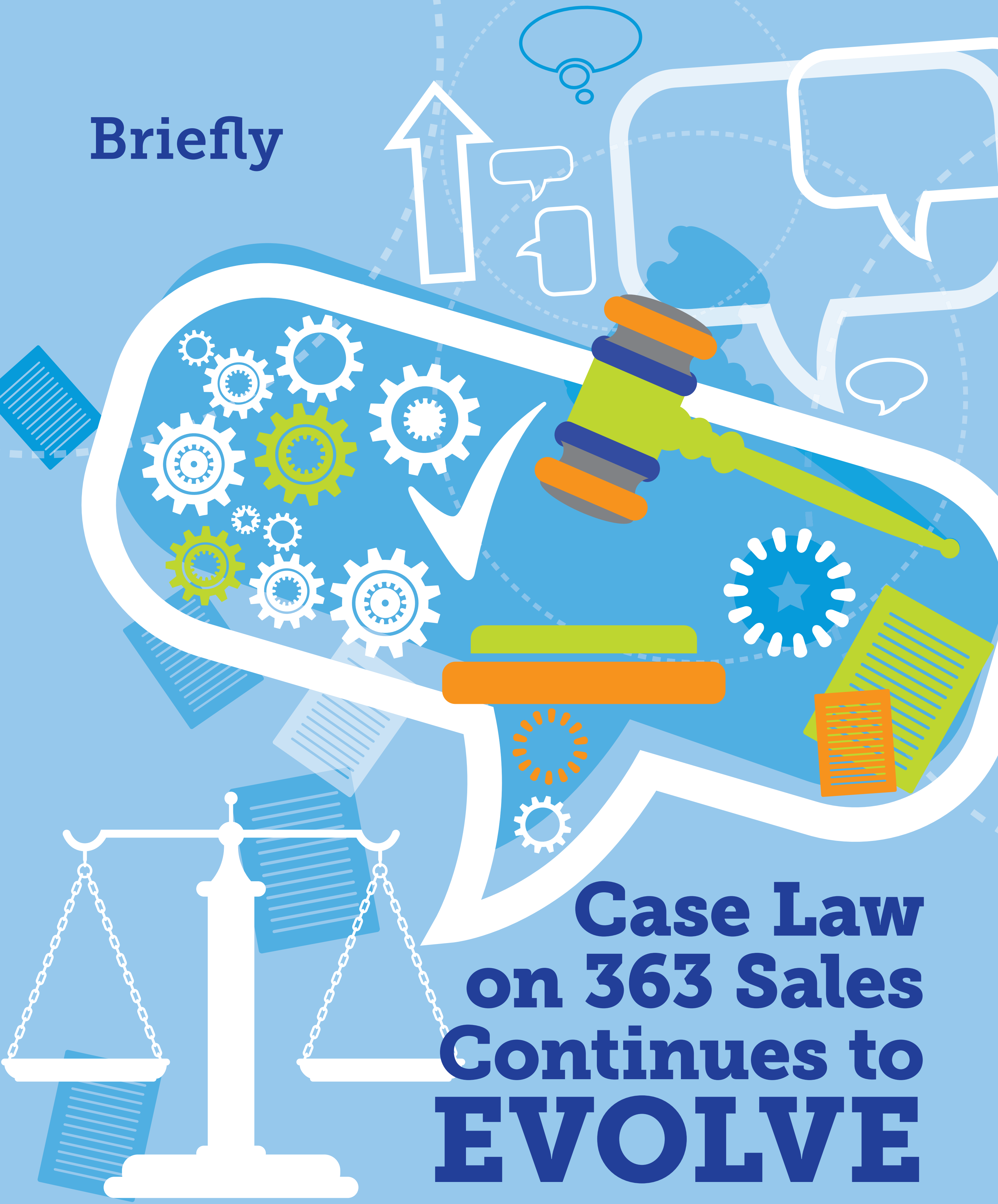
Briefly



Case Law on 363 Sales Continues to EVOLVE

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Over the past two decades, Chapter 11 has become the favored forum for the sale of distressed companies in the United States. Section 363 of the U.S. Bankruptcy Code is a strong tool for maximizing the value of struggling companies and providing predictability in distress sales.

Where there is much commercial activity, there is usually also much evolution in the law. The law surrounding 363 sales is no exception, and over the past several years, there have been a number of decisions that have significant implications for the outcome of distress sales.

Free and clear...of what?

One of the great advantages of 363 sales is that the Bankruptcy Code provides for sales to be free and clear of "interests" in the property being sold. Bankruptcy courts construe this language broadly to include most claims, encumbrances, and liens of creditors of the seller. There are a few standard exceptions, including unknown future product liability claims (*i.e.*, for injuries that have not yet occurred) and environmental claims. One of the constantly evolving areas of the law involves other categories of claims that may be able to pass through and be asserted by preexisting creditors against a buyer, including pension plan claims, covenants running with the land, and trademark rights.

Pension Plan Claims. One hot issue in recent years has been pension liability under the federal Employee Retirement Income Safety Act (ERISA). Sellers frequently owe obligations for underfunded pension obligations, and buyers may be unwilling to close an acquisition unless they can purchase free of these liabilities. In a recent decision, the Bankruptcy Court for the District of Delaware in *In re: Ormet Corp.*[1] found that a buyer can purchase free and clear of successor liability for underfunded pension obligations owed to a multi-employer pension plan.

In that case, the court found that the clear language of the Bankruptcy Code prevented the imposition of successor liability and approved the sale free and clear of the ERISA obligations. In its decision, the court noted that imposing successor liability on buyers for pension obligations would have the effect of rearranging the priority scheme in bankruptcy and, in addition, would drastically reduce the price of assets sold through bankruptcy. This appears to be a significant vindication of the 363 process, especially compared to non-bankruptcy sales.

In the 2011 case of *Einhorn v. M.L. Ruberton Constr. Co.*,[2] the 3rd U.S. Circuit Court of Appeals found that a buyer in a distress sale completed *outside of bankruptcy* is liable for underfunded multi-employer plan pension obligations.[3]

Covenants Running with the Land. Deed restrictions and covenants running with the land can be significant concerns for buyers in 363 sales, and the law is evolving on the issue of whether such sales can erase restrictions on land. In addition, the question of what constitutes a true restriction on land, such as a covenant running with the land as opposed to a simple contractual agreement between parties, can be a hotly litigated issue.

The 2013 decision by the 5th U.S. Circuit Court of Appeals in *In the Matter of Energytec, Inc.*[4] considered the question of land-related rights, analyzing whether an ongoing payment obligation arising as part of a pipeline sale was a covenant running with the land that would survive the 363 process. Interpreting Texas law, the court found that the obligation was a covenant running with the land. More importantly, however, that finding did not conclude the case. Instead, the court determined that the Bankruptcy Court needed to consider whether the holder of the payment rights could be forced to accept a monetary satisfaction, in which case the property could be sold free and clear of the interest under Section 363(f) regardless of whether it was a covenant running with the land.[5]

Other recent cases have addressed the issue of whether certain contract rights related to land may be rejected as executory contracts or found unenforceable under state law, which would also result in the property being eligible to be sold free and clear of such interests.[6]

Trademark Rights. The Bankruptcy Code provides that parties that license intellectual property from a debtor have the option to continue using the intellectual property, even after a 363 sale of the debtor's assets in bankruptcy—the purchaser buys subject to the preexisting rights of such parties.[7] Under the Bankruptcy Code, "intellectual property" is defined to include trade secrets, patents, and copyrights. Trademarks, however, are expressly excluded from the definition, and it has long been thought that a debtor could shed its trademark licenses in bankruptcy.

Two recent decisions have put that belief in serious doubt. In *In re Exide Techs.*,[8] the 3rd U.S. Circuit Court of Appeals found that a one-time sale of a perpetual, royalty free, exclusive trademark license as an integrated part of an asset sale agreement is not a contract that can be rejected in bankruptcy, and therefore the trademark license cannot be shed by the debtor. The 8th U.S. Circuit Court of Appeals recently followed suit in *Lewis Brothers Bakeries Inc. v. Interstate Brands Corp. (In re Interstate Bakeries Corp.)*.[9] The result is that a buyer may be unable to purchase assets in bankruptcy free and clear of the trademark license rights of the debtor's licensees. This is a significant blow to the value that the debtor can achieve in bankruptcy, because buyers in the trademark context often need the exclusive right to control who can operate under the trademark.

The Lender's Right to Credit Bid... How Much?

One of the age-old aspects of any distress sale is the right of a secured lender to "credit bid" against its collateral—*i.e.*, to bid at a distress auction without coming out of pocket any money, and instead offsetting the amount of its bid against the face amount of the outstanding debt. In theory, the credit bid allows the lender to keep all bidders honest, as the lender has the ability to overbid until the auction brings a sufficient price. One of the growing trends in credit bidding has been the "loan-to-own" strategy, in which a would-be buyer purchases the secured debt from the existing lender with the intent of overbidding to acquire the company.

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There are numerous recent decisions on credit bidding, at least one of which helps and others that hurt, with regard to the rights of parties attempting to credit bid. In *Radlax Gateway Hotel et al v. Amalgamated Bank*,[10] the U.S. Supreme Court found that in a 363 sale to be conducted as part of a reorganization plan, the debtor is required by the Bankruptcy Code to give a lender the right to credit bid. Previously, there had been some question as to whether in a sale under a Chapter 11 plan the secured lender could be denied the right to credit bid if it received alternative treatment under the plan. The Supreme Court put this issue to rest, protecting the credit bid right of secured creditors in connection with a Chapter 11 plan.

Aside from this decision, however, the rights of credit bidders have come under significant scrutiny of late. For example, in *Dish Network Corp. v. DBSD N. Am., Inc.*,[11] the 2nd Circuit found that a party carrying out a loan-to-own strategy could be denied the right to vote on a Chapter 11 plan when it acted in bad faith and with ulterior motives.

On the heels of *DBSD*, the Bankruptcy Court for the District of Delaware held in *In re Fisker Automotive Holdings, Inc.*,[12] that the credit bid of a lender exercising a loan-to-own strategy would be restricted to the amount it paid for the debt, instead of the face amount of the debt. In distress scenarios, secured debt often changes hands at a significant discount, and if the buyer can bid the debt in the full amount, it gains a significant bidding advantage often called the "credit bid bump." *Fisker* found that in certain circumstances, the buyer of the debt will be restricted to the purchase price for the debt and thus lose the credit bid bump.

The facts in *Fisker* involved what the court viewed as a bad faith attempt by the debtholder to force the debtor into a quick sale for fictitious reasons. The court found that allowing the credit bid in the full amount would not only chill the bidding but would also likely prevent the auction from happening at all. Questions about what portions of the claim were secured, unsecured, and of uncertain status supported restriction of the credit bid, the court said.

The Bankruptcy Court for the Eastern District of Virginia issued a decision in *In re Free Lance-Star Publishing Company of Fredericksburg*[13] soon after *Fisker*, finding that a loan-to-own debt purchaser would have its credit bid restricted to less than half the face value of debt. The facts of the case involved alleged misconduct by the debt purchaser in attempting to expand its liens beyond the rights provided in the security documents, questions about the extent of the liens, an overzealous loan-to-own strategy, and a perceived negative impact on the overall auction process.

Bankruptcy Auctions Are Final…But When?

One of the disadvantages of 363 sales for buyers is the typical requirement that they participate in an auction.[14] After spending significant funds to conduct due diligence, a potential buyer may find that it is unable to come away with the prize when pitted against other would-be purchasers. Indeed, it may be that other bidders actually rely on the initial interested buyer's diligence in making their decision to purchase the assets. One way that a buyer can mitigate this risk is by acting as the "stalking horse," obtaining the right to a break-up fee and expense reimbursement if it is overbid.

Once the bid deadline has passed with no competing bids, or a buyer has actually won the bidding in a competitive auction process, the buyer wants to know that the process will be respected and its purchase price approved. This is not always the case, however.

For example, if a bid deadline passes with no competing bids, then in the absence of a deadline in a confirmed Chapter 11 plan that prohibits any extension,[15] parties will sometimes try to extend the bid deadline or reopen the bidding process, much to the chagrin of the winning bidder (which may have to threaten to walk to force the debtor to comply with the deadline). Moreover, even after a full and fair auction has been held, some courts may reopen the auction if a new bidder that is willing to bid a higher value appears. This has become a significant issue in distress sales of late.

Three recent cases illustrate the issue. In *In re Western Biomass Energy LLC*,[16] the Bankruptcy Court for the District of Wyoming reopened an auction on the basis of objections by the secured creditor and the unsecured creditors' committee when a post-auction bid offered more than twice the highest bid price. The new bid also included a distribution to unsecured creditors, while the auction price provided none. In *Allied Systems Holdings, Inc.*,[17] the Bankruptcy Court for the District of Delaware reopened an auction on the basis of objections by the unsecured creditors' committee and the debtor, asserting that irregularities had occurred during the auction. The parties argued that the best way to cure those was to reopen the auction to allow participation of a post-auction bidder offering a substantially higher price.

Finally, in *In re Sunland, Inc.*,[18] the U.S. Bankruptcy Court for the District of New Mexico reopened the auction when a third party came forward with a significantly higher bid at the sale hearing after the close of the auction. The price was approximately $5 million higher than the winning bid at the auction. The court found that, despite the potential that reopening the auction could destroy confidence in judicial sales, the auction should be reopened because approving the highest bid at the auction was not in the best interests of the estate.

Court Approval Is Enough…As Long as the Board also Approves?

Under state law, a sale of substantially all assets of a company generally requires a shareholder vote. In addition, for asset sales outside of Chapter 11, it is usually a condition of closing under the asset purchase agreement that the seller provide evidence that it has complied with all corporate formalities in obtaining approval of the sale. Such evidence includes an opinion of counsel, a secretary's certificate, a resolution of its board of directors, and copies of its charter and bylaws showing the company's internal governance rules upon which opining counsel has relied.

One of the advantages of a 363 sale in Chapter 11 is that shareholder approvals and evidence at closing of corporate formalities are generally considered unnecessary. The seller is subject to Bankruptcy Court oversight, and the buyer receives an order stating that the seller is authorized to transfer its assets.

A recent holding by the U.S. Bankruptcy Court for the District of Delaware has put into question what actions a board needs to undertake to approve a sale. In the case of *In re Energy Future Holdings Corp.*,[19] the Bankruptcy Court was presented with bid procedure objections asserting that the boards of numerous affiliates might have conflicts of interest in connection with Energy Future's proposed 363 sale. The court took issue with the boards for a muddled decision-making process, noting that it was unclear that the boards of all the affiliates had properly approved the proposed sale procedures. The court then conditioned the proposed sale process on several requirements, including that the various boards hold meetings to consider the conflict of interest issues and to determine how they wished to proceed in directing the company's counsel with regard to the sale.

The result of *Energy Future* has been that, in connection with a proposed 363 sale, sellers' counsel have begun advising in many cases that the board hold a formal meeting to approve the sale procedures at the outset and then, once the auction has occurred, a second meeting to approve the results of the auction prior to presenting the winning bidder to the court.[20] This is taking place even in cases in which there is no alleged conflict of interest for the board. It may be that buyers will also begin requiring in their asset purchase agreements the satisfaction of corporate formalities in connection with closing, although this is likely an overextension of the ruling in *Energy Future*.[21]

In *Energy Future*, the court was making clear that the board during bankruptcy could not abdicate its role in guiding the company. The court was not, however, abdicating its own authority to approve a 363 sale, power the court has regardless of corporate formalities. A court order approving a 363 sale should continue to be clear authority for a debtor and its buyer to close a sale. J

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[1] 2014 WL 3542133 (July 17, 2014).

[2] 632 F.3d 89 (3d Cir. 2011).

[3] Note that the recently issued "Final Report and Recommendations of the ABI Commission to Study the Reform of Chapter 11" suggests that 363 sales should *not* be free of successorship liability under federal labor laws (which, while undefined in the report, probably include ERISA), although the commission recommended that 363 sales should be free and clear of civil rights claims. The court in *Ormet* reasoned that federal law does not elevate labor law to a higher priority than civil rights law, and therefore, under existing 3rd Circuit precedent allowing sales free and clear of civil rights claims, there was no reason to treat the two differently.

[4] 739 F.3d 215.

[5] See 11 U.S.C. Section 363(f)(5) (permitting sale free and clear if entity could be compelled to accept a money satisfaction of its interest).

[6] See, *e.g., In re Nevel Props. Corp.*, 2012 WL 528179, 2012 Bankr. LEXIS 551 (Bankr. N.D. Iowa, Feb. 17, 2012); *In re Tousa*, 393 B.R. 920, 924 (Bankr. S.D. Fla. 2008). See generally, Wolf-Smith, "Shedding Burdensome Restrictive Covenants in Real Estate Sales," *Am. Bankr. Inst. J.* at 30 (Nov. 2014).

[7] 11 U.S.C. Section 365(n).

[8] 607 F.3d 957 (2010).

[9] 751 F.3d 955 (2014).

[10] ____ U.S. ____, 132 S.Ct. 2065 (2012).

[11] *In re DBSD N. Am., Inc.*, 634 F.3d 79 (2d Cir. 2011).

[12] 510 B.R. 55 (2014).

[13] 512 B.R. 798 (2014).

[14] According to the humorous *Devil's Dictionary of Bankruptcy Terms*, the definition of a 363 auction is, "What the stalking horse hopes a 363 sale will *not* become," Anders *et al.* (2007 Peppercorn Press) (*emphasis added*).

[15] See, *e.g., River Terrace Estates, Inc.*, Case No. 14-11829 (Bankr.N.D. Ind) (confirmed Chapter 11 plan with non-waivable deadline and firm "limited contingency" bid package requirements, to prevent potential for bidding disputes and to ensure maximum value without delay where bondholder direction unavailable).

[16] Case No. 12-21085 (Bankr. D. Wyo. Aug. 6, 2013).

[17] See Morgan, "363 Asset Sales: Delaware Bankruptcy Court Agrees That 'It ain't over 'til it's over,'" Weil Bankruptcy Blog (Sept. 13, 2013).

[18] 507 B.R. 753 (Bankr. D. N.M. 2014).

[19] *Energy Future Holdings Corp., et al.*, Dkt. No. 2699, Case No. 14-10979 (D. Del. Nov. 4, 2014).

[20] For example, the debtor undertook a very deliberate board approval process to confirm the winner of the auction in the *In re Sears Methodist Retirement Systems, Inc.*, Chapter 11 proceedings in February 2015. Case No. 14-32821-11 (N.D. Tex. 2014).

[21] For disclosure purposes, the author notes that his current firm (1) acts as buyers' counsel in the *Sears Methodist* case, and (2) acts as Delaware counsel and conflicts counsel to an official committee in *Energy Future*. In addition, the author at his former firm acted as debtor's counsel in the *River Terrace* case.