s Law Dictionary*, p. 1441 (7th ed. 1999).)