2 approaches to the sale of assets in liquidating Chapter 11 cases

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Imagine this scenario: XYZ Company (Company) has been a long time customer of ABC Bank (Bank). The Company has an asset-based loan with the Bank and its borrowings are subject to a typical borrowing base formula. The Company's sales have deteriorated and it is in default of certain financial covenants contained in the loan documents with the Bank. The orderly liquidation value of the Company's assets (the Bank's collateral) is sufficient to pay the Bank off in full, but little or nothing will be left over to pay junior priority secured creditors and unsecured creditors. The Company markets its assets and finds a buyer. The buyer is interested in purchasing the Company's assets, but wants to protect itself against successor liability and fraudulent transfer claims. Consequently, the buyer is not willing to purchase the Company's assets through a secured party sale under Article 9 of the Uniform Commercial Code. In addition, the buyer is demanding that the sale occur under Chapter 11 of the Bankruptcy Code free and clear of liens and encumbrances. The Bank is concerned over the rapidly declining value of its collateral and the diminishing availability under the Company's borrowing base. A quick sale of the Company's assets will preserve the jobs of the Company's employees, the substantial majority of which will be hired by the buyer. In addition, a quick sale of the Company's assets will preserve the going concern value of the Company and will maximize the value of its assets. The Bank is willing to provide a debtor in possession financing facility to allow the Company to operate in Chapter 11, subject to a short sale timeline to close the sale of the Company's assets to the buyer.

2 approaches to the sale of assets in liquidating

Sale of Assets in a Chapter 11 Bankruptcy Case

A debtor may pursue a sale of its assets in two ways under Chapter 11 of the Bankruptcy Code.

1. The first procedural mechanism is under section 363(b) of the Bankruptcy Code, which permits the sale of assets pursuant to a motion filed with the court.
2. The second procedural mechanism is under section 1123(a)(5) of the Bankruptcy Code, which permits the sale of assets pursuant to a plan of reorganization/liquidation.

MOTION TO SELL ASSETS FREE AND CLEAR OF LIENS AND ENCUMBRANCES UNDER SECTION 363(B)

Under section 363(b)(1) of the Bankruptcy Code, "the trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." In approving the sale of assets outside the ordinary course of business and outside of a Chapter 11 plan pursuant to section 363 of the Bankruptcy Code, courts, including those in the Sixth Circuit, have adopted the "sound business purpose" test established by the Second Circuit in *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983). (See also *Stephens Industries, Inc. v. McClung*, 789 F.2d 386, 391 (6th Cir. 1986); *In re Nicole Energy Services, Inc.*, 385 B.R. 201, 230 (Bankr. S.D. Ohio 2008.)

Factors to be considered by the court include, but are not limited to:

- The proportionate value of the asset to the estate as a whole.
- The amount of elapsed time since the filing.
- The likelihood that a plan of reorganization will be proposed and confirmed in the near future.
- The effect of the proposed disposition on future plans of reorganization.
- The proceeds to be obtained from the disposition vis-à-vis any appraisals of the property.
- Whether the asset is increasing or decreasing in value.
- What is the benefit to the debtor's estate (is the proposed sale solely for the benefit of the debtor's secured lender)?

Before seeking approval of a transaction pursuant to section 363(b) of the Bankruptcy Code, a debtor must consider its fiduciary duties to all creditors and interest holders for the court to approve the proposed sale. In addition, the bankruptcy court must conclude, from the evidence, that the movant satisfied its fiduciary obligations and established a valid business justification to conduct the sale outside of a plan. Courts will also consider whether the fiduciaries that control the debtor are truly disinterested with regards to the sale – if the fiduciaries that control the debtor's decisions in connection with the sale will directly benefit from the sale, then the court must carefully consider whether it is appropriate to defer to their business judgment.

In order to sell assets free and clear of liens, claims, and encumbrances under section 363(b) of the Bankruptcy Code, the debtor must also establish through evidence that it meets one of the five requirements under section 363(f) of the Bankruptcy Code. Under section 363(f), a debtor can sell its property free and clear of interests if:

- Applicable non-bankruptcy law permits the sale of such property free and clear of such interest.
- The party asserting the lien, claim or interest consents to the sale.
- The interest is a lien and the purchase price for the property is greater than the aggregate amount of all liens on the property.

- The interest is subject to a bona fide dispute.
- Such entity could be compelled to accept a money satisfaction of such claim.

If the debtor is unable to satisfy one of these five requirements, the sale free and clear of liens and encumbrances will be denied.

If substantially all of the assets of a debtor can be sold under section 363(b), without prior confirmation of a Chapter 11 plan, then the sale can be accomplished much earlier in the Chapter 11 process, resulting in significantly lower legal and accounting fees, and a much quicker sale. This is the process favored by secured lenders to liquidate collateral through a Chapter 11 sale process.

SALE OF ASSETS IN A PLAN OF REORGANIZATION/LIQUIDATION UNDER SECTION 1123(A)(5)

The alternative to section 363 sales in Chapter 11 bankruptcy cases is the sale of assets in a plan of reorganization or plan of liquidation under sections 1123(a)(5)(D) and 1141(c) of the Bankruptcy Code. Section 1123(a), which governs the contents of a Chapter 11 plan states:

> "a plan shall- ... (5) provide adequate means for the plan's implementation, such as ... (D) sale of all or any part of the property of the estate, ..." section 1123(b) states: "a plan may - (4) provide for the sale of all or substantially all of the property of the estate, and distribution of the proceeds of such sale among holders of claims or interests. ..."

Factors to be considered in determining whether a sale should occur under the plan confirmation process versus a motion under section 363(b) of the Bankruptcy Code include:

- Does the estate have the liquidity to survive until confirmation of a plan?
- Will the sale opportunity still exist as of the time of plan confirmation?
- If not, how likely is it that there will be a satisfactory alternative sale opportunity, or a stand-alone plan alternative that is equally desirable (or better) for creditors?
- Is there a material risk that by deferring the sale, the patient will die on the operating table? (*In re General Motors Corp.*, 407 B.R. 463, 488 (Bankr. S.D.N.Y. 2009.)

Under section 1141(c) of the Bankruptcy Code, except as provided in subsections (d)(2) and (d)(3) of section 1141 and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor.

Balancing Speed vs. Disclosure and Plan Confirmation Requirements

In the 34 years since *Lionel*, section 363(b) asset sales have become common practice in large-scale corporate bankruptcies. Although debtors need flexibility and speed to preserve going concern value, certain courts have held that one or more classes of creditors should not be able to nullify Chapter 11's requirements and the protections afforded by the plan confirmation process. Section 363 sales are predicated upon a debtor's judgment to assess the exigency of the situation, but puts creditors at a disadvantage because they must act quickly, despite an informational disadvantage, to successfully object to a motion for sale. Once a court authorizes the sale, creditors have very limited opportunity for redress because mootness operates to protect good faith buyers and foreclose appeals. Sales in a plan entail lengthy confirmation processes, but are viewed as protecting creditors' rights and protecting the sanctity of the bankruptcy proceedings. The balancing of due process rights of creditors versus the "need for

speed" in concluding a sale process will be factors to be considered in the sale of assets in a liquidating Chapter 11 case.

Who "Pays the Freight" in a Liquidating Chapter 11 Case?

In addition to the sale timing and procedural issues set forth above, the question of who is responsible for funding the wind-down of the debtor's estate often is an issue that will need to be addressed in a liquidating Chapter 11. Certain courts have held that a secured lender needs to "pay the freight" of a liquidating Chapter 11 case in order to use the Chapter 11 process to liquidate its collateral. The term "pay the freight" may have different meanings depending on which court and judge you are in front of. Certain courts hold that a secured lender must agree to pay all administrative expenses incurred during the Chapter 11 case, including 503(b)(9) claims (claims for the value of goods received by the debtor within 20 days before the commencement of the bankruptcy case, which goods have been sold to the debtor in the ordinary course of the debtor's business), plus some distribution to unsecured creditors. Other courts have less stringent requirements in order for a debtor to use Chapter 11 of the Bankruptcy Code to sell its assets where the sale proceeds are insufficient to pay all administrative claims and make a distribution to unsecured creditors.

Conclusion

The *Lionel* factors must still be considered and addressed by debtors and secured lenders seeking the protections of Chapter 11 to sell a debtor's assets under section 363(b) of the Bankruptcy Code. *Lionel* provides unsecured creditors' committees and the Office of the United States Trustee leverage by which they can object to a quick sale outside of a plan in order to compel secured lenders to "pay the freight" of the Chapter 11 case.

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Team member bio