Let's Make a Deal: Sales of Distressed Businesses in Insolvency Proceedings

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Introduction

I started practicing law in 1978, dealing primarily with corporate mergers and acquisitions. In the wake of the enactment of the U.S. Bankruptcy Code, I shifted my practice to insolvency counseling and, along with most of the bankruptcy and insolvency legal community, was routinely involved in reorganization cases resulting in the financial restructuring of various debtor enterprises. My practice has followed the evolution of reorganization practice nationwide, and I have come full circle. If asked today to describe how I spend the majority of my time, I would respond that I work in the distressed mergers and acquisitions arena, representing selling debtors, interested buyers, and lenders seeking to monetize their collateral. I expect my experience is similar to many, if not most, bankruptcy and insolvency attorneys around the country. Following are my thoughts about how and why we arrived at a world in which bankruptcy cases most often result in sales of distressed businesses as going concerns, and how the sale process is structured.

The Bankruptcy Code: Then and Now

For the first two decades following the 1978 enactment of the U.S. Bankruptcy Code, Chapter 11 cases often resolved in the way Congress intended when enacting the new code. 11 U.S.C. § 101, *et seq*. Debtors in financial distress sought the protection of Chapter 11 to give them time to negotiate with their secured and unsecured creditors. This process often resulted in a plan of reorganization, which, upon confirmation by the bankruptcy court, established a new contractual "deal" between the debtor and its constituent creditors. Although Section 363 of the code authorized a debtor to seek court authorization to sell assets out of the ordinary course of business, the section was used to sell individual assets. Courts were not routinely presented with requests to approve sales of substantially all of a debtor's assets. In fact, early cases under the code required the showing of an emergency, as the sale of substantially all of the debtor's assets without a plan was found to deny creditors the protections of Chapter 11. See e.g. *In re Lionel Corp*, 722 F.2d 1063 (2nd Cir. 1983); *In re White Motor Credit Corp.*, 14 B.R. 584 (Bankr. N.D. Ohio 1981). However, in the mid 1990s, the corporate insolvency landscape began to experience an accelerating transformation. Today, Chapter 11 as it is most often utilized is almost unrecognizable to the Bankruptcy Code's congressional authors. Instead of companies reorganizing under Chapter 11, creditors and debtors almost always employ Chapter 11 as a vehicle for the court-sanctioned sale of entire businesses as going concerns, leaving reorganizations as Congress envisioned only an infrequently used and mostly theoretical option.

Causes for the Shift to Section 363 Sales

There were a number of reasons for this dramatic change. First, with the economic boom of the 1990s, businesses took advantage of easy credit and borrowed heavily, often leveraging their assets beyond their value. If thereafter a business experienced distress, unlike early cases under the Bankruptcy Code, compromising unsecured debt was not an option because the secured creditors were often underwater and comprised a large, sometimes the largest, portion of the unsecured claims, giving them the legal power as both secured and unsecured creditors to block any plan of reorganization.

Perhaps more importantly, secured lenders used their early experiences with Chapter 11 cases to modify their tactics. They realized that Chapter 11 reorganizations were very expensive, being burdened by significant administrative expenses in the form of Chapter 11 professional and other costs that did nothing to fix the endemic problems of a troubled business. Additionally, the Bankruptcy Code gave a debtor reorganizing under Chapter 11 significant weapons, such as the threat of a "cram-down," to attempt to use against the secured lenders as part of the reorganization process. See 11 U.S.C. § 1129(b)(2)(A).

Lenders determined that they often could enhance their control of the case by carefully crafting a debtor-in-possession financing arrangement under Section 364 of the Bankruptcy Code, which was conditioned on the debtor's agreement to sell the business under Section 363 by a specific date. If there were no equity in the assets securing the lender's loan and the debtor's cash needs necessitated financing, an order from the bankruptcy court allowing it to use the lender's cash collateral would not provide sufficient cash to continue operations. Debtors in this circumstance frequently had few if any unencumbered assets, and were therefore unable to obtain court approval for a priming third-party loan. They were also unlikely to be able to find subordinate financing from third-party debtor-in-possession lenders. Consequently, they had few alternatives and in many cases were forced to accede to their existing lender's demands.

For lenders, inducing the debtor to promptly sell its assets under Section 363 avoided the requirement that the entire Chapter 11 case be funded. Additionally, a 363 sale provided the lenders with the opportunity to quickly sell assets in a court-supervised proceeding free and clear of liens, claims, and encumbrances, and still realize the premiums arising from the sale of a business as a going concern. Lenders thereby avoided the expense and delay of resorting to state law remedies, such as real estate foreclosure proceedings and sales under Article 9 of the Uniform Commercial Code. Finally, the court supervision of the sale insulated the transaction from subsequently being challenged as a fraudulent transfer. See 11 U.S.C. § 548; the Uniform Fraudulent Transfer Act, Wis. Stat., ch. 242.

The 363 Trend Becomes the Norm

Today, this trend has become the norm. The vast majority of Chapter 11 cases filed today result in the sale of the debtor's assets out of the ordinary course of business under Section 363 of the Bankruptcy Code. The sale proceeds are distributed after confirmation of a plan of liquidation or conversion of the case to a Chapter 7 liquidation. Even some of the nation's largest Chapter 11 cases, such as *Chrysler* and *GM*, have followed this path. See *In re Chrysler Motor Company*, No. 09-50002, 2009 WL 1357948 (Bankr. S.D.N.Y. May 4, 2009); *In re General Motors Corp.*, 407 B.R. 463, 474 (Bankr. S.D.N.Y. 2009). In states such as Wisconsin and Florida, assignments for the benefit of creditors' statutes offer even less expensive and more streamlined forums than Chapter 11 to sell businesses as going concerns. See Wis. Stat., ch. 128; Fla. Stat., ch. 727.

I am not quite prepared to write the final epitaph of "true" reorganizations under Chapter 11 of the Bankruptcy Code. However, given the current economic climate, I believe they will occur only infrequently. The world of distressed businesses we will most frequently inhabit in the near term is one in which bankruptcy or state receivership courts will be asked to approve sales of going concern businesses to the bidder offering the highest or otherwise best price. We will examine why the benefits of court-supervised distress sales usually make them preferable to out-of-court transactions, and dissect the sales process to see how the sales are often structured. Finally, we will explore the myriad of negotiating dynamics confronting the selling estate, its creditors, and the potential buyers that desire to acquire a going concern business at what may be a bargain price.

The Distressed Company Environment

"Going out of business sales," "bankruptcy," "financial distress," and the like are terms that describe a debtor that is financially wounded and therefore vulnerable to competitors and, perhaps, bargain-hunting purchasers. Because of the stigma associated with financial distress in a competitive marketplace, it seems almost axiomatic that a company offered for sale through a traditional non-distress sales process should fetch a higher price than one that is being sold under the pall of a court-supervised bankruptcy or insolvency proceeding. Why would a lender or debtor selling a company choose to use a process that would seem to drive the price down? Although the buyer may have the opportunity to acquire a business at a lower price in a court-supervised distress sale situation, the counterbalancing fear of the erosion of the customer base, the disruption of supply relationships, and the potential loss of key employees would seem almost always to militate in favor of a traditional sales process.

The Lender's View

From a lender's perspective, the fact that a company is in distress usually means it is cash-constrained. The debtor is probably past due in payments to its vendors and the subject of collection threats or lawsuits. Each dollar paid to insistent past-due trade vendors erodes the lender's collateral base, especially if the debtor is losing money from operations. If the debtor can be induced to file a bankruptcy proceeding, the automatic stay imposed by Section 362 of the Bankruptcy Code temporarily "stops the bleeding." Payments to trade and other unsecured creditors for pre-petition debts are suspended, and the lender's collateral is preserved.

In many situations, the lender and the debtor are at the end of a protracted period of credit agreement defaults and forbearance agreements. See

Peter C. Blain, *Forbearance Agreements Line by Line: A Detailed Look at Forbearance Agreements and How to Change Them to Meet Your Needs*, Aspatore Books (2009). The lender may be concerned that unless there is a process that is guaranteed to result in a closing, the owners could spend precious time and resources on a traditional sale process and then at the last moment refuse to close a transaction they decide garners an insufficient price.

Any out-of-court sale of a company in distress that results in certain creditors being unpaid is inherently burdened by the risk of angry second-guessing by those creditors post-closing. Unhappy unsecured creditors could complain that the process was flawed and did not produce fair consideration for the debtor, raising the specter of a post-closing fraudulent transfer claim. This is particularly a risk if the buyer insists on a "no-shop" provision in a letter of intent. These provisions, which are standard in non-distress sales, give a single buyer the exclusive opportunity to attempt to close a sale for a period of time without competition from other interested potential purchasers. No-shop clauses significantly circumscribe, or eliminate altogether, the marketing of the company, and give disappointed trade creditors ammunition to argue that the sales price should have been higher.

Occasionally, the selling debtor's owners or its affiliates are the successful purchasers, a circumstance that almost always raises unsecured creditors' suspicions that the sale was somehow inappropriate. Under the Uniform Fraudulent Transfer Act, one of the "badges of fraud" is a transfer of assets to an insider of the debtor. See e.g. Wis. Stat.§ 242.04 (2)(a). The statute of limitations for fraudulent transfer claims is set by state law and is often four years or more, a long period for a lender to be at risk. See Wis. Stat. § 893.425. In contrast, an open sale process that is approved by a supervising court virtually insulates a transaction from post-closing attacks. Finally, the lenders may believe a bankruptcy court-supervised sale that is properly run will test the marketplace as widely as possible without being burdened by no-shop provisions. While the lender may accept a lower initial offer, it is wagering that employing a process that ensures aggressive marketing of the assets to as many strategic and financial buyers as possible, and that culminates in a successful auction, is the least risky means to produce the optimal price.

The Debtor's View

Although some businesses experience sudden distress, many debtors and lenders have engaged in a workout process for an extensive period of time. The turnaround everyone hoped for does not materialize. Nonetheless, given the cost of a bankruptcy proceeding and the likely negative impact on customers, suppliers, and employees, the decision to file for protection is one that is not made casually.

However, many businesses' balance sheets are burdened with secured indebtedness in amounts that exceed the value of the assets. This significantly reduces, or perhaps eliminates altogether, many of the tactical options that would otherwise be available. A business with this profile will likely be unable to reorganize by reducing or deferring its unsecured indebtedness, or by financing the reorganization process utilizing a debtor-in-possession lender.

The lender's insistence on a course of action that will result in the debtor's owners realizing little or nothing on their investment is difficult for them to accept. However, it may be the only feasible option available. In a closely held business, the owners, who may have personally guaranteed the lender's indebtedness, may be able to negotiate a release or compromise of the guaranties by agreeing to a sale. They also may be able to secure employment with the buyer. Less cynically, the owners may agree to a sale to permit the enterprise to which they have devoted a portion of their lives to continue as a profitable corporate citizen that continues employment for employees for whom they feel responsible.

The Buyer's View

An interested buyer will have competing goals and objectives. On the one hand, the buyer will want to limit the marketing of the target and the length of the sale process as much as possible to reduce competition and increase the chance that it will be the successful purchaser. This is best done by an out-of-court sale and the inclusion of a no-shop or exclusivity provision, usually in the letter of intent. However, often the process is being driven by a lender and the first time the target company is available is after the insolvency proceeding is filed.

More importantly, a target that is in financial distress is likely subject to significant creditor pressure. A buyer that is evaluating a target company before the filing of a court proceeding may be willing to risk competition for the asset in exchange for the benefit of an order from a court transferring the assets free and clear of all liens, claims, and encumbrances. If it is willing to bind itself to close as a "stalking horse" bidder, it is also able to receive other protections such as a break-up fee or expense reimbursement, as discussed below. Given the usual tangle of creditor issues, it is not uncommon for a buyer to agree to compete for the purchase of the target's assets *only if* there is a court proceeding to insulate it from trailing claims. The order approving the sale brings finality to the transaction that is often determined to be more important than the inside track exclusivity can bring.

The Marketplace Today

Our country is currently facing an economic crisis without precedent. In late 2008, credit markets became frozen, and at this writing, they are only at the initial stages of a thaw. Greece, Spain, Portugal, and Italy are currently in various stages of economic distress, which is spilling over into the rest of the European Union and threatening to stifle the nascent recovery in the United States.

Compare the current situation with the economic landscape of just a few years ago within which credit was easy to obtain and companies experiencing financial distress had multiple refinance options if their existing lender became fatigued. If a refinance was not possible, countless venture capital firms with seemingly boundless available capital stood ready to vigorously compete for the limited purchase opportunities that existed. This almost always ensured robust bidding for those distressed companies that were offered for sale. While strategic purchasers almost always participated in the sales process, venture capital firms burning to employ their capital often priced strategic buyers out of the market.

The realities of present economic conditions stand in stark contrast. Today, sales of distressed companies in insolvency settings offer unique opportunities for strategic buyers with access to capital. Many of those same venture firms that only a few years ago were the rapacious purchasers of distressed enterprises are currently desperate sellers and are not looking for new buying opportunities. With the exit of venture firms and the resulting dramatic constriction of the pool of purchasers, purchase prices for distressed companies have plummeted. This is particularly true in industries hardest hit by the recession, such as automotive and housing, and for commercial real estate, especially condominium projects.

The lack of capital and the shrinking pool of potential buyers, especially financial buyers, have often forced lenders to choose among several unattractive alternatives. They could choose to sell at any price to exit the credit. Alternatively, they could consider offering financing to potential buyers, which requires the lender to stay in a distressed deal, albeit with a new debtor. Finally, they could choose to credit bid for the assets and hold them until market conditions improve. See the discussion below regarding recent decisions that call into question a secured creditor's right to credit bid. Because all regulated lenders are under extreme governmental scrutiny, the alternative ultimately selected may be forced upon them by their own economic circumstances. This is certainly a dramatic change from the financial world we inhabited only a few years ago.

The Distressed Enterprise Sale Process

Distressed sales in bankruptcy usually follow a pattern. The participants and the roles they play are the same from case to case, and the sale process employed is quite similar. In a typical bankruptcy sale, there is often a two-part marketing process, the first to select a stalking horse bidder and the second to market the assets in light of the stalking horse bid. The stalking horse bid and bid procedures are usually approved by the court after the stalking horse is selected and prior to the second marketing phase. This second period is usually followed by an auction, which in turn is followed by a hearing at which the court approves the winning bid and authorizes the debtor to close the transaction. This general framework is discussed in considerable detail below.

The Key Participants

In addition to the debtor and its senior secured lender, the other major participants in distress bankruptcy sales are typically a financial adviser retained by the debtor, the unsecured creditors' committee and perhaps its advisers, creditors with junior liens, and the stalking horse and other bidders. With some sales, environmental and engineering consultants also may play significant roles. Each player affects the sales process, and their respective actions will greatly affect the ultimate results. It is therefore important to understand the roles they play and the inter-party dynamics.

The Financial Adviser

Whether they call themselves investment bankers, crisis managers, workout specialists, or financial advisers (for convenience, we will call them "financial advisers"), these parties play a crucial role in defining the sales process and achieving the highest or otherwise best price for the assets. The retention of an experienced financial adviser, especially one knowledgeable in the target company's specific industry, greatly increases the prospect that the asset will be exposed to the proper segments of the marketplace. A knowledgeable and experienced financial adviser may be the difference between a highly successful sale and a disappointing one.

The debtor usually retains financial advisers as professional persons under Section 327 of the Bankruptcy Code. The elements of a financial adviser's compensation often include a minimum fee that is paid up front or periodically, recoupment of out-of-pocket costs and expenses, and a success component that is based upon the price ultimately received for the assets. Usually, much time and effort goes into the selection of the financial adviser, with various candidates competing for the engagement in "beauty contests," at which the adviser candidates extol their expertise, indicate their fee structures, and present extensive references and testimonials.

When a tentative selection is made, the selection process continues with the negotiation of the fee agreement, which will usually be attached to the motion to retain the consultant. Key provisions usually include the graduated increments by which the fee increases based upon the sale price and when the fee is due. The debtor and lender want the fee to be due upon a successful closing of a sale, while the financial adviser often wants a fee if it procures a ready, willing, and able buyer, even if a closing doesn't occur.

Once engaged, the financial adviser gets to work—creating a data room, (which is often electronic, accessible by password, and the access to which is monitored electronically), creating or enhancing their prospect database, and creating a "teaser" letter, which in a page or two describes the target. Simultaneously, they begin preparation of the "book"—a detailed sales memorandum that provides a full description of the target, including financial and competitive information about the target and its place in the industry. Debtor's counsel will usually review and approve of items placed in the data room to ensure accuracy and, where necessary, that necessary qualifications or disclaimers are included.

Together with the debtor's counsel, the financial adviser prepares a form of confidentiality agreement that must be executed by any interested party prior to its receiving the sales memorandum or gaining access to the data room, the target, or its employees. In many cases, the confidentiality agreement is extremely important, as major competitors may be among the interested buyers. The financial adviser will coordinate site visits by those interested parties that sign the confidentiality agreement, and will regularly report the status of the sales effort to the debtor, lender, and the creditors' committee. The financial adviser may also be tasked with financially qualifying prospective bidders. The financial adviser often runs the auction at the end of the sales effort and is almost always a key witness at the sale approval hearing. At that hearing, which is the culmination of the process, the financial adviser testifies regarding the extent of the sales effort, how the auction was conducted, and why the proposed purchaser has presented the highest or otherwise best offer.

Financial advisers can add significant value by "working the bidders." If they have industry expertise, financial advisers may have had past dealings with potential bidders and have built up credibility with them. Drawing upon these relationships, the advisers can induce prospective buyers, which may initially be lukewarm, to seriously compete to acquire the target. Financial advisers are often best positioned to knowledgeably inform bidders about a target's real or potential market strengths. If they possess industry expertise, financial advisers often can recognize and highlight strategic combinations that may make an asset uniquely valuable to certain bidders. This process is constant and continues throughout the sales effort, culminating at the auction itself.

The Stalking Horse Bidder

Among the first milestones of most sale processes is the identification of the stalking horse bidder. While some sales proceed as "naked auctions" with no stalking horse bids, these are relatively rare. A naked auction process is sometimes employed when there is such weak interest in the asset that a floor price acceptable to the secured lender cannot be negotiated. Consequently, the secured lender wants to preserve its right either to credit bid for the asset or, at least, withhold its consent to sell it. At the other end of the spectrum, if the interest in the asset is so robust that the parties are confident that the sale will be successful, the parties may want to avoid having to pay the break-up fee or expense reimbursement discussed below. Most sales fall somewhere in between, and the parties conclude that a stalking horse bid would be desirable. With the selection of a stalking horse bid, a floor is established for the sales price, a party is contractually committed to purchase the asset at that price, and the marketplace is informed that the asset will be sold.

For strategic reasons, some buyers decline to compete to be selected as the stalking horse. These parties prefer to watch how the sale dynamics unfold and keep their bidding strategy confidential. They may want to wait to see what the floor price will be before they expend significant time and resources pursuing a transaction, particularly if the deal is only one of several available opportunities. However, usually a number of interested parties vigorously seek to become the stalking horse because of the significant benefits that flow from that status.

Break-up Fees and Expense Reimbursement

Among the most significant benefits that accrue to the stalking horse is the ability to receive a break-up fee and/or reimbursement of expenses. A stalking horse bidder is required to expend significant resources to undertake a level of due diligence investigation sufficient to agree to be contractually bound to close if no higher or better offer is received. However, because of the competitive nature of the sales process, the purchaser has no assurance that it will be the winning bidder at its conclusion. The payment of a break-up fee ensures the stalking horse that it will be able to recoup its costs if does not make the successful bid. While during the process other bidders will undoubtedly conduct their own due diligence, often the work done and data compiled by the stalking horse is made available to them.

The concepts of a break-up fee and expense reimbursement are often used interchangeably, but they are in fact different. A true break-up fee is a fixed number paid if the stalking horse is not the successful bidder, without regard to the actual expenses incurred by the stalking horse. Expense reimbursement is the reimbursement of actual expenses the stalking horse can prove it expended in connection with the transaction. Some courts will approve a flat break-up fee, and most courts will approve expense reimbursement. While a court will rarely approve both a break-up fee and reimbursement of expenses, many buyers initially request that they receive both. Following is a provision from a stalking horse bidder's asset purchase agreement that provides for both a break-up fee and expense reimbursement:

> If Seller consummates an Alternative Transaction, then Seller agrees to pay to Purchaser upon the closing of any applicable Alternative Transaction an amount equal to the sum of: (i) $250,000 (the "Break-Up Fee"), plus (ii) an amount (the "Cost Reimbursement") equal to the lesser of (x) $250,000.00 or (y) the actual out-of-pocket expenses of Purchaser paid or payable to third parties, and which have not otherwise been reimbursed to Purchaser, any affiliate of Purchaser, or any assignee or designee thereof, with respect to (a) Purchaser's due diligence in connection with the Transaction, (b) Purchaser's reasonable legal fees and expenses incurred in connection with the Transaction, and (c) Purchaser's preparations for the Closing Date.

More often, courts will approve the lesser of an amount designated as a break-up fee or reimbursement of actual expenses supported by evidence submitted by the stalking horse bidder. Regarding amounts, break-up fees of between 3 and 5 percent have been found to be reasonable. See e.g. *In re Ray Realty Fulton* Inc., No. 1-09-41225, 2009 WL 2600760 (Bankr. E.D.N.Y. Aug. 21, 2009); *In re Metaldyne Corp.*, 409 B.R. 661 (Bankr. S.D.N.Y. 2009).

Recently, in *In re Reliant Energy Channelview L.P., et al.*, 594 F.3d. 200 (3d. Cir. 2010), the Third Circuit Court of Appeals acknowledged the usefulness of break-up fees in certain circumstances but refused to approve them when the court found they were not necessary to procure the first bid. The court observed that by the time the request to approve a break-up fee was made, the stalking horse bidder had already incurred the expenses requested to be reimbursed.

Break-up fees are very common in Section 363 sales, and almost always the stalking horse bidder will have incurred the costs of due diligence to enable it to make its bid before the motion to approve the bid and the break-up fee is filed. It will be interesting to see if this position will be followed in other jurisdictions. One important aspect the court did not address is the fact that in most cases, the stalking horse is legally bound to close if there is not a higher or otherwise better bid. This requires the stalking horse bidder to reserve capital or financing for the duration of the sale process to be able to close the transaction if successful. To have the certainty of a buyer with sufficient committed capital or financing to close the transaction has significant value and is often worth a break-up fee, especially if the debtor is hemorrhaging cash due to operational losses.

Influence Over the Process: The Asset Purchase Agreement

Another significant benefit available to the stalking horse bidder is the ability to influence the sale process. This is usually done in several ways. By custom, the stalking horse bidder usually drafts the asset purchase agreement used in connection with the transaction. While the sale will almost always be "as is, where is," the asset purchase agreement often contains representations and warranties (which, while they will not survive the closing, can be a condition to closing); affirmative and negative covenants; provisions regarding termination and payment of the break-up fee; and other conditions to closing. More importantly, all other bidders usually are required to agree to a form of agreement substantially similar to the agreement executed by the stalking horse bidder. A stalking horse bidder that may be willing to assume various contracts or exclude certain assets may be able to craft an asset purchase agreement that gives it a competitive advantage over other buyers.

A normal condition included in the asset purchase agreement is that an order be entered by the court that approves its bid, the form of asset purchase agreement, the break-up fee, and the bid procedures to be utilized for the sale. A typical condition in an asset purchase agreement follows:

> As soon as reasonably possible after the Effective Date, Seller shall file the Procedures and Sale Motion with the Bankruptcy Court, together with required supporting papers and required notices, and shall take such action as reasonably necessary to request a hearing to approve the Bidding Procedures as soon as practicable after the Effective Date, but in no event more than fifteen (15) Business Days following the Effective Date. The Bidding Procedures shall be subject to Purchaser's reasonable approval and shall provide, among other things, that Seller may consider a bid (other than from Purchaser) at the Auction only if such bid (i) is from a Qualified Bidder, (ii) has a value greater than or equal to the sum of (A) the Purchase Price, (B) the Break-Up Fee, and (C) the Cost Reimbursement (collectively the "Overbid Amount"), and (iii) is not subject to financing, due diligence, authorization, or other contingencies. The Bidding Procedures shall also provide that Seller may consider bids in excess of the Overbid Amount only if such bids are increments of $50,000, and Purchaser shall be entitled to apply the Break-up Fee and Cost Reimbursement to any bid made by Purchaser in excess of the Purchase Price. Finally, the Bidding Procedures shall provide that any creditor of Seller entering a winning credit bid at the Auction shall pay the Break-up Fee and Reimbursement Costs to Purchaser within two (2) Business Days following the Auction.

Establishment of Bid Procedures

The bid procedures outlined in or attached to the motion to approve the stalking horse bid usually include terms that can be of significant benefit to the stalking horse, and are subject to the stalking horse's approval. There is almost always a required overbid amount by which any competing bidder must exceed the stalking horse bid to be a qualifying bid. This amount usually exceeds the break-up fee plus an additional amount, and if set high enough can be a disincentive for other bidders.

Additionally, the ability of the stalking horse to credit bid its break-up fee is also often included as part of the bid procedures. This concept recognizes that because the estate has to pay a break-up fee to a stalking horse if it is unsuccessful, the stalking horse's bid could actually be at a lower dollar amount but be of greater economic value to the estate than competing facially higher bid, and therefore be deemed to be an otherwise better bid. On the other hand, the other constituents may want to limit the credit bid of the break-up fee to the initial bid to ensure each subsequent bid increases the purchase price on an absolute basis. Many stalking horse bidders also negotiate to be relieved of the obligation to post a bid deposit, which is almost always required of other bidders to have them declared to be a "qualified bidder" permitted to participate in the sale process. Finally, the bid procedures may contain the manner in which the auction will be conducted, such as the order of bidding, which the stalking horse may attempt to craft to its advantage.

The Unsecured Creditors' Committee

In most Chapter 11 cases, a committee of the seven largest unsecured creditors willing to serve is appointed to represent the interests of the debtor's unsecured creditors. See 11 U.S.C. § 1102. If the sale proceeds are expected to be sufficient to pay the secured lender in full, the unsecured creditors' committee will have a very significant role in reviewing and approving the marketing effort and the bid and sale procedures, because the unsecured creditors will stand to directly benefit from a successful sale.

However, as indicated above, in many Section 363 sales today the secured lender's collateral has a value less than the total debt and there is no realistic expectation that any proceeds of sale will flow down to the unsecured creditors. Nonetheless, in many jurisdictions the committee and the U.S. trustee take the position that if a secured creditor desires to use the Chapter 11 process to sell a business as a going concern and thereby realize a greater return than could be obtained utilizing state law remedies, it should "carve out" or set aside an amount of the sale proceeds for the unsecured creditors. Without an agreed carve-out, the creditors' committee may try to create leverage by objecting to—from the lender's viewpoint, obstruct—the sale process by taking discovery, etc. Because the secured lender may be the largest secured and unsecured creditor in the case, it may view this tactic as a form of extortion. Nonetheless, depending on the jurisdiction, the court may be sympathetic to the committee's arguments. A secured lender will almost always carefully weigh the potential costs of an extensive delay in the sale process arising from a fight with the committee, particularly if the business is suffering operational losses, and may decide that negotiating the "tip" demanded by the committee is more cost-effective than engaging in protracted legal wrangling while the business further deteriorates.

There is authority that permits a lender to agree to pay a portion of the proceeds of sale to which it is entitled to a junior class without regard to the legal priorities that would normally have to be respected in a bankruptcy case. See *In re SPM Mfg. Corp.*, 984 F.2d 1305 (1st Cir. 1993). See also *In re MCorp Financia, Inc.*, 160 B.R. 941 (S. D. Tex. 1993); *In re World Health Alternative, Inc.*, 344 B.R. 291 (Bankr. D. Del. 2006); *In re DBSD N. Am. Inc.*, 419 B.R. 179 (Bankr. S.D.N.Y. 2009); *In re Avado Brands Inc.*, Case No. 07-11276 (MFW) (Bankr. D. Del. 2007). But see *In re Armstrong World Industries*, 320 B.R. 523 (D. Del. 2005) (wherein the court disapproved an automatic transfer of property distributed in a plan from one class to another); *In re Irdium Operating, LLC*, 478 F.3d 452 (2nd Cir. 2007) (wherein a gift was made in settlement of a claim dispute and the court found the property "gifted" was not the property of the gifting creditor).

The concept of a gift by a secured creditor has been imported into Section 363 sales, and motions to approve payments to junior secured lien or unsecured creditors have been approved. See Appendix H for an example of an agreement which creates a carve out for a junior lienor and unsecured creditors. This may be important if there are substantial tax claims or other priority claims that would otherwise take proceeds ahead of the unsecured creditors. By agreeing to a carve-out and the "gift" provisions, the secured lender tactically may be both avoiding an expensive fight with the creditors' committee and gaining an important ally to assist it in convincing the court that the sale process is in the best interests of the estate and most of its creditors.

Junior Secured Creditors

Another constituency that may have the ability to influence a Section 363 sale is a junior lien holder. Rights of creditors with interests in property are defined in Section 363(f), which provides:

> (f) 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 values 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.

11 U.S.C. § 363(f).

Sections 363(f) (3) and (5) of the Bankruptcy Code will most often apply in cases in which a creditor with a junior lien on the property to be sold objects to sale.

Cases Related to Junior Liens

Various courts interpreting Section 363(f) (3) have reached different conclusions regarding whether the "aggregate value of all liens on such property" means the face value of the liens or their economic value. See generally George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process,* 76 Am.Bankr.L.J. 235 (2002). The courts finding that the appropriate statutory interpretation is economic value have overruled objections by objecting junior lienors who are out of the money and who have no economic stake in the proceeds. See *In re Beker Ind. Corp.*, 63 B.R. 474 (Bankr. S.D.N.Y. 1986). However, critics point out that even in those circumstances, the property will be sold for an amount *equal* to the liens encumbering them, not *greater* than those liens, as the statute requires. See *In re Canonigo*, 276 B.R. 257, 264 (Bankr. S.D. Cal. 2002).

In those jurisdictions that hold that the section means the face value of liens, the inquiry shifts to Section 363(f) (5). See *In re Terrace Chalet Apartments Ltd.*, 159 B.R. 821 (N.D. Ill. 1993). These courts have relied upon the cram-down provisions of Section 1129(b) as a sufficient legal basis to compel the objecting junior lienor to accept a money satisfaction, which may be zero, for its interest. See Id. at 829.

Other courts have criticized using one section of the Bankruptcy Code to provide authority for actions under another section. Recently, the Ninth Circuit Bankruptcy Appellate Panel in *Clear Channel Outdoor Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (B.A.P. 9th Cir. 2008), overruled a bankruptcy court that relied upon Section 1129(b) to approve a sale over the objection of an under-secured junior lien holder. The Bankruptcy Appellate Panel imposed the objecting creditor's lien on the property post-sale. The reinstated lien became a lien senior to the interests of the senior secured party that purchased the property by a credit bid, and thereafter substantially improved it.

The *Clear Channel* decision was a surprise to many parties involved with Section 363 sales. The decision continues to dramatically affect sales around the country, particularly those in which the claim of the objecting junior lien holder is large. In the wake of this decision, title insurers are placing exceptions in title policies, and many senior lenders are unwilling to indemnify purchasers to ensure that the property is ultimately sold free and clear of liens, claims, and encumbrances. To facilitate a sale, first lien holders reluctantly agree to carve out a portion of the sale proceeds for the objecting junior lienor to buy their consent. In the case described in Appendix H, the junior lien holder had a $38 million claim, giving it substantial leverage in light of *Clear Channel.*

There are relatively few decisions that discuss *Clear Channel.* However, one recent, well-reasoned bankruptcy court decision, *In re Jolan Inc.*, 403 B.R. 866 (Bankr. W.D. Wash. 2009), points out that *Clear Channel* only addressed whether Section 1129(b) provided a sufficient legal or equitable proceeding required by Section 363(f)(5) to permit a sale over the objection of the lien holder, and concluded that it did not. The *Clear Channel* court did not address other types of proceedings, such as state law receivership or foreclosure proceedings, sales of personal property under Article 9 of the Uniform Commercial Code, or sales to satisfy tax liens. Any of these, said the court, may provide an adequate basis to overrule an objection. Id. at 869-70. However, until there is circuit court authority that resolves the issue, the *Clear Channel* decision will continue to be a concern.

One way for secured creditors to avoid the objections from out-of-the-money junior lien creditors is to insist at the time the loan is made that the junior creditor enter into an inter-creditor and subordination agreement that requires the junior creditor to consent to any sale under Section 363 to which the senior creditor consents. The American Bar Association has recently published a model inter-creditor agreement that includes this provision. See Commercial Finance Committee, American Bar Association Section of Business Law, *Report of the Model First Lien/Second Lien Inter-creditor Agreement Task Force,* 65 Bus. Law. 3 (2010).

The Distressed Enterprise Sale Process

After the selection of the stalking horse bid, the asset purchase agreement is finalized and the motion to approve the purchase agreement and bid procedures is prepared and filed with the court, accompanied by the form of the proposed order. The parties want to ensure that the manner in which the assets are marketed is approved in advance by the court. This includes the scope of and length of time of the marketing effort, and often the manner in which the sale is advertised. This is done to preclude later objections that the highest or otherwise best price was not obtained because the marketing effort was deemed in some way deficient.

The bid procedures also indicate who will conduct the auction, which party has the authority to determine which bid is the highest in any particular round, and which is the ultimate highest or otherwise best bid at the conclusion of the auction. These issues are the subject of considerable negotiation among the constituent parties. Often, a single party, usually the debtor or lender, is authorized to exercise this authority after consultation with the other parties in the case. The requirement of consultation facilitates the making of consensus decisions during the auction, which avoids disputes after the fact.

Following the court's approval of the stalking horse agreement and the bid procedures motion, the intensive marketing period commences. Non-stalking horse bidders undertake their financial and business due diligence investigation of the debtor and the assets, including site visits, analysis of the information in the data room, physical inspections, and environmental testing.

Buyers may also want to talk to employees and the debtor's key suppliers and customers, although this is usually very carefully managed to prevent a competitor from inappropriately interfering with the debtor's business relationships and thereby devaluing the assets. Competitors sometimes conduct due diligence without a real interest in purchasing the target, but rather to attempt to identify key employees, customers, or other confidential information. Although it is not realistic to exclude competitors from the diligence process, special care must be taken to prevent them from gaining information that would allow them to more effectively compete with the target once sold. Where this is a risk, the debtor's counsel may insist on being present during discussions with bidders who are direct competitors of the target.

It is during this period that an expert financial adviser has the opportunity to maximize the sale price for the assets by continuing discussions with the interested parties. By exploiting competitive relationships and highlighting strategic opportunities, the financial adviser "works" the buyers to try to make sure that as many as possible are fully informed and prepared to participate in the auction. The length of the marketing period varies and is dependent upon a number of factors, including the complexity of the assets being sold, the financial condition of the target (which may be deteriorating), and sometimes the seasonality of the target's business. These circumstances could dictate a process as long as six months, and as short as twenty days. However, most marketing periods range between thirty and ninety days.

The Sale and Auction

Occasionally, a motion is filed indicating that the estate intends to sell assets to a purchaser on particular terms unless a higher or otherwise better bid is received. No auction is scheduled, and no motion to approve bid procedures is filed. This usually happens in smaller cases or if the assets are deteriorating so rapidly that an extensive marketing period is not feasible. It also occurs when the initial price for the assets is so high that no higher or otherwise better offers are realistically expected.

Qualification of Bidders

Far more often, the process culminates in an auction attended by interested parties determined to be "qualified bidders." The requirements for qualification and entitlement to participate in the auction are generally defined in the bid procedures motion. Qualification generally entails satisfying the financial adviser or other party running the auction that the bidder has the financial ability to close if successful; depositing of cash or cash equivalents with the debtor or debtor's counsel, which can be in a significant amount; and submission of a marked-up asset purchase agreement that is substantially similar to the agreement executed by the stalking horse.

<u>Financial Sufficiency</u>

The determination of financial sufficiency is fact-intensive. A successful publically traded company may have to do no more than refer the adviser to its publically filed financial statements. A closely held bidder, on the other hand, may have to submit financial statements, give evidence of available cash resources, or provide commitments from lenders to support financial sufficiency. The obvious objective is to try to prevent a situation in which the successful bidder is unable to close the transaction.

<u>Bid Deposit</u>

The bid deposit posted by each qualified bidder is usually refundable only upon the terms of the bid procedures order. It is not uncommon for the amount of the deposit to be a percentage of the price offered by the stalking horse bidder. In most situations, the second highest or otherwise best bid is determined to be the "backup bid," and the backup bidder's deposit is retained until the winning bidder closes the transaction, at which time it is returned. If for any reason the winning bidder fails to close, the winning bidder's deposit is retained as partial damages for the breach, and the debtor is authorized to close with the backup bidder and apply its deposit to the purchase price. The deposits of the other bidders are returned promptly after the court approves the sale to the winning bidder.

Substantially Similar Asset Purchase Agreement

Typically, the third requirement for qualification is the submission of a mark-up of an asset purchase agreement that is substantially similar to the agreement executed by the stalking horse. While the agreement must be "substantially similar," it is common for there to be differences in each bidder's agreement that may prove to be important in the final evaluation of the bids. For example, an agreement that the purchaser will hire substantially all of the debtor's employees and thereby avoid a priming wage lien in a state like Wisconsin may cause a facially lower bid to be deemed better than a bid that excludes this provision. See Wis. Stat., ch. 109. This is because, considering the net economic impact on the estate, the lower bid may be better. Similarly, a bid made pursuant to an asset purchase agreement providing for the debtor's assumption and assignment to the bidder of a greater number of executory contracts may be deemed to be a better bid because it avoids the claims that will arise upon rejection of the contracts. See generally 11 U.S.C. § 365. Additionally, the bidder's agreement to pay cure costs in connection with the assumption and assignment of designated executory contracts will also cause an offer to be viewed more favorably than one that places this burden on the estate. See 11 U.S.C. § 365(b) (1).

Auction Rules

Most bid procedures orders permit the party conducting the auction to establish rules for the auction that are not inconsistent with the approved bid procedures. The auction rules address logistical issues relating to the conduct of the auction. For example, rules may provide that only the debtor, committee, and lender representatives, and qualified bidders and their respective advisers, may attend the auction. Members of the media are generally not permitted to attend. The rules may also specify whether the bidders must appear in person or may appear by telephone; that the auction will be conducted in rounds; establish the order of bidding; and the time within which a bidder must make a bid or pass during a specific round. The rules may also provide that the public portion of the auction proceedings be transcribed by a court reporter to ensure that a record is available for reference during the auction, and in the event that objections are later raised regarding the manner in which the auction was conducted.

The Auction

As long as it is consistent with the bid procedures approved by the court and the auction rules are employed, the auction itself can be conducted in different ways. Some auctions are open outcry, during which the bidders make their bids in the presence of all other bidders. More often, each bidder group will be sequestered in a separate room, and the party conducting the auction will shuttle among the rooms accepting additional bids. My experience suggests that the latter logistical dynamic most often produces the highest result, although there are many theories about which auction strategy is best.

The first bid above the stalking horse bid must be in the amount of the court-approved overbid, and subsequent bids are generally required to be in excess of the existing high bid by at least the minimum bid increment set forth in the bid procedures. Generally, bids made are irrevocable and must be unconditional. At the conclusion of each round, the debtor or other party conducting the auction and the constituent creditors confer and designate the highest bid made in that particular round, taking into account factors such as the credit bid of the break-up fee, payment of cure costs of assumed executory contracts, potential wage lien liability, etc. After they make their determination of the highest bid in the round, the bidders usually reconvene in a general session, and the party conducting the auction announces on the record the results of the bidding for the round. The rounds of bidding continue until no additional bids are received. At that point, the party conducting the auction, the debtor, and the constituent creditors determine and announce on the record the highest or otherwise best bid, which is declared to be the winning bid, and the next highest or otherwise best bid, which is declared to be the backup bid.

It is important to note that while many auction procedures speak in terms of the highest and best bid, the better practice is to use the concept of *highest or otherwise best bid.* There may be circumstances in which the provisions of the asset purchase agreement, regarding, for example, the hiring of substantially all employees and thereby avoiding a wage lien, the credit bid of a break-up fee, or the assumption of specific contracts, may cause the facially *highest* bid not to be the *best* bid.

The Conclusion of the Auction: When Is the Bidding Over?

This seems like a fairly straightforward question. Every auction in a court-supervised proceeding is followed by a hearing at which the court is asked to approve the sale for the highest or otherwise best bid made. However, bids are sometimes attempted to be made subsequent to the closing of the auction, and even at the hearing itself. This makes the above question a fairly complex one. In court-supervised distressed sales, there are two competing principles at issue. The first is to achieve the highest price for the bankruptcy estate, and the second is to ensure that the sales process has finality that encourages robust bidding. *Compare Precision Ind. Inc, v. Qualitech Steel SBQ Ltd.*, 327 F.3d. 537 (7th Cir. 2003) with *In re Chung King Inc.*, 753 F.2d 547 (7th Cir. 1985).

These two principles were addressed by the Seventh Circuit Court of Appeals in *Corporate Assets Inc. v. Paloian*, 368 F.3d 761 (7th Cir. 2004). The court reviewed an auction at the conclusion of which a party, Buyer One, was declared the winner. However, Buyer One was told that while the auction was likely final, Buyer One could not be given 100 percent assurances because the bid procedures approved by the court provided that the sale wasn't final until the court approved the sale.

After the closing of the auction but before the sale hearing, a second bidder, Buyer Two, made a higher bid, claiming that the fact that purchased equipment could be stored on the debtor's premises was announced only during the auction could not be communicated to its principals. In light of the higher bid, the debtor asked the bankruptcy court for authority to conduct a second auction. The court agreed, and at the second auction, Buyer One was again the highest bidder, but this time at a price $350,000 higher than Buyer One's bid in the first auction. The bankruptcy court approved the results of the second auction, and Buyer One appealed.

The appellate court addressed the two competing considerations of highest price and finality, and acknowledged that the court is required to walk a tightrope between them. However, in walking that tightrope, the definiteness of a bidder's expectations and the state of the sale process are very important factors to be considered. In *Paloian*, the bid procedures provided that the sale was not final until the bankruptcy court approved it. This, plus the fact that the confusion caused because new information about the ability of buyers to store the purchased assets was not available until during the auction, led the court to decline to follow those circuits that placed a greater emphasis on finality and predictability. See *In re Gil-Bern Industries, Inc.*, 526 F.2d 627 (1st Cir. 1975). The court also indicated that the bankruptcy court's discretion would have been greatly diminished if the results of the first auction had been approved. Had the bankruptcy court entered an order approving the sale, said the Seventh Circuit, a grossly inadequate sale price, fraud, or mistake would likely have to be present to justify reopening the process. *Paloian*, 368 F.3d. 761, citing *In re Food Barn Stores, Inc.*, 107 F.3d 558 (8th Cir. 1997).

The lessons of *Paloian* are several. First, the bid procedures should be drafted very carefully and specify that when the auction is declared closed, the bidding is over. While the sale will always be subject to court approval, the parties won't be able to claim they had the expectation that additional bidding was possible. The party conducting the auction should be very careful about what is said at the auction. Having a record to rely on is very helpful in turning back later challenges. The terms of the sale should not be changed at the auction. This leaves the stakeholders vulnerable to the claim that the playing field was not a level one, and that the process was unfairly flawed. Finally, the hearing to approve the sale should be held as soon after the auction as possible, as the legal standard to reopen the bidding becomes much higher once the sale is approved. Practically, I always try to schedule the auction in the beginning of the week and seek a date for the hearing to confirm the sale before an intervening weekend, if possible.

Sale Approval Hearing and Closing

Sales Approval Hearing

The assets have been marketed, bidders have been qualified, and one of them has been declared the winner of the auction. The penultimate step to a successful sale is the sale hearing. At the hearing, the evidence presented will most often describe the marketing and the auction process, indicate that the proposed buyer has no connection to the debtor (or describe in extensive detail what connections exist), show that the buyer is a good-faith purchaser, and demonstrate that the sale process was conducted in good faith, without collusion and in accordance with the approved bid procedures. The financial adviser's testimony about the marketing process and the conduct of the auction may be crucial in demonstrating to the court that the assets were adequately exposed to the marketplace and the bid selected as the winning bid was the highest or otherwise best.

At the sale hearing, the court will address any objections filed by disappointed bidders or creditors. If the sale has been properly conducted, the burden on the objecting party will be quite high and the sale will likely be approved over the objections raised. The court's finding that the buyer acted in good faith is very important, because if this finding is made, the sale cannot be overturned on appeal. See 11 U.S.C. § 363(m).

The Sale Approval Order

The provisions of the order approving the sale are very carefully crafted. In accordance with the provisions of the asset purchase agreement, the form and content of the order are usually subject to the buyer's approval. While every transaction is unique, almost every sale approval order will include a finding that the buyer acted in good faith consistent with the provisions of Section 363(m) of the Bankruptcy Code; that the assets are being conveyed free and clear of liens, claims, and encumbrances, with all such liens, claims, and encumbrances attaching to the proceeds of sale; and will approve the assumption by the debtor and the assignment to the buyer of those executory contracts designated by the buyer. See Appendix I for an example of a sale approval order.

The order approving the sale is automatically stayed for fourteen days under Bankruptcy Rule 6004, unless the court orders otherwise. See Fed. R. Bankr. P.§ 6004(h) (2010). On occasion, the parties will ask the court to waive this stay to allow the sale to close sooner. Objecting parties who have appeared at the sale hearing and have had their objections overruled have fourteen days to appeal the court's decision. See Fed. R. Bankr. P.§ 8002. The burden is on the appellant to seek a stay of the approval order pending appeal. The debtor and the buyer will almost always respond to a motion for stay pending appeal with a request that the court condition any stay on the appellant posting a *supersedeas* bond in a substantial amount. See Fed. R. Bankr. P § 8005. If a stay is not granted and the transaction closes, the appeal will likely be dismissed as moot. See *Hower v. Molding Systems Engineering Corp.*, 445 F.3d 935 (7th Cir. 2006); *In re Lloyd*, 37 F.3d 271 (7th Cir. 1994); *In re CGI Ind.*, 27 F. 3d 296 (7th Cir. 1994).

The Closing

After the approval of the sale by the court, the parties prepare to consummate the closing. This process is fairly similar to closings of asset sales in non-distressed situations, with a few notable exceptions. The cure amounts of contracts that the buyer has designated to be assumed and assigned to it may be an additional portion of the purchase price paid at closing or escrowed pending any litigation with counterparties to the contracts over the cure amounts due. Closing deliveries will usually include a certified copy of the sale approval order, trustee's or quit claim deeds for real estate (rather than warranty deeds), and "as is, where is" bills of sale for personal property conveyed. Real estate title insurance policies provided pursuant to the asset purchase agreement will also have bankruptcy-specific provisions.

From the sale proceeds paid at closing, the break-up fee and/or expense reimbursement due to any unsuccessful stalking horse bidder is paid, and amounts carved out by the secured lender for unsecured creditors or other parties are either paid or escrowed. It is also customary to escrow a portion of the purchase price for any post-closing "true up" of estimates of working capital assets following a count of inventory, work in process, and raw materials and verification of outstanding accounts receivable. Finally, after the closing, the bid deposit posted by the backup bidder is released.

Special Circumstances Related to Receivership Sales

The costs of reorganizing under Chapter 11 ranks high among the factors that cause lenders to utilize the Section 363 process as an alternative means of realizing on their collateral. However, Chapter 11 is a forum within which the U.S. trustee will form a creditors' committee that will retain advisers and most likely seek a carve-out. In every Chapter 11 case, there are statutorily required creditor meetings and numerous hearings, which, even if the business is sold promptly under Section 363, will add significantly to the transaction costs. Consequently, lenders dealing with debtors sustaining daily operational losses have a significant economic incentive to look for even less costly alternatives, especially if, as is often the case, the lenders are under-secured.

Differences between Jurisdictions

Illinois practitioners frequently sell businesses utilizing a common law assignment for the benefit of creditors. This process, which by practice is based upon the distribution and procedural framework of the Bankruptcy Code, is non-statutory and is not court-supervised. The buyer receives no order approving the sale and, consequently, there is no insulation of the seller from subsequent creditor claims that the sale constituted a fraudulent transfer. Other states, such as Wisconsin and Florida, have enacted statutes that create a court-supervised procedural scheme that is often the preferred method used to sell assets of a distressed enterprise on a going concern basis. See Wis. Stat., ch. 128; Fla. Stat., ch. 727.

Wisconsin's Chapter 128: Assignments for the Benefit of Creditors

Chapter 128 is a hybrid statute that contains aspects of both a Chapter 7 liquidation and a Chapter 11 reorganization under the Bankruptcy Code. The proceeding is court-supervised and results in the statutory liquidation of an enterprise for the benefit of creditors. Enterprises are frequently operated in the ordinary course until sold in whole or in part pursuant to a process very similar to a sale under Section 363.

A voluntary Chapter 128 commences with an assignment of the assets to an assignee selected by the debtor. Thereafter the assignee, who must be a resident of the state of Wisconsin, petitions the court to appoint him or her as a receiver. By practice (rather than by statute), the order granting the petition, which is often entered *ex parte*, includes a stay of any actions against the debtor or to collect a debt owed to the enterprise; a provision to allow the receiver to operate the enterprise in the ordinary course; and usually a provision to pay pre-petition wages and benefits. Other typical first-day motions, which are also usually entered *ex parte* subject to subsequent creditor objections, include motions for a financing order, an order to pay the pre-filing claims of critical vendors, and an order to approve a sale process. Any creditor may seek the appointment of a receiver of its choice on an involuntary basis if the enterprise is insolvent or if a judgment has been returned unsatisfied. Secured creditors occasionally seek this relief. Once a receiver is appointed in an involuntary proceeding, there is no difference between an involuntary proceeding and a voluntary proceeding.

While a Chapter 128 proceeding is similar to a federal bankruptcy proceeding, there are significant differences. For example, there is no provision permitting the assumption and assignment of executory contracts over the objections of a counterparty. In addition, the Chapter 128 court has no authority (other than full faith and credit) to enforce the stay against creditors taking action against assets located outside the borders of Wisconsin. U.S. Const., art. IV, § 1. There is also no statutory authority for the appointment of a creditors' committee. Finally, secured creditors cannot be forced to participate in the proceeding, but instead can seek to enforce their state law remedies against their collateral. See *Wis. Brick & Block Corp. v. Vogel*, 54 Wis. 2d 321, 195 N.W.2d 664 (Wis. 1972).

On the other hand, a Chapter 128 proceeding is considerably less expensive than a Chapter 11 proceeding, because there is no creditors' committee and there are significantly fewer administrative requirements. In fact, many cases are concluded with only hearings to approve bid procedures and to approve the sale itself. In addition, the absence of a creditors' committee means there is no request for a carve-out. Because the receiver is the legal title holder to the assets, the receiver is authorized by the court to convey the assets to the buyer. Secured creditors avoid taking title to real property, as they would if they purchased it by a credit bid at a foreclosure sale, and thereby avoid being in the chain of title for environmental and other purposes.

Because the process is court-supervised, secured creditors also are almost always inoculated from having to defend actions premised on the sale process being commercially unreasonable, or from allegations that the sale constituted a fraudulent transfer. These risks haunt lenders in private sales of personal property under the Uniform Commercial Code. A sale under Chapter 128 also avoids delays caused by Wisconsin's statutory foreclosure process and the debtor's right to redeem the property. See generally Wis. Stat., ch. 846. A typical Wisconsin commercial foreclosure action often takes seven to nine months if there are no contested issues. By comparison, a Chapter 128 sale can be closed within thirty to ninety days from the filing of the case, or sooner if an emergency can be demonstrated. Consequently, Chapter 128 is almost always seriously considered by secured creditors when evaluating alternative methods to dispose of their Wisconsin collateral.

State courts have concurrent jurisdiction with the federal bankruptcy courts and, occasionally, a creditor will file an involuntary petition for relief under the Bankruptcy Code (or the debtor will file a voluntary petition if the Chapter 128 was filed involuntarily). The typical response is to ask the bankruptcy court to abstain from asserting jurisdiction under Section 305 of the code, on the grounds that interests of creditors would not be best served by displacing a state court-appointed receiver. This argument is particularly forceful if time has elapsed between the appointment of the receiver and the involuntary bankruptcy petition, and if a sales process has commenced. While it is impossible to predict a result without specifics, the bankruptcy courts in the Eastern and Western Districts of Wisconsin have been persuaded to grant motions to abstain. See e.g. *In re Franchise Foods, Inc.*, No. 07-27597 (Bankr. E.D. WI. 2007).

While not applicable in every circumstance, Chapter 128 and similar statutes often prove to be the most cost-efficient and expeditious procedural vehicles to sell assets of distressed businesses. Sales by state court-appointed receivers achieve most of the benefits of a Chapter 11 sale process at fraction of the cost, while at the same time avoiding the risks to the lender of exercising Uniform Commercial Code or real estate mortgage foreclosure remedies. Practitioners considering the sale of a distressed enterprise should make it a practice to inquire whether there is an available state receivership statute, and discuss with local counsel whether such a remedy might in fact be the best of the available alternatives.

Philadelphia Newspapers: A Pivotal Case That May Alter Strategy

The Third Circuit Court of Appeals recently decided a case that could affect the strategy and tactics involved in the sale of distressed businesses. In *In re Philadelphia Newspapers LLC*, 599 F.3d 298 (3d Cir. 2010), the proposed bid procedures for the sale of substantially all of the assets of the *Philadelphia Inquirer* and the *Philadelphia Daily News* provided that all bids had to be in cash and that no credit bids were permitted. A stalking horse purchaser, which had an insider relationship with the debtor, bid just under $40 million for assets encumbered by more than $300 million of debt. The lenders opposed approval of the bid procedures, expressing their intention to credit bid. The bankruptcy court found that Section 1129(b) of the Bankruptcy Code incorporated a secured creditor's right to credit bid and refused to approve the procedures. The debtors appealed, and the district court reversed.

In upholding the district court, the Third Circuit majority acknowledged that for sales under Section 363, Section 363(k) gives a secured creditor the right to credit bid for the assets unless the court for cause orders otherwise. However, the court agreed with the district court's finding that the bankruptcy court erred in holding that this right to credit bid was necessarily required in every exercise of the cram-down provisions of Section 1129(b) in connection with plans of reorganization.

Section 1129(b) (2) (A) of the Bankruptcy Code provides that a plan can be confirmed over the objection of a secured creditor if:

> (A) With respect to a class of secured claims, the plan provides—
>
> (i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363 (k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause(i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims

11 U.S.C. § 1129(b)(2)(A).

The lenders strenuously argued that the right to credit bid had to be read to be part of the indubitable equivalent standard in Subsection (iii), because the process of credit bidding was the means to determine what constituted the value of, and therefore the indubitable equivalent of, their claim. "Indubitable equivalence" is a murky concept that originated in an opinion by Judge Learned Hand in *In re Murel Holding Corp.*, 75 F. 2d 941 (2d Cir. 1935), and has mystified bankruptcy practitioners for decades. The lenders relied heavily on a prior Third Circuit opinion in *In re SubMicron Systems Corp.*, 432 F.3d 448 (3rd Cir. 2006), where the court permitted an under-secured creditor to bid the entire face amount of its claim, recognizing that the credit bid thereupon becomes the value of the lender's security interest in the collateral.

The court disagreed, finding that as a matter of law, the provisions of Subsections (ii) and (iii) have to be read to provide independent bases of confirming a plan over a secured creditor's objection. Relying on a Fifth Circuit Court of Appeals decision, *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009), the court approved the bid procedures. However, the court failed to note that in *Pacific Lumber*, the assets were widely marketed over an extended period of time, allowing the Fifth Circuit to find that the stalking horse's bid was the indubitable equivalent treatment of the secured creditor's claim. *Pacific Lumber*, 584 F.3d at 248. However, significantly, the *Philadelphia Newspapers* court said that whether a sale pursuant to the bid procedures without the right to credit bid provided the secured creditors with the indubitable equivalent of their lien was a question that was not before it. *Philadelphia Newspapers*, 599 F.3d. at 313.

In a strong dissent, Judge Ambro explained that credit bidding permits a secured creditor to ensure its collateral will not be sold for a price lower than what the secured creditor believes it is worth. This is counterbalanced by a cash bidder's ability to outbid a low credit bid to ensure the secured creditor does not acquire the assets for less than a fair value. Id. at 320-321. Regarding cram-down, Judge Ambro read Section 1129 (b) to mean that rather than providing three distinct cram-down paths that are applicable in every plan, the treatment of the secured creditor's claim in the plan determines which of the three cram-down methods is applicable in that circumstance. Id. at 325-327. When the plan of reorganization contemplates a sale, only Subsection (ii), and not Subsection (iii), is relevant. In that circumstance, recognition of the right of a secured creditor to credit bid is required by Sections 1129(b) (2) (A) (ii) and 363(k).

In the wake of *Philadelphia Newspapers*, debtors and unsecured creditors may perceive that their leverage has significantly increased. If they are unable to agree upon what they consider is an adequate carve-out, for example, they could threaten to propose a plan based upon a sale of the business and deprive the secured creditor of its right to credit bid.

However, on reflection, the impact of the case may not prove to be that significant. First, the court specifically pointed out that it was only interpreting the requirements of Section 1129(b) (2) (A) as a matter of law. The issue of whether an auction conducted pursuant to the procedures excluding the right to credit bid could produce the indubitable equivalent as required by Section 1129(b)(2)(A)(iii) was not before it and not being decided. This would have to be decided by the bankruptcy court after the auction and during the plan confirmation process. In light of the *SubMicron* decision, it is unclear how the bankruptcy court (or the Third Circuit, for that matter) would actually rule if faced with the issue.

On a more practical level, assuming the secured creditor has an allowed claim that is senior in priority, while a credit bid would obviously be preferable from an administrative standpoint, nothing would preclude the lender from participating in a plan sale as a cash bidder knowing that the cash would "round trip" and come back to it as the senior lienor. This is exactly what the *Philadelphia Newspapers* lender group did, outbidding other cash buyers at the auction and essentially paying itself the $139 million purchase price. While it will be interesting to see how the legal issues relating to Section 1129 (b) (2) (A) will ultimately be addressed by the other circuits, given this practical outcome, this decision may have a less significant impact on distress sales than one might have originally thought.

Conclusion

Given the economic climate we are presently experiencing, financial distress will continue to be a frequent event in the life cycle of many businesses. Chapter 11 and occasionally state receivership proceedings will be utilized to provide orderly forums to address the debtor's financial issues. As stated at the outset, sales of businesses as going concerns under Section 363 of the Bankruptcy Code or a state law analog will be selected as the best alternative far more frequently than a costly and time-consuming reorganization proceeding or resorting to state law remedies. The acquisition process will most likely unfold along the lines discussed herein. Hopefully, most of these situations will result in the assets being sold on a going concern basis to an adequately capitalized purchasing entity that will preserve the debtor's franchise, continue employment for its employees, and permit the buyer to rehabilitate the target into a viable, productive, and profitable corporate citizen.

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