THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 26 No. x xx, 2010

RECENT DEVELOPMENTS IN BANKRUPTCY CODE SECTION 363 SALES

The Chrysler, GM, and Lehman bankruptcies illustrate the trend to section 363 sales of substantial assets when there are exigent circumstances. Courts have cleared the way for such sales by rejecting sub rosa plan objections, permitting debtors to use incentives for stalking-horse bidders, and generally holding that debtors may sell assets free and clear of liens, claims, and other interests. Secured creditors may favor such sales because of their speed and efficiency, and because a claimant's right to credit bid for the assets is protected by section 363.

By Amy R. Wolf, Scott K. Charles, and Alexander B. Lees *

When a distressed company files for bankruptcy, a corporate acquisition often is seen as the best way to preserve the debtor's going-concern value. Such an acquisition can be accomplished either through a plan of reorganization or an auction. In contrast to the deliberate and time-consuming process of developing, soliciting votes for, and obtaining court approval of a plan of reorganization, an auction conducted under section 363 of the Bankruptcy Code — which authorizes a trustee or a debtor in possession to sell all or part of the estate's assets — generally is an expeditious process to sell property that is rapidly losing value. Because of this relatively attractive feature, asset sales have become common practice in large-scale corporate bankruptcies over the past 25 years. Some commentators have even argued that "[c]orporate reorganizations have all but disappeared" as a result of the ascendancy of section 363 sales.[1] And, as a Court of Appeals recently observed, the economic crisis of 2008 and 2009 appears to have accelerated this trend.[2] This article focuses on recent developments in the increasingly important area of section 363 sales.

OBTAINING COURT APPROVAL OF AN ASSET SALE

The Evolution of the Standard — from Lionel *to* General Motors

[1] Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751, 751 (2002) ("Giant

footnote continued from previous column…

corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use Chapter 11 merely to sell their assets and divide up the proceeds.").

[2] *See In re Chrysler LLC*, 576 F.3d 108, 113 (2d Cir. 2009) (discussing trend of section 363 sales replacing traditional chapter 11 reorganizations), *vacated as moot*, *Indiana State Police Pension Trust v. Chrysler LLC*, 130 S. Ct. 1015 (2009).

* *AMY R. WOLF is of counsel, SCOTT K. CHARLES is a partner, and ALEXANDER B. LEES is an associate at Wachtell, Lipton, Rosen & Katz. The authors' e-mail addresses are, respectively, ARWolf@wlrk.com, SKCharles@wlrk.com, and ABLees@wlrk.com.*

RSCR Publications LLC Published 12 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $650 per year in U.S., Canada, and Mexico; $695 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (866) 425-1171 or visit our Web site at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@hotmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 1051-1741.

Section 363 of the Bankruptcy Code authorizes a trustee or a debtor in possession to sell all or part of a debtor's assets. Asset sales that are within the ordinary course of business do not require approval of the bankruptcy court. Transactions that occur on a day-to-day or other routine basis, such as a retailer's sale of inventory to customers, usually are considered to be in the ordinary course of business. On the other hand, the sale of all or a significant portion of a debtor's assets, or an otherwise large or unusual transaction, will be considered a sale outside the ordinary course of business, requiring notice to interested parties and bankruptcy court approval under section 363(b)(1) of the Bankruptcy Code.

The standard for approval of outside-the-ordinary-course sales of assets in the chapter 11 setting was first addressed by the Second Circuit in *In re Lionel Corp.*[3] *Lionel* held that in order to approve sales of major assets outside a plan of reorganization, the bankruptcy court must be presented with evidence demonstrating that there is a "good business reason" for the proposed sale.[4] Under this standard, a bankruptcy court considers all salient factors, including the value of the assets to be sold in relation to the estate as a whole, the effect that disposing of the assets would have on the ability to confirm a plan of reorganization, and whether the value of the assets is increasing or decreasing.[5]

Generally, a chapter 11 debtor may obtain permission without difficulty to divest itself of business operations that are "non-core" or obsolete, even when the operations are profitable or not declining in value. A more difficult issue is presented when a chapter 11 debtor requests permission to sell one or more of its core operations, or all or substantially all of its assets. Inasmuch as the fundamental purpose of chapter 11 is to reorganize a debtor's business, proposed sales of assets that will leave few, if any, assets around which to reorganize historically have required a strong showing of a special need justifying a sale prior to and apart from the process of confirming a plan of reorganization.[6] In recent years, however, the scope of permissible sales of assets pursuant to section 363 has widened considerably.

The recent bankruptcies in the United States automotive industry present excellent examples of substantial asset sales being confirmed because of a perceived emergency. Both the Chrysler and the General Motors bankruptcies involved substantial asset sales arising in the context of rapidly declining going-concern value and the threat of evaporating financing opportunities. In the Chrysler case, the bankruptcy court approved the sale of substantially all of the debtors' assets, finding that such approval was "necessary to preserve some portion of the going-concern value of the Chrysler business and to maximize the value of the Debtors' estates."[7] Chrysler had suspended operations

[3] 722 F.2d 1063 (2d Cir. 1983).

[4] *Id.* at 1071.

[5] *Id.*

[6] *See, e.g.*, *In re Whitehall Jewelers Holdings, Inc.*, No. 08-11261 (KG), 2008 WL 2951974, at *6 (Bankr. D. Del. July 28, 2008) ("[W]hen a pre-confirmation [section] 363(b) sale is of all, or substantially all, of the Debtor's property, and is proposed during the beginning stages of the case, the sale transaction should be 'closely scrutinized, and the proponent bears a heightened burden of proving the elements necessary for authorization'") (citation omitted); *In re George Walsh Chevrolet, Inc.*, 118 B.R. 99, 101 (Bankr. E.D. Mo. 1990) ("A sale of substantially all of the Debtor's assets other than in the ordinary course of business and without the structure of a Chapter 11 Disclosure Statement and Plan . . . must be closely scrutinized and the proponent bears a heightened burden of proving the elements necessary for authorization."); *In re Indus. Valley Refrigeration & Air Conditioning Supplies, Inc.*, 77 B.R. 15, 17 (Bankr. E.D. Pa. 1987) (a sale of virtually all of the debtor's assets "can be permitted only when a good business reason for conducting a pre-confirmation sale is established and . . . the burden of proving the elements for approval of any sale out of the ordinary course of business — including provision of proper notice, adequacy of price, and 'good faith' — is heightened").

[7] *In re Chrysler LLC*, 405 B.R. 84, 96 (Bankr. S.D.N.Y. 2009). The bankruptcy court was affirmed by the Court of Appeals. *In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009). The Second Circuit's decision was vacated on the technical ground that the case became moot before the Supreme Court could hear an appeal. *Indiana State Police Pension Trust v. Chrysler LLC*, 130 S. Ct. 1015 (2009).

in order to conserve resources, but had done so "with a view towards ensuring that the facilities were prepared to resume normal production quickly after any sale," meaning that "[a]ny material delay would result in substantial costs."[8] Furthermore, the financing being offered by the government to fund Chrysler was contingent on a quick closing, and the purchaser of the assets had the option to withdraw its commitment if the sale were not closed within a few weeks.[9] Similarly, the bankruptcy court in the General Motors bankruptcy determined that "a good business reason" justified a sale of substantially all of the debtors' assets where General Motors had "no liquidity of its own and [a] need to quickly address consumer and fleet owner doubt," and where the U.S. Treasury's willingness to continue funding the company was contingent upon the approval of a section 363 sale within days.[10]

Yet another example of the increasing trend to authorize substantial sales of assets in exigent circumstances occurred in the Lehman Brothers bankruptcy. Lehman sold essentially all of its multibillion-dollar broker-dealer business to Barclays Capital less than a week after its September 15, 2008 chapter 11 filing. The sale was justified on the ground that the value of the business was rapidly eroding and no other suitor besides Barclays had appeared on the scene to help forestall the free fall.

The Vanishing Sub Rosa ***Plan Doctrine — from*** Braniff ***to*** General Motors

Although section 363 sales are often favored over reorganization plans due to their efficiency and rapidity, they are not without criticism. A particular concern is that a section 363 sale may allow one class of creditors to "strong-arm the debtor-in-possession, and bypass the requirements of Chapter 11 to cash out quickly at the expense of other stakeholders, in a proceeding that amounts to a reorganization in all but name, achieved by stealth and momentum."[11] That is, a sale outside the ordinary course of business, particularly one involving all or substantially all of a debtor's assets, can have a sufficient impact on creditors' rights as to constitute a "disguised plan of reorganization," approval of which would bypass the procedural and substantive safeguards of the traditional plan process. Because the Bankruptcy Code's requirements for confirmation of a plan are specially designed to ensure both the democratic participation by and fair treatment of creditors, a sale of assets under section 363(b), which does not impose such requirements, cannot serve as a substitute for a chapter 11 plan.[12] Accordingly, an element in the bankruptcy court's assessment of transactions outside the ordinary course of business is whether the transaction infringes upon creditor priorities and other protections afforded by the process required for confirmation of a chapter 11 plan. A sale will not be approved if it constitutes a so-called *sub rosa* (secret) chapter 11 plan.

The *sub rosa* plan doctrine was first articulated in *In re Braniff Airways, Inc.*[13] In *Braniff*, the debtor airline had entered into an agreement to sell certain of its landing slots, which constituted significant assets of its business. The sale agreement, among other things, required secured creditors to vote in favor of a future plan of reorganization, released the claims of all parties against the debtor, and dictated certain aspects of a future plan. The Fifth Circuit held that the proposed sale agreement attempted to fix the terms of a chapter 11 plan and thus could not be approved.[14]

After *Braniff*, *sub rosa* plan objections became ubiquitous in bankruptcy litigation. But such objections have rarely proved successful. Indeed, as the General Motors and Chrysler bankruptcies demonstrate, the *sub rosa* plan doctrine usually will not get in the way of the approval of a section 363 sale when the sale meets the *Lionel* standard and is perceived as necessary to preserve going-concern value. The bankruptcy court in the

---

[8] 405 B.R. at 96.

[9] *Id*. at 96-97.

[10] *In re Gen. Motors Corp.*, 407 B.R. 463, 491-92 (Bankr. S.D.N.Y. 2009). No appeal was taken from the *General Motors* decision.

[11] *In re Chrysler LLC*, 576 F.3d at 116 (citing *Motorola, Inc. v. Official Comm. of Unsecured Creditors and JPMorgan Chase Bank, N.A. (In re Iridium Operating LLC)*, 478 F.3d 452, 466 (2d Cir. 2007) ("The reason sub rosa plans are prohibited is based on a fear that a debtor-in-possession will enter into transactions that will, in effect, short circuit the requirements of

footnote continued from previous column…

Chapter 11 for confirmation of a reorganization plan." (internal quotation marks and alteration omitted)).

[12] Under the Bankruptcy Code, even where a sale of all assets is accomplished via a section 363 sale, a plan still is needed to distribute the proceeds from the sale to the appropriate stakeholder.

[13] 700 F.2d 935 (5th Cir. 1983).

[14] Other courts have referred to a *sub rosa* plan as a "creeping plan of reorganization" or a "*de facto* plan." *See, e.g.*, *In re Dow Corning Corp.*, 192 B.R. 415, 427-28 (Bankr. E.D. Mich. 1996); *In re Lion Capital Group*, 49 B.R. 163, 175 (Bankr. S.D.N.Y. 1985).

General Motors case approved the sale of substantially all of General Motors' assets over a *sub rosa* plan objection where the debtor was short on liquidity, desperately needed to maintain customer confidence, and required a sale to be approved quickly in order to continue receiving government bailout money.[15] According to the court, "it is hard to imagine circumstances that could more strongly justify an immediate 363 sale."[16]

Similarly, in the Chrysler bankruptcy, the Second Circuit observed the "apparent conflict between the expedient of § 363(b) sales and otherwise applicable features and safeguards of Chapter 11."[17] But the court went on to affirm the approval of substantially all of Chrysler's assets — again over a *sub rosa* plan objection — based primarily on evidence that Chrysler's going-concern value was declining rapidly. The court reached its conclusion with almost no discussion of whether the sale had the effect of evading the plan confirmation process, stating that a good business reason existed for the sale because Chrysler "fit the paradigm of the melting ice cube."[18]

STALKING-HORSE BIDDERS AND BREAK-UP FEES

To meet the criteria of section 363, courts generally require that a debtor conduct a robust public auction process under which all parties in interest, including all creditors, receive adequate notice of the auction, and the applicable deadlines and procedures. If there is a stalking-horse bid, stakeholders must first be given the opportunity to object to any deal-protection or bidding-incentive measures to be provided to the stalking horse. Such measures can include, among other things: (i) expense reimbursement provisions, pursuant to which the seller commits to reimburse the stalking horse for out-of-pocket costs of due diligence; (ii) break-up fee provisions, which require the seller to pay the stalking horse a certain amount if a competing bid is accepted; (iii) minimum overbid provisions, pursuant to which a competing bidder must exceed the stalking horse's bid by a designated amount; and (iv) terms-of-sale restrictions requiring competing bids to match certain non-price terms in the stalking-horse's bid, such as, for example, provisions regarding the extent of the assets included in the sale, treatment of management and other employees, and the timing and conditions of closing.

The break-up fee — sometimes described as "an incentive payment to a prospective purchaser with which a company fails to consummate a transaction"[19] — is perhaps the most frequently litigated bid protection measure. Generally, a seller agrees to provide a stalking horse with a break-up fee of a specified dollar amount or a percentage of the transaction value if the stalking-horse's bid attracts better offers and the seller consummates a sale to a higher bidder.[20] Bidding incentives like break-up fees serve at least three useful functions for a firm selling its assets: attracting or retaining an initial bid, establishing a bid minimum, and attracting additional bidders.[21] Although some courts have indicated that they will apply a more stringent standard of review to the use of bidding incentives in bankruptcy, the majority of courts permit debtors to use bidding incentives as long as the parties negotiate at arm's length and such incentives encourage, rather than chill, bidding for the assets.

In *In re O'Brien Environmental Energy*,[22] the Third Circuit took a different approach to break-up fees, mandating that the payment of a break-up fee would have to meet the standard of Bankruptcy Code section 503 — the provision that allows for the payment of post-petition administrative expenses where "the fees were actually necessary to preserve the value of the estate."[23] The *O'Brien* court found that awarding the stalking horse fees in that case was unnecessary to the preservation of the estate because the large difference between the stalking horse's original offer and the final price "strongly suggests that it was the prospect of purchasing [the debtor] cheaply, rather than the prospect of break-up fees or expenses that lured [the stalking horse] back into the bidding."[24] The court also determined the break-up fee to be unnecessary because the stalking horse could produce no evidence that its bid was a catalyst for further bidding, rather than simply a

[15] *In re Gen. Motors Corp.*, 407 B.R. at 491-92.

[16] *Id*. at 491.

[17] *In re Chrysler LLC*, 576 F.3d 108, 113 (2d Cir. 2009), *vacated as moot*, *Indiana State Police Pension Trust v. Chrysler LLC*, 130 S. Ct. 1015 (2009).

[18] *Id*. at 117-19.

[19] *In re Integrated Resources*, 147 B.R. 650, 653 (S.D.N.Y. 1992). Break-up fees also are known as termination fees because they represent compensation for the termination (or break up) of the relationship between a seller and a stalking horse.

[20] *See In re S.N.A. Nut Co.*, 186 B.R. 98, 101, 106 (Bankr. N.D. Ill. 1995).

[21] *In re Integrated Resources, Inc.*, 147 B.R. at 662.

[22] 181 F.3d 527 (3d Cir. 1999).

[23] *Id.* at 535.

[24] *Id.* at 537.

minimum bid. Finally, because the debtor gathered and provided to all bidders much of the information they needed to decide whether to bid, and the stalking horse had "strong financial incentives to undertake the cost of submitting a bid," the court found that reimbursement of expenses was unnecessary to preserve value for the estate.[25]

The Third Circuit's approach to break-up fees in *O'Brien* was reiterated recently in *In re Reliant Energy Channelview LP.*[26] In that case, Kelson Channelview LLC entered into an asset-purchase agreement providing for various bid protections, including a break-up fee, and requiring the debtors to seek court approval of such provisions. The bankruptcy court approved certain bid protections but rejected the break-up fee provision and declined to authorize the sale without a competitive auction. Kelson did not participate in the auction and was outbid. The Third Circuit, following *O'Brien*, concluded that the break-up fee was not necessary to preserve the value of the estate because Kelson's agreement was conditioned only on the debtors' seeking approval of the bid protections, not on the court's actual approval. The fact that Kelson made its bid without assurance that it would be paid a break-up fee "destroy[ed] Kelson's argument that the fee was needed to induce it to bid."[27] In addition, the court recognized that the break-up fee provision might have benefited the estate by preventing Kelson from abandoning the transaction, but agreed with the bankruptcy court that such a benefit was outweighed by the potential harm the break-up fee could do by chilling bidding, especially given evidence of another suitor willing to make a higher offer.[28]

PURCHASING ASSETS "FREE AND CLEAR"

When assets are sold in bankruptcy, interests in property — such as liens — do not necessarily attach to the assets post-sale. This is because section 363(f) of the Bankruptcy Code authorizes assets to be sold "free and clear of any interest" in the property.

Successor Liability and the Expansive Scope of "Interests in Property" — from TWA *to* Chrysler

The "free and clear" protection for a section 363 buyer applies only to holders of "interests." A minority of courts have read the word "interest" in section 363(f) as representing solely an *in rem* property right such as a security interest, to the exclusion of the general ability to seek a recovery from the debtor based on a contract or other legal right.[29] Most courts, however, have interpreted the term "interest in property" broadly to permit sales free not just of liens and secured claims, but also of other kinds of claims, such as general unsecured claims with a connection to the property being sold. *In re Trans World Airlines, Inc.*[30] is a leading case holding that the type of interest in property that may be extinguished through a section 363(f) sale should be read quite broadly. The court ruled that assets of the debtor can be sold free and clear of general unsecured claims attributable to the prior operation of those assets.[31]

The Second Circuit recently adopted this approach in the Chrysler bankruptcy. The debtor sought to sell assets free and clear of liability for product defects in vehicles it had produced pre-petition. A group of tort victims objected, arguing that personal injury claims are not "interests in property" subject to section 363(f). The Second Circuit acknowledged that it had "never addressed the scope of the language 'any interest in such property'" and that "the statute does not define the term," but went on to agree with the Third Circuit's holding in *Trans World Airlines* that it would be "inconsistent with the Bankruptcy Code's priority scheme" to allow tort claimants to assert successor liability against the purchaser of the debtor's assets "while limiting other creditors' recourse to the proceeds of the asset sale."[32] The court added that the exigent circumstances surrounding Chrysler's bankruptcy and the urgent need to approve a sale and preserve going-concern value bolstered the conclusion that a sale free and clear of successor liability claims was warranted: not only was "[t]he possibility of transferring assets free

[25] *Id.* at 537-38.

[26] 594 F.3d 200 (3d Cir. 2010).

[27] *Id*. at 207.

[28] *Id*. at 207-08.

[29] *See In re White Motor Credit Corp.*, 75 B.R. 944, 948-49 (Bankr. N.D. Ohio 1987) (section 363 solely bars assertion of secured claims against sold property because general unsecured claimants do not hold "interests," though bankruptcy court has wide equitable powers to cut off unsecured claims); *In re New England Fish Co.*, 19 B.R. 323, 326-28 (Bankr. W.D. Wash. 1982) (holding that unsecured claims do not constitute "interests" under section 363(f), but cutting off successor liability as inconsistent with the claims priority scheme outlined in the Bankruptcy Code).

[30] 322 F.3d 283 (3d Cir. 2003).

[31] *Id.* at 290-91 (no buyer liability for employment discrimination claims).

[32] *See In re Chrysler LLC*, 576 F.3d 108, 124, 126 (2d Cir. 2009) (quoting *Trans World Airlines*, 322 F.3d at 292).

and clear of existing tort liability . . . a critical inducement to the Sale," but also, "had appellants successfully blocked the Sale, they would have been unsecured creditors fighting for a share of extremely limited liquidation proceeds."[33] Notably, however, the Second Circuit's conclusion that section 363(f) permits asset sales free and clear of successor liability does not necessarily apply to tort claims that are unknown at the time of the sale. The court expressly "decline[d] to delineate the scope of the bankruptcy court's authority to extinguish future claims, until such time as we are presented with an actual claim for an injury that is caused by Old Chrysler, that occurs after the Sale, and that is cognizable under state successor liability law."[34]

The interpretation of section 363(f) adopted by the Third and Second Circuits enables assets to be cleansed of a broad spectrum of unsecured claims. A well-drafted sale order entered pursuant to this section can expressly protect a buyer from any liability for claims against the seller that the buyer has not agreed to assume.

The Power of Junior Lienholders to Block Sales Free and Clear of Their Interests — Clear Channel *and Its Aftermath*

Section 363(f) affords a sale "free and clear" status if any of five conditions is met. One such condition is enumerated in section 363(f)(5), which permits a sale free and clear of interests when an interestholder "could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[35] This subsection prevents recourse against a purchaser from unsecured claims that arose from the operation of the purchased assets. As to the effect of section 363(f)(5) on secured claims, the conventional wisdom had been that it permitted a sale over the objection of a secured creditor whose claim will not be paid in full by the purchase price whenever release of the security hypothetically could be compelled. This could occur in a foreclosure action by a lienholder senior to the objecting creditor, or in a "cramdown" by a debtor confirming a chapter 11 plan — a procedure under section 1129(b) of the Bankruptcy Code by which a debtor can force a reorganization plan upon a non-consenting class of claimants so long as the dissenting class is afforded certain protections.[36]

Some bankruptcy courts have endorsed the conventional view concerning section 363(f)(5).[37] A much-noted decision from a bankruptcy appellate panel in the Ninth Circuit, however, reached a contrary conclusion. In *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, the court rejected the notion that the possibility of cramdown satisfies section 363(f)(5), observing that to hold otherwise would be to "sanction[] the effect of cramdown without requiring any of § 1129(b)'s substantive and procedural protections."[38] It thus allowed a junior lienholder to block a free-and-clear sale where there was no showing that some legal or equitable proceeding existed that could compel the junior lienholder to accept less than full payment for its claim.[39]

The upshot of the *Clear Channel* decision is that a holder of an out-of-the-money security interest may effectively block any sale of its collateral under section 363. If followed, the decision could complicate section 363 sales of assets subject to underwater security interests, in some instances necessitating a resort to the chapter 11 plan process instead. That said, the principal case to date addressing *Clear Channel*'s interpretation of section 363(f)(5) suggests that courts — even those in the Ninth Circuit — still may be amenable to a more expansive reading of the statute. The bankruptcy court in *In re Jolan, Inc.*[40] stated that *Clear Channel* took a particularly narrow view of section 363(f)(5) because the parties in that case had not identified legal and equitable proceedings that would satisfy the provision's requirements, and because the court chose to limit its holding to the arguments presented by the parties.[41] The

[33] *Id.*

[34] *Id.* at 127.

[35] 11 U.S.C. § 363(f)(5).

[36] *See* George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 AM. BANKR. L.J. 235, 252 (2002); Robert M. Zinman, *Precision in Statutory Drafting: The* Qualitech *Quagmire and the Sad History of § 365(h) of the Bankruptcy Code*, 38 J. Marshall L. REV. 97, 138-39 (2004-2005).

[37] *See, e.g.*, *In re Gulf States Steel, Inc. of Ala.*, 285 B.R. 497, 508 (Bankr. N.D. Ala. 2002); *In re Healthco Int'l, Inc.*, 174 B.R. 174, 176 (Bankr. D. Mass. 1994); *In re Terrace Chalet Apartments, Ltd.*, 159 B.R. 821, 829 (N.D. Ill. 1993); *In re Hunt Energy Co.*, 48 B.R. 472, 485 (Bankr. N.D. Ohio 1985).

[38] *See Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25, 46 (B.A.P. 9th Cir. 2008).

[39] *See id.* at 42-46.

[40] 403 B.R. 866 (Bankr. W.D. Wash. 2009).

[41] *See id.* at 869.

Jolan court then identified numerous "legal and equitable proceedings [under applicable state law] in which a junior lienholder could be compelled to accept a money satisfaction."[42] It thus held that a trustee could auction property free and clear of all liens, notwithstanding that the proceeds might be insufficient to pay junior lienholders.[43]

Furthermore, notwithstanding *Clear Channel* and the possibility that it will be followed by other courts, junior lienholders in many instances will be foreclosed from challenging sales free and clear of their interests due to the operation of section 363(f)(2). Under that provision, a trustee or debtor in possession may sell property free and clear of all interests if the parties holding the interests consent to such treatment. It is common for an intercreditor agreement to provide for the junior creditors' consent in advance to such transactions, which should satisfy this section. In addition, where a credit agreement vests authority in a single agent to act on behalf of a group of lienholders, the agent's consent will bind even those individual lienholders that oppose the sale. This occurred in the Chrysler bankruptcy, where the relevant credit agreement and related documentation allowed an administrative agent to direct a collateral trustee — the actual holder of the lenders' liens — to consent to the sale of the debtors' assets free and clear of the lenders' liens upon a majority vote of the lenders. Where 92.5% of the outstanding principal amount of the loans under the credit agreement concurred with the sale, the dissenting parties were deemed to have consented to the sale as well for purposes of section 363(f)(2).[44]

CREDIT BIDDING

In a bankruptcy sale pursuant to section 363, as in a foreclosure sale governed by state law, secured creditors ordinarily may use their claims as consideration for a purchase of their collateral. Since the creditor is not bidding with cash, it may be able to bid more than a competing bidder that will be required to pay cash, providing the creditor with a substantial advantage in an auction. Additionally, of course, as the holder of the debt secured by the property, it benefits directly from any increase in the sale price if others bid cash in response to its credit bid.

[42] *Id*. at 869-70.

[43] *Id*. at 870.

[44] *See In re Chrysler LLC*, 405 B.R. 84, 101-03 (Bankr. S.D.N.Y. 2009), *aff'd*, 576 F.3d 108, 119-20 (2d Cir. 2009).

Collective Action — GWLS ***and Its Progeny***

Several recent cases have addressed the issue of how the right of credit bidding — expressly granted to secured creditors under section 363(k) of the Bankruptcy Code[45] — is affected when the relevant loan documents establish a collective action regime. Generally, courts have held that when a credit agreement authorizes an agent to act on behalf of a group of lenders, this includes the right to bid the debt of the lenders in a section 363 sale, even over the objection of a dissenting lender.

In *In re GWLS Holdings, Inc.*,[46] for example, the debtor sought to sell its assets in a section 363 sale, and the collateral agent for the first lien lenders sought to credit bid the entire amount owing to the lenders under the credit agreement. One lender, Grace Bay Holdings II, LLC, objected to the credit bid of its $1 million lien, pointing to contractual language prohibiting any "amendment" to or "waiver" of the credit agreement that "release[d] substantially all of the Collateral" without the consent of all first lien lenders.[47] The Bankruptcy Court for the District of Delaware rejected this argument, however, relying principally on language in the credit agreement granting the agent authority to exercise "all rights and remedies" of the lenders under applicable law. According to the court, the right to credit bid under section 363(k) fell within the ambit of this provision.[48] As another judge for the same court stated in a similar case, *In re Foamex International*: "it's a natural consequence of the authority given the agent in the credit agreement that it be able to do a 363(k) credit bid. . . . To read it any other way would . . . lead to chaos in 363 sales."[49]

A similar result was reached by the Bankruptcy Court for the Southern District of New York in *In re Metaldyne Corp.*[50] Relying both on *GWLS* and the Second Circuit's decision in *Chrylser* — which held that an agent could consent to the sale free and clear of a

[45] *See* 11 U.S.C. § 363(k) (holder of claim that is secured by property may bid at sale of property and offset such claim against the purchase price unless the court for cause orders otherwise).

[46] 2009 WL 453110 (Bankr. D. Del. Feb. 23, 2009).

[47] *Id.* at *2.

[48] *See id.* at *5-6.

[49] No. 09-10560 (Bankr. D. Del. May 26, 2009) (relying on *GWLS* in approving credit bid of administrative agent where minority group of debtholders under credit facility did not consent).

[50] 409 B.R. 671 (Bankr. S.D.N.Y. 2009)

group of lenders' liens — the court authorized the sale of substantially all of the debtor's assets pursuant to the credit bid of an agent for a consortium of lenders under a term loan facility. The court rejected the argument of a holder of less than 1% of the facility that each lender had the sole authority to control the bidding of its own claim where the loan documents gave the agent the right to "exercise any and all rights afforded to a secured party" under applicable law.[51]

The Debtor's Ability to Limit Credit Bidding in the Plan Context — Philadelphia Newspapers ***and*** Pacific Lumber

Whereas section 363(k) of the Bankruptcy Code expressly gives a secured creditor the right to credit bid in an asset sale, the right of credit bidding in the context of a chapter 11 plan is less certain. Two recent Court of Appeals decisions have ruled that, in contrast to a sale under section 363, credit bidding may not necessarily be required if a sale free and clear of a secured creditor's liens is effectuated under a reorganization plan. The context for both of these cases was a "cramdown" — the debtor sought confirmation of a plan of reorganization to which a class of creditors objected. Under section 1129(b)(2)(A) of the Bankruptcy Code, a plan may be crammed down on a dissenting class of secured claims when one of three requirements is met: (1) the claimants retain their liens on the collateral and receive deferred cash payments totaling at least the amount of their claims, (2) if the collateral is sold free and clear of the claimants' interests, the claimants are allowed to credit bid and their liens attach to the proceeds of the sale, or (3) the claimants realize the "indubitable equivalent" of their claims.[52]

In *In re Philadelphia Newspapers, LLC*,[53] the debtor sought approval of bidding procedures that specifically prohibited credit bidding by secured lenders. A divided panel of the Third Circuit, over a sharply worded dissent, held that even though section 1129(b)(2)(A) provides that a plan may be crammed down on a dissenting class of secured claims when the right to credit bid is preserved, it provides in the alternative that cramdown may occur when the secured claimants realize the "indubitable equivalent" of their claims. The court declined to hold that a secured creditor, as a matter of law, must be allowed to credit bid in order to receive the "indubitable equivalent" of its claim: "The auction of the Debtors' assets has not yet occurred. Other public bidders may choose to submit a cash bid for the assets. The value of the real property that the Lenders will receive, in addition to cash, under the terms of the proposed plan has not yet been established. And the secured claim itself has not yet been judicially valued . . . . We are simply not in a position at this stage to conclude, as a matter of law, that this auction cannot generate the indubitable equivalent of the Lenders' secured interest in the Debtors' assets."[54]

In *In re Pacific Lumber Co.*,[55] the Fifth Circuit similarly concluded that a plan under which a secured claimant's collateral was sold free and clear of the claimant's lien, but the claimant was not allowed to credit bid, was fair and equitable. In that case, the proceeds of the sale were sufficient to pay the claimant the full amount of the judicially determined value of its collateral (but not the full amount of the indebtedness), and the court concluded that this provided the creditor with the "indubitable equivalent" of its claim.[56]

In light of these two decisions, unsecured creditors may object to a proposed sale of significant assets under section 363 on the ground that such a transaction should instead be pursued through the chapter 11 plan process in which the right to credit bid can more readily be limited. It is not yet clear, however, whether other courts will follow the lead of the Third and Fifth Circuits.[57] Should other courts follow *Pacific Lumber*

---

[51] *Id.* at 676, 677-78.

[52] 11 U.S.C. § 1129(b)(2)(A)(i)-(iii).

[53] 599 F.3d 298 (3d Cir. 2010).

[54] *Id.* at 313.

[55] 584 F.3d 229 (5th Cir. 2009).

[56] *Id.* at 246-47.

[57] Indeed, both the majority and the dissent in *Philadelphia Newspapers* expressly indicated that the decision merely established that a plan providing for a sale of a secured creditor's collateral free and clear of the secured creditor's lien *could* be fair and equitable without allowing the secured creditor to credit bid, not that any particular plan actually *was* fair and equitable. 599 F.3d at 313 ("We approve the proposed bid procedures with full confidence that such analysis will be carefully and thoroughly conducted by the Bankruptcy Court during plan confirmation, when the appropriate information is available."); *see also id.* at 338 n.22 (Ambro, J., dissenting) ("I do not take the majority opinion to preclude the Bankruptcy Court from finding, as a factual matter, that the debtors' plan is a thinly veiled way for insiders to retain control of an insolvent company minus the debt burden the insiders incurred in the first place. Nor do I take the majority opinion to preclude the Bankruptcy Court from concluding, at the confirmation hearing, that the plan (and resulting proposed sale of assets free of liens and without credit bidding) does not meet the overarching 'fair and equitable' requirement."). Even

and *Philadelphia Newspapers*, secured creditors may be left with little option but to design mechanisms for making cash bids, the proceeds of which should be recycled back to them through their security interests in the proceeds of the sale.

On the other hand, the impact of *Pacific Lumber* and *Philadelphia Newspapers* may be greatly diminished by virtue of secured lenders' leverage in negotiations over the use of their collateral in bankruptcy. The Bankruptcy Code requires that there be "adequate protection" of a secured creditor's collateral when the debtor seeks to use or sell collateral securing a pre-petition debt, or when the debtor obtains post-petition credit secured by property of the estate.[58] In negotiating post-petition financings or the use of their pre-petition collateral, creditors can, and in fact have begun to, demand provisions expressly preserving their right to credit bid in asset sales.■

footnote continued from previous page…

Philadelphia Newspapers, then, gives bankruptcy courts substantial leeway to determine that any particular plan providing for such a sale is not fair and equitable.

[58] 11 U.S.C. §§ 363(e), 364(d).