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What's Your Bid?

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I Can Use § 363 for That?!

When talking about a sale of the debtor's property pursuant to 11 U.S.C. § 363, several things may come to mind — maybe a public auction of a tangible piece of property in the debtor's bankruptcy estate, such as equipment or real estate, or maybe a sale of the debtor's business as a going concern. However, when assessing a chapter 11 debtor's restructuring options, debtor's counsel can and should take a broad view of § 363 beyond its more traditional applications. Private sales and sales of property free and clear of non-debtor interests other than *in rem* liens offer two less common uses for § 363. Between § 363 and sales pursuant to a confirmed reorganization plan under § 1129, the debtor and potential purchasers alike have a suite of options to accomplish a wide range of objectives in chapter 11.

Private Sales

The Federal Rules of Bankruptcy Procedure contemplate both public auctions and private sales under § 363.¹ Whether the debtor chooses to use a public auction or private sale is subject to the business-judgment rule.² For a private sale, the debtor must provide all interested parties with adequate notice of the plan to sell, the sale price must be fair and reasonable, and the purchaser must act in good faith.³

Generally, a private sale will be quicker and cheaper than a public auction. Parties to the sale can negotiate terms prior to the bankruptcy filing, and while private sales are still subject to bankruptcy

court approval and require notice and a hearing, the debtor can avoid the time needed for a bid procedure hearing and time needed to conduct an auction, which results in lower professional fees.

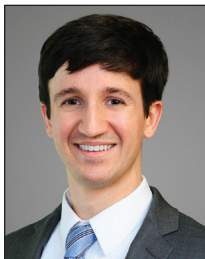
However, private sales also come with potential risks. Private sales are more fact-dependent than public auctions, and the debtor must demonstrate to the bankruptcy court that a private sale satisfies the business-judgment rule.⁴ A bankruptcy court may be more inclined to probe into the fairness of the price fetched at a private sale as opposed to a public auction.

A private sale can also toggle to a public auction at any time, and vice versa.⁵ Unless debtor's counsel anticipates a potential pivot and prepares in advance for the transition to a public auction, the debtor may be forced to either start the public auction process from scratch, including seeking court approval of the sale and auction procedures upon notice and a hearing, or to conduct an auction without court-approved procedures. Thus, while a successfully completed private sale can offer appealing speed at a reduced cost, the sale can be delayed if it converts to a public auction, causing time and cost to increase, potentially dramatically.

Consider the following fact pattern: The debtor signs an asset-purchase agreement with a buyer on the eve of filing chapter 11 and files a private sale motion with its other first-day filings. Before the hearing on the debtor's motion to sell, a new bidder appears and offers more than the debtor would have received through the prearranged private sale. In light of the new bid, the debtor announces an auction, but the original proposed buyer returns with an offer higher than what the debtor would have received from the new bid conditioned on the debtor's cancellation of the auction. The debtor cancels the auction, but shortly afterwards the competing bidder offers



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1 Fed. R. Bankr. P. 6004(f) states that “[a]ll sales not in the ordinary course of business may be by private sale or by public auction.”

2 See *In re 160 Royal Palm LLC*, 600 B.R. 119, 128 (S.D. Fla.), *aff'd*, 785 F. App'x 829 (11th Cir. 2019) (“The use of a private sale, to take advantage of the offer ... was within the debtor's business judgment.”); *In re Bakalis*, 220 B.R. 525, 531-32 (Bankr. E.D.N.Y. 1998) (discussion of judicial use of iterations of business-judgment rule to evaluate trustee's sale recommendations); *In re Diplomat Const. Inc.*, 481 B.R. 215, 218 (Bankr. N.D. Ga. 2012) (same). There are some variations on this rule. For example, the Seventh Circuit has held that a sale of property of the bankruptcy estate is an exercise of fiduciary duty requiring an “articulated business justification.” *In re Schipper*, 933 F.2d 513, 515 (7th Cir. 1991).

3 See, e.g., *In re MF Global Inc.*, 467 B.R. 726, 730 (Bankr. S.D.N.Y. 2012).

4 See, e.g., *In re 160 Royal Palm LLC*, 600 B.R. at 128; *In re Bakalis*, 220 B.R. at 531-32; *In re Diplomat Const. Inc.*, 481 B.R. at 218-19.

5 See, e.g., *In re 160 Royal Palm LLC*, 600 B.R. at 128.

even more than the original buyer's latest increased offer, prompting the debtor to reopen the auction once more. The original buyer again makes a superior offer if the debtor cancels the auction. This cycle can continue over and over until a winning offer has finally been accepted and approved.

While this scenario illustrates one way that headaches can arise for the debtor and potential buyers in the context of a private § 363 sale, other traps lie in wait for the unwary. For example, private-sale purchasers risk losing any bid protections negotiated with the debtor, such as break-up fees, if such protections have not first been approved by the bankruptcy court and the private sale is ultimately called off or converted to public auction.

In *O'Brien Envtl. Energy Inc.*,⁶ a stalking-horse bidder entered into a contract to purchase substantially all of the debtor's assets pursuant to a private sale subject to bankruptcy court approval of a breakup fee.⁷ The bankruptcy court refused to approve the fee, in part because the proposed sale failed to satisfy the claims of some of the debtor's creditors, but allowed the stalking horse to return post-sale to apply for a break-up fee at the close of bidding.⁸ A public auction was held, and the stalking-horse bidder reentered the bidding for the debtor's assets, reserving the right to apply for a break-up fee in the event that it did not have the winning bid.⁹

When the stalking-horse bidder failed to submit the highest and best bid for the debtor's assets, it applied for a break-up fee and costs totaling more than \$4 million.¹⁰ The bankruptcy court denied the break-up fee request,¹¹ and on appeal, the Third Circuit affirmed, stating:

We recognize that [the stalking horse's] decision to return to the bidding may have been influenced by the Bankruptcy Court's expressed willingness to reserve the question of [break-up] fees [and expenses] for later determination. Nonetheless, when [the stalking horse] decided to reenter the bidding, it knew that it risked not receiving any breakup fees or expenses. Its decision to proceed in the face of this risk undercuts its current contention that it viewed the fees and expenses as necessary to make its continued involvement worthwhile.¹²

Thus, because private-sale purchasers generally will not have an opportunity to obtain bankruptcy court approval of a negotiated break-up fee prior to a sale hearing, particularly when the sale terms are negotiated on the eve of the debtor's bankruptcy filing, private-sale purchasers should remain aware of the risk that any negotiated break-up fee might not be honored by the bankruptcy court.

Interest-Stripping

In addition to offering the debtor significant freedom in choosing *how* to conduct a sale of property, § 363 also permits the debtor to sell many different types of property free and clear of a broad array of interests held by nondebtor

third parties. Specifically, § 363(f) permits the debtor to sell property "free and clear of *any interest* in such property of an entity other than the estate, only if" one of the following conditions is met:

- (1) applicable nonbankruptcy 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.

The First, Second, Third, Fourth, Seventh and Ninth Circuit Courts of Appeals have taken the position that the phrase "any interest" can be expanded beyond traditional *in rem* liens.¹³ Bankruptcy and district courts in other jurisdictions have also done so.¹⁴ Some notable, relatively recent expansions of interests that may be stripped off in a § 363 sale include the following: (1) workers' compensation experience rating given by a credit-rating agency used in underwriting decisions to determine insurance premiums;¹⁵ (2) unemployment tax contribution rating for determining amounts owed under the state's unemployment tax;¹⁶ and (3) assessments due under the Coal Industry Retiree Health Benefit Act.¹⁷

Plan Sales

Despite their noted efficiencies, § 363 sales have some limitations. If the debtor cannot satisfy the requirements of § 363, sales pursuant to a confirmed reorganization plan under § 1129 can be used to avoid certain § 363 formalities, requirements and limitations. While the debtor proceeding with a plan sale must still be cognizant of § 363 to ensure satisfaction of the "best interests of creditors" test of § 1129(a)(7) (which requires that each creditor that has not accepted a chapter 11 plan must receive no less than it would if the debtor's assets were liquidated in a chapter 7 case), the debtor can accomplish some sale objectives that are impossible under § 363. For example, through a plan sale, unlike a § 363 sale, the debtor may strip claims and defenses related to an interest in a consumer credit transaction.¹⁸ As is the case

13 See, e.g., *In re PBBPC Inc.*, 484 B.R. 860, 869 (B.A.P. 1st Cir. 2013) (Massachusetts Division of Unemployment tax-contribution rating); *In re Chrysler LLC*, 576 F.3d 108, 126 (2d Cir.) (product-liability claims), cert. granted, judgment vacated sub. nom., *Indiana State Police Pension Tr. v. Chrysler LLC*, 558 U.S. 1087 (2009); *In re Trans World Airlines Inc.*, 322 F.3d 283, 290 (3d Cir. 2003) (travel voucher and Equal Employment Opportunity Commission claims); *In re Leckie Smokeless Coal Co.*, 99 F.3d 573, 582 (4th Cir. 1996) (Coal Act benefit plans); *Precision Indus. Inc. v. Qualitech Steel SBQ LLC*, 327 F.3d 537, 545 (7th Cir. 2003) (lease of real property); *Matter of Spanish Peaks Holdings II LLC*, 872 F.3d 892, 900 (9th Cir. 2017) (lease of real property).

14 See, e.g., *In re K & D Indus. Servs. Holding Co. Inc.*, 602 B.R. 16, 27 (Bankr. E.D. Mich. 2019), *aff'd*, 850 F. App'x 966 (6th Cir. 2021), *aff'd*, 850 F. App'x 966 (6th Cir. 2021); *City of St. Petersburg v. Total Containment Inc.*, No. 06-20953-CIV, 2008 WL 11402030, at *6 (S.D. Fla. Nov. 4, 2008); *In re Polyurethane Foam Antitrust Litig.*, 86 F. Supp. 3d 769, 780-81 (N.D. Ohio 2015).

15 *In re ARSN Liquidating Corp.*, 2017 WL 279472 at *6 (Bankr. D.N.H. Jan. 20, 2017).

16 *In re PBBPC Inc.*, 484 B.R. at 869.

17 *United Mine Workers of Am. Combined Benefit Fund v. Walter Energy Inc.*, 551 B.R. 631, 642-44 (N.D. Ala. 2016).

18 See 11 U.S.C. § 363(o) ("Notwithstanding subsection (f), if a person purchases any interest in a consumer credit transaction ... and if such interest is purchased through a sale under this section, then such person shall remain subject to all claims and defenses that are related to such consumer credit transaction or such consumer credit contract, to the same extent as such person would be subject to such claims and defenses of the consumer had such interest been purchased at a sale not under this section." (emphasis added)); see also *In re Ditech Holding Corp.*, 606 B.R. 544, 591 (Bankr. S.D.N.Y. 2019) ("If a purchaser acquires an interest in a Consumer Creditor Agreement not under a section 363 sale, section 363(o) does not apply.").

6 *In re O'Brien Envtl. Energy Inc.*, 181 F.3d 527, 537 (3d Cir. 1999).

7 *Id.* at 529.

8 *Id.* at 529-30.

9 *Id.* at 530.

10 *Id.*

11 *Id.*

12 *Id.* at 537; see also *id.* at 537-38 ("The record thus adequately supports the conclusion that awarding breakup fees and expenses to [the stalking horse] was not actually necessary to preserve the value of [the debtor's] estate.") (citing 11 U.S.C. § 503(b)(1)(A)).

with a private § 363 sale, even if debtor's counsel is planning to hold a private plan sale, preparing to toggle to a public auction with a stalking-horse bidder is time well spent.

Conclusion

Well-designed private sales, when properly executed, can unlock value from estate property with efficiency and speed. Interest-stripping can be employed to remove more than just traditional *in rem* liens. A plan sale can achieve many of the same goals as a § 363 sale without strict adherence to § 363's requirements. For a savvy bankruptcy practitioner, the use case for a § 363 sale (and plan sale) is broader than the bread-and-butter public auction, which can benefit the debtor and creditors alike. **abi**

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