

CHAPTER 11 - 101 THE NUTS AND BOLTS OF CHAPTER 11 PRACTICE: A PRIMER

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Nonplan Sales of a Business

Editors' Note: *This is the sixteenth of 22 installments that are being published here, with permission from the American Bankruptcy Institute. The series, read consecutively, will give the reader a broad overview of the Chapter 11 bankruptcy process. The installments are chapters from a CD-Rom that is available for purchase for \$50 (\$20 to ABI members) through the ABI. For more information, you can call the ABI at (703) 739-0800 or go to www.abiworld.org. The authors welcome your comments and questions as well, and you may feel free to contact them. Jonathan Friedland is a member of the ABI Board of Directors as well as a member of NACM Oregon.*

Some believe that bankruptcy courts are fast becoming the forum of choice for sales of businesses, troubled or not. Whether this was part of the intent behind the enactment of Chapter 11, the practice is here to stay. In fact, some courts have adopted guidelines to supplement the Bankruptcy Code and Rules, on how such sales must be conducted. We have attached a sample set of guidelines as Appendix 16(b).

The bankruptcy sale process under § 363 may provide benefits that range from *res judicata* findings that the sale is not a fraudulent conveyance or otherwise improper or subject to later avoidance; that directors and officers of the debtor have acted in good faith and in an exercise of their reasonable business judgment, consistent with their fiduciary duties; and that the purchaser shall not be liable as a successor of the debtor under non-bankruptcy law. These benefits, coupled with a 10-day appeal period and both statutory mootness under § 363(m) and equitable mootness under case law, make a sale appeal difficult to prosecute successfully. Taken together, it is not hard to see why some view Chapter 11 as the ultimate mergers and acquisition statute.

The Bankruptcy Code provides two separate and distinct sets of provisions under which a bankruptcy debtor or trustee may sell property free and clear of claims or interests: (1) pursuant to a plan or (2) in a nonplan sale. First, §§ 1123(a)(5)(D) and 1141(c) govern sales made as part of a plan of reorganization confirmed after an extensive disclosure and hearing process as described in Chapter 14. Second, §§ 363(b) and 363(f) govern sales made prior to plan approval and impose only the Bankruptcy Code's minimal requirements for notice and a hearing.

In comparison to the plan confirmation process, the nonplan § 363(b) sale procedures require much less in the way of notice, disclosure, or opportunities for objectors and alternate bidders to actually be heard. That, coupled with the apparent willingness of courts to make many findings that are beneficial to the seller, the buyer, the insiders and the professionals in the case, provide a speedy, effective way to accomplish a sale.

Bankruptcy Code § 363(b) allows sales of property of the estate out of the ordinary course of business, and § 363(f) permits a trustee or DIP to sell property of the estate "free and clear" of liens or other interests in the property, if any one of five 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.

Thus, § 363 can be used to authorize a pre-plan sale free and clear of interests through a motion to sell. Absent an objection, and assuming that the pleadings provide an evidentiary basis to support the sale, there is not even a need for a hearing, although a hearing typically is held.

The term “interest”—the group of rights that an asset may be sold free and clear of—is not defined in the Bankruptcy Code. Further, courts have largely ignored the absence of the word “claims” in § 363(f) and, despite the absence of the word, somewhat routinely approve pre-plan sales free and clear of claims as being within the power to sell free and clear of interests.

A Chapter 11 debtor whose goal is a sale free and clear will generally proceed straight to a pre-plan sale before (if ever) engaging in the costly and time consuming process of proposing, confirming, and consummating a plan of reorganization. In fact, it is not uncommon for reorganization cases that began with a plan as the goal to end with a pre-plan sale after things bog down in the middle of the case. The plan process can consume too much time, generate too much expense, or fail to result in a feasible exit strategy for the debtor.

Further, under § 363(m), an appeal of a sale order will likely be rendered moot if the sale has been consummated, assuming that requisite findings of good faith were made and no stay of the order is granted prior to the closing. Obtaining a stay generally requires posting a bond which can prohibitively expensive. Bankruptcy Code § 363(m) provides:

The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section [which are implicated in any 363(f) sale] of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

Bankruptcy Code § 363(m) creates a race to close a transaction as soon after entry of the sale order as possible to prevent any stay from issuing and to moot potential appeals. Rule 6004(g) stays sale orders automatically for 10 days—which gives an objecting party time to seek a further stay while it appeals—but courts may, and often do, waive the 10-day stay in their sale approval order.

Findings of Fact and Conclusions of Law in § 363 Sale Orders

Bankruptcy courts commonly enter extensive findings of fact and conclusions of law supporting § 363(f) sale orders. These typically contain detailed provisions insulating the seller, the purchaser, their insiders and professionals from liability. In practice, these findings of fact and conclusions of law are drafted by the debtor’s and the purchaser’s counsel, which may include comments from others, such as the unsecured creditors committee. Despite the somewhat shaky foundation, the practice is widespread and generally accepted. The authority to make such findings is thought to reside in §§ 363(b) and (f) or to emanate from § 105(a), the “all writs” provision of the Bankruptcy Code.

Some less accommodating courts have recently examined the self-serving excesses of these kinds of sale-comfort orders and have found many of their provisions to be not only improper but also unenforceable and not entitled to preclusive effect in later proceedings if they were not expressly determined in the sale motion proceeding. *See, e.g., In re Automationsolutions Int’l, LLC*, 274 B.R. 527 (Bankr. N.D. Cal. 2002). The probable result of cases like *Automationsolutions* is the development of a new comfort provision in the sale order: a finding of fact that all findings and provisions of the order address matters that were necessarily determined in the sale. In any event, the practice of including these broad, insulating provisions in the sale order is likely to continue.

Although § 363(f) has been used to bar tort claims that arise post-sale from a product manufactured pre-sale or pre-petition, this practice is somewhat questionable. The most recent decisions seem to foreclose application of § 363(f) to so called “future”

tort claims by limiting the claims that can be barred on due process grounds.

Conclusion

The old bias in favor of reorganization by plan and against pre-plan sales of substantial portions of a debtor's assets has eroded over the years. This has led to the frequent use of Chapter 11 for pre-negotiated sales of business assets. The § 363 sale is quicker and cheaper than a plan. It also does not require a vote by creditors, and it may protect the buyer from, among other things, fraudulent conveyance risk, successor liability, and the debtor's insiders from breach of fiduciary duty and other claims.

Some counsel routinely advise purchasers of distressed businesses that the preferred method of acquisition is through a quick Chapter 11 case featuring a pre-negotiated asset purchase agreement and a pre-plan sale free and clear under § 363(f). Indeed, the best practice may be at least to advise clients of the potential benefits of this strategy. In a sense, the Bankruptcy Code is being used to resolve the problem that purchasers often have, in that they are unable to take comfort from the representations, warranties, covenants, and indemnities of the seller of a business, whether failing or not. A free-and-clear sale order with protections for all parties involved that is final and nonappealable, supported by the Bankruptcy and Supremacy Clauses of the United States Constitution, and entitled to full faith and credit in federal and state courts across the country is an effective tool that eliminates the need for the parties to negotiate a transactional mechanism to allocate risk between them.

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