ASSET SALES UNDER CHAPTER 11 OF THE U.S. BANKRUPTCY CODE

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I. Introduction

This outline provides a general business and legal overview of the sales process under chapter 11 of Title 11 ("chapter 11") of the United States Code (the "Bankruptcy Code") including, importantly the "stalking horse" bid and auction process, and explores the procedural and substantive provisions that govern bankruptcy sales in the United States. This outline also identifies key strategic considerations for parties interested in becoming "stalking horse" bidders.

II. Chapter 11 in General

A. **Debtor permitted to continue the operation of the business**: In chapter 11, the debtor generally is permitted to continue the operation of the business as it was conducted prior to the bankruptcy. 11 U.S.C. §§ 1107, 1108. Absent the appointment of a chapter 11 trustee, existing management remains in place. Matters of corporate governance remain within the province of the officers and directors. A trustee can be appointed to replace management, but only for "cause." See, e.g. In re W.R. Grace & Co., 285 B.R. 145 (Bankr. D. Del. 2002) (holding that appointment of chapter 11 trustee is mandatory upon a finding of fraud, dishonesty, incompetence or gross mismanagement by debtor's current management); In re General Oil Distributors, Inc., 42 B.R. 402 (Bankr. E.D.N.Y. 1984) (holding that where the debtor had displayed prepetition incompetence, violation of fiduciary obligations and dishonesty on the part of managers, but exhibited no post-petition wrongdoing, such conduct did not rise to a level sufficient to justify the appointment of a trustee). 11 U.S.C. § 1104. For most courts, this requires a showing of gross mismanagement or fraud. Absent misconduct of this type, a bankruptcy court generally will not appoint a chapter 11 trustee. 11 U.S.C. § 1104(a)(1);

B. **Matters outside ordinary course of business require prior bankruptcy court approval**: Matters that are outside of the ordinary course of business, which would encompass significant business or legal decisions, require prior bankruptcy court approval. A decision to sell all or a substantial part of the debtor's business requires court approval. 11 U.S.C § 363(b)(1).[1]

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C. **Goal of chapter 11**: The goal of a chapter 11 proceeding is the approval of a plan of reorganization or a plan of liquidation. The reorganization plan or liquidation plan is a judicially sanctioned contract that specifies the terms for repayment of creditors' claims and the means by which the debtor will be reorganized or liquidated to accomplish the promised repayment.

III. Sales Permitted in chapter 11

A. **Reorganization can take many different forms**: A reorganization under chapter 11 can take many different forms. It is not limited to a rehabilitation based on internally generated cash flow. Chapter 11 can be, and often is, used to accomplish the sale of the debtor's business. Some sales are structured to transfer control of the debtor to a purchaser as part of an investment made by the purchaser under a plan of reorganization, while other sales are more typical purchases of assets. The sale can also take place early in the chapter 11 case, prior even to the debtor's proposal of a plan of reorganization. In general, sales of assets are typically consummated either as Section 363 sales or as sales pursuant to the debtor's plan of reorganization.

B. **Chapter 11 Sale as Part of a Plan of Reorganization**: A chapter 11 sale can be structured to occur as part of a plan of reorganization. When the sale involves a substantial portion of the debtor's assets, some courts will not permit the sale to take place prior to plan confirmation unless the debtor can demonstrate a business justification for the pre-plan sale. See In re Lionel Corp., 722 F.2d 1063, 1070-71 (2d Cir. 1983) (holding a sale of chapter 11 debtor's 82% interest in subsidiary would have been permitted if the debtor-in-possession could demonstrate "business justification"). An appropriate business justification would be the need to have a prompt sale due to the debtor's deteriorating financial condition. See In re Equity Mgmt. Sys., 149 B.R. 120, 124 (Bankr. S.D. Iowa 1993) (finding that although proposed long term leases and ultimate sale of debtor's truck tractors were in the ordinary course of the debtor's business, court nevertheless felt the transaction required judicial scrutiny and found that the leases and sale were warranted where assets were depreciating and needed to "be placed in an income producing mode as soon as possible"). When a sale occurs as part of a plan, however, creditors enjoy the safeguards that are part of the plan approval process,

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15 proceedings on behalf of foreign representatives of Canadian debtors under the CCAA and BIA. Aaron also has served as Adjunct Professor at Northwestern University School of Law for many years and as a lecturer at the University of Chicago. Mr. Hammer's latest article, "Understanding Chapter 15 of the United States Bankruptcy Code: Everything You Need to Know About Cross-Border Insolvency Legislation in the United States" (*Law and Business Review of the Americas*, Spring 2008), recently was cited to the U.S. Supreme Court on an issue involving multinational insolvencies. Aaron can be reached at ahammer@freebornpeters.com; or at (312) 360-6558.

[1] Section 363 of the Bankruptcy Code establishes procedures for the use, sale and lease of the property of the debtor's bankruptcy estate, both in and outside of the ordinary course of the debtor's business. 11 U.S.C. § 363.

but that are not included in a pre-plan sale. Such plan safeguards include, for example, extensive disclosure regarding the debtor's financial condition, ability to make payments to creditors and creditor voting rights. 11 U.S.C. §§ 1123-1127.

C. **Chapter 11 Sale as a Section 363 Sale**: Section 363 sales have become the prevalent method for disposing of a debtor's assets, primarily because Section 363 sales provide certain benefits over plan sales. Section 363 of the Bankruptcy Code enables a debtor to sell property other than in the ordinary course of its business with the approval of the Bankruptcy Court. Courts typically require debtors wishing to sell their assets under Section 363 (as opposed to selling their assets under Section 1123 as part of a plan) to provide a sound business purpose for its use and a strong showing that a sale outside of a plan of reorganization is justified. See In re Lionel Corp., 722 F.2d at 1071 (stating that, to determine if a sound business purpose exists, a bankruptcy judge must consider "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, which of the alternatives of use, sale or lease the proposal envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value"). The debtor will likely be given considerable discretion to design a method of sale that best fits its objectives and circumstances. While the Bankruptcy Code imposes general requirements such as notice procedures and court approval, it does not prescribe the precise manner of sale. Similarly, the debtor has discretion in determining which assets it wishes to offer for sale. It could seek to sell substantially all of its business or instead to market its assets separately. The prospective buyer – particularly if it is the first buyer to deal with the debtor – often can influence the manner by which the debtor exercises its discretion in structuring the sale process.

D. **The prevailing method of sale in the U.S. is through an auction process**: The prevailing method of sale in the United States is through an auction process. U.S. bankruptcy courts prefer auctions and view auction procedures as ensuring that maximum value for a debtor's assets will be obtained. It is practically impossible to have a truly private sale in the bankruptcy context because almost any sale of significant assets will be outside of the ordinary course of business and will have to be approved by the bankruptcy court, which will almost certainly require the debtor to open the sale up and allow interested third parties to place bids. See Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.), 147 B.R. 650, 659-60 (S.D.N.Y. 1992) ("Break-up fees are important tools to encourage bidding and to maximize the value of the debtor's assets.").

IV. The "Stalking Horse" Bidder

A. **General Background**: Most sales for significant assets of debtors begin with the selection of "stalking horses."[2] The first party to make a binding commitment to purchase a debtor's assets is often known as a "stalking horse." The stalking horse is the initial bidder who enters into an agreement with the debtor to purchase the assets to be sold. The agreement will contain the initial purchase price (the "stalking horse bid") as well as many conditions, one of which is that the debtor's obligations are conditioned on there being no higher or better offers at the auction (if one is to be held) or the Section 363 hearing. Once the purchase agreement is executed, the stalking horse bid is used to establish a floor for subsequent bids. The deal may subsequently be shopped around by the debtor to attract higher or better offers.

B. **Risks and Disadvantages Associated With Becoming a Stalking Horse Bidder**

1. **Debtor's fiduciary duty to creditors exposes prospective purchaser to risk**: If the debtor determines to go forward with a sale, it will owe a fiduciary duty to the bankruptcy estate and its creditors to obtain the best offer possible. See In re Ionosphere Clubs, Inc., 113 B.R. 164, 169 (Bankr. S.D.N.Y. 1990) ("A debtor-in-possession must act as a 'fiduciary of his creditors' to 'protect and conserve property in his possession for the benefit of creditors' and to refrain [ ] from acting in a manner which could damage the estate or hinder a successful reorganization of the business."). The debtor's fiduciary duty to the bankruptcy estate, and the fact that no agreement signed by the debtor will be binding on it until approved by the bankruptcy court, exposes a prospective purchaser to the risk that it will become a "stalking horse" for other bidders, even if the proposed sale in the first instance has been structured as a private sale. The debtor probably will not agree to deal exclusively with a prospective bidder, other than for a limited period of time. And even if it does so, that agreement would not be binding unless and until approved by the bankruptcy court. If a more favorable offer for the assets is presented before court approval of the initial agreement is obtained, the court is almost certain to allow the sale process to be opened up to include other bidders. The court's overriding goal will be to maximize value for the benefit of creditors.

2. **Risk of spending substantial sums of money**: The stalking horse runs the risk of spending substantial sums of money and investing significant amounts of time conducting due diligence only to be outbid by other

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2 Some Section 363 Sales are conducted without a stalking horse. The reasons for this range from a lack of interest from prospective buyers to a sense of urgency that does not allow the time needed to negotiate a stalking horse agreement and bidding procedures. In these circumstances, the business is usually sold to the highest bidder at a bankruptcy court-sponsored auction.

prospective purchasers. For this reason, the stalking horse buyer is often provided with "bid protections" by which the stalking horse's expenses are reimbursed in the event that it is outbid by another buyer. In addition, a stalking horse may invest its time and money in conducting due diligence, and the debtor may elect to abandon the sale process altogether.

3. **Negotiations with the debtor and related parties may prove difficult**: Stalking horse bidders will be negotiating not only with the seller, but directly or indirectly with numerous other parties, possibly including secured and unsecured creditors, landlords, bondholders, equity holders, the debtor's financial and legal advisors, trustees and labor unions. The role and authority of the management team of the seller itself therefore may be unclear, especially given that ultimate approval rests with the bankruptcy court.

4. **Stalking horse bears the risk of bidding too high**: The stalking horse bears the risk of bidding too high, especially if the business is in an industry, such as telecommunications, in which there is a rapidly growing glut of assets for sale. Thus, what seemed a reasonable price for the sale assets at the outset of negotiations may seem extraordinarily high three months later when the court-sponsored auction occurs.

5. **No deal-protective contractual provisions that a bidder might receive in a non-bankruptcy sale**: While, as discussed in Section IV.C below, some protections are available to stalking horses, it is still possible that the stalking horse may not receive the full benefit of deal-protective contractual provisions (e.g., break-up fees, topping fees) that it might receive in a non-bankruptcy sale. For these reasons, some prospective buyers may prefer to allow another bidder to take the role of stalking horse, while waiting to see the final terms approved by the bankruptcy court. The prospective purchaser then might be in a better position to make a decision whether or not to offer a higher bid. See Calpine Corp. v. O'Brien Environmental Energy, Inc. (In re O'Brien Envtl. Energy, Inc.), 181 F.3d 527 (3d Cir. 1999) (holding that the stalking horse bidder was not entitled to the break-up fee because the debtor, not the stalking horse bidder, incurred the expense of due diligence, the break-up fee was not necessary to induce the stalking horse's bid, and the stalking horse bidder failed to show that its bid served as a catalyst to higher bids).

C. **Court-approved bidding procedures are a mechanism to afford protections to the stalking horse**. The risks posed for a stalking horse can be lessened through the mechanism of a court-approved bidding process. The bidding procedures are the court-approved means by which a chapter 11 debtor conducts a Section 363 sale. These procedures will determine, among other things, who can participate in the bidding process and on what terms, how competing bids will be assessed, and the ramifications to the seller of selecting a bidder other than the stalking horse. As such, the bidding procedures are the most important strategic aspect of a Section 363 sale, for both buyers and seller.

1. **Bidding procedures typically contain certain protections that are available only to the stalking horse**. Bid protections are not set forth in the Bankruptcy Code, but have been developed because, as a practical matter, no sophisticated prospective purchaser will proceed to the signing of an asset purchase agreement without them. See In re 995 Fifth Ave. Associates, L.P., 96 B.R. 24, 28 (Bankr. S.D.N.Y. 1992) (holding that bidding incentives may be "legitimately necessary to convince a white knight to enter the bidding by providing some form of compensation for the risks it is undertaking"). The bid protections sought to be obtained must be described in the motion seeking sale authorization and approval of the procedures governing the bidding at the auction. Such protections may include the following:

    a. **Break-up fee**: A break-up fee is a fee that is paid to the stalking horse by the debtor if the stalking horse bid is not accepted because of a higher or better offer. It is designed to compensate the stalking horse for establishing a bidding floor, which facilitates other bids. Break-up fees are justified on the basis that the stalking horse should be compensated for the time, expense and risks it takes in playing this role. In general, break-up fees in the range of two to three percent of the purchase price plus a reimbursement of legal fees and other transaction expenses are deemed appropriate. The Bankruptcy Court will determine whether the break-up fee seems reasonably designed to compensate the losing stalking horse bidder for its time and effort and for encouraging other parties to submit bids, or whether the break-up fee will chill the bidding process by creating an insurmountable financial burden that would deter other potential purchasers from submitting bids. See In re Integrated Res., Inc., 147 B.R. at 659-60 ("Break-up fees are important tools to encourage bidding and to maximize the value of the debtor's assets. The usual rule is that if break-up fees encourage bidding, they are enforceable; if they stifle bidding they are not enforceable. In fact, because directors of a corporation have a duty to encourage bidding, break-up fees can be *necessary* to discharge the director's duties to maximize value.").

        (i) **Courts have used different standards in approving break-up fees**: Depending on the jurisdiction, break-up fee are assessed by one of the following standards:

            (a) **Business Judgment Rule**. Bankruptcy courts following the business judgment rule or modified business judgment rule employ the same business judgment standard used in determining the appropriateness of specific corporate actions. In re Integrated Resources, Inc., 147 B.R. at 660 (adopting modified business judgment rule, pursuant to which the court must consider whether the relationship between the parties was tainted by self-dealing or manipulation, whether the fee hampers, rather than encourages, bidding, and whether the amount of the fee is unreasonable relative to the purchase price).

(b) **Best Interests of the Estate Test**: Some bankruptcy courts use an alternative approach for the consideration of break-up fees, and look not to whether the break-up fee is within the business judgment of the debtor, but whether the transaction will "further the diverse interests of the debtor, creditors and equity holders, alike." In re Lionel Corp., 722 F.2d at 1071; In re S.N.A. Nut Co., 186 B.R. 98, 104 (Bankr. N.D. Ill. 1995) ("Since 'any money that a bidder receives through a bidding incentive comes out of the pockets of the creditors of the estate...there should be a direct relationship between the reimbursement an unsuccessful buyer receives and the benefit to the estate from the unsuccessful buyer's bid.'") (citations omitted); In re Hupp Industries, Inc., 140 B.R. 191 (Bankr. N.D. Ohio 1992) (refusing to authorize 2.1% break-up fee where secured creditor and unsecured creditors committee objected, holding that the break-up fee would be an unwarranted expense upon the estate after applying the above-cited test).

(c) **Administrative Claim Analysis**: Bankruptcy Courts using this analysis reject the business judgment rule and best interest of the estate tests and, instead, treat an application for break-up fees as a request for allowance of administrative expenses under 11 U.S.C. § 503(b). Under this standard, the allowability of break-up fees, like that of other administrative expenses, depends upon the requesting party's ability to show that the fees were "actual and necessary" to preserve the value of the estate. In re O'Brien Environmental Energy, Inc., 181 F.3d at 535 (3d Cir. 1999) (denying break-up fees because party failed to establish that break-up fees were necessary to preserve the value of the debtor's estate pursuant to 11 U.S.C. § 503(b)(1)(A)).

(ii) **It is important that the proposed break-up fees and expense reimbursements be pre-approved by the bankruptcy court to ensure payment of fees for professionals**: Since break-up fees and expense reimbursements (see below) are designed to compensate the stalking horse for its due diligence and related transaction expenses (including professional fees, bank fees, and other related expenses incurred in connection with the signing of a purchase agreement), it is important that the proposed break-up fee be pre-approved by the bankruptcy court before the auction and sale approval process begin. See In re O'Brien Envtl. Energy, Inc., 181 F.3d at 535 (3d Cir. 1999) (because the proposed break-up fee and related expenses had not been pre-approved by the bankruptcy court and were ultimately rejected by the court, the unsuccessful stalking horse bidder did not receive a break-up fee in this case).

b. **Expense Reimbursements**: Parties often agree that in the event of a breach by the seller of the purchase agreement, the seller will reimburse some portion of the expenses incurred by the aggrieved purchaser in negotiating and preparing the agreement. Typical expense reimbursement provisions range from less than 1% of the total value of the assets being sold to an uncapped amount for all actual expenses incurred in certain instances.

c. **Minimum Over-Bid Protection**: Minimum over-bid protection is an amount by which a new bid must exceed the stalking horse bid in order to qualify as a competing bid. This amount is usually in excess of the stalking horse's break-up fee in order to insure that the bid will actually constitute a higher offer to the seller after the payment of the break-up fee.

d. **Right to match any other bids**: The stalking horse bidder can seek the right to match any other bids, and bidding procedures often provide the initial bidder with the opportunity to submit an additional bid as part of a final auction process if a qualifying overbid is made.

e. **Limitation of the debtor's ability to consider other offers to a stated period of time**: The stalking horse may want to limit the debtor's ability to consider other offers to a stated period of time, e.g., for a period of 30 to 60 days, depending on the circumstances. The stalking horse may want the auction to be as soon as possible, and a time limit may prevent the debtor from holding up the process by entering into intense and lengthy negotiations with other bidders.

f. **Requirement that other bidders submit "qualifying bids"**: Often, subsequent bidders will be required to submit bids that are on similar or better non-price terms as that of the initial offer to facilitate an "apples to apples" comparison with the initial bid. In addition, subsequent bids usually must exceed the initial offer by certain minimum amounts.

g. **Criteria for determining "highest and best" bid**: The bid procedures should describe the conditions by which the estate representative will determine what is the "highest and best" bid, reserving to that representative some discretion in making this determination. Various forms of consideration may be part of an offer, each valued differently. For example, one party may make an offer consisting of only cash, another party may make an offer consisting of cash and equity, while yet another party may make an offer consisting of only equity. Therefore, it is advisable for the stalking horse to try to limit the type of consideration to cash or cash equivalents or to specify how less liquid consideration will be valued.

h. **No-shop provisions**: Although the stalking horse cannot prohibit other prospective purchasers from bidding, the stalking horse should try to include no-shop provisions into the sale documentation and bidding procedures, which would prevent the debtor from actively pursuing and shopping around for other bidders.

2. **Additional items typically included among bid procedures**:

a. **Definition of "qualified bidder"**: a definition of who will be permitted to bid, typically one who signs a confidentiality agreement, who delivers reliable financial statements and whom the seller determines is financially and managerially capable of closing the transaction;

b. **Minimum requirements for a bid to be considered a "qualified bid"**: A qualified bid requirement could include provisions that require a significant cash deposit, that the scope of the bid be substantially equivalent to the scope of the stalking horse bid, that the bidder have executed a purchase agreement, that the bid not be contingent on any financing or other non-regulatory conditions, that the bid not provide for any break-up fees, and that the bid comply with overbid requirements;

c. **Entitlement of qualified bidders to due diligence**;

d. **Establishment of bid deadline and requirement for a good-faith deposit, to be forfeited if the bidder wins the auction and culpably fails to close**;

e. **Specific delineation of contractual terms of bid.** A "qualified bid" may be required to include a precise identification of particulars, if any, wherein contract terms of the second bidder differ from those of the first bidder;

f. **Location and procedures for auction**; and

g. **Reservation of right of debtor to modify the bidding procedures.**

3. **Objections to Bidding Procedures**: After the bidding procedures have been negotiated between the prospective buyer and seller and submitted to the bankruptcy court for approval along with the executed purchase agreement, interested parties are then given an opportunity to object to the bidding procedures. Objections to the bidding procedures often allege either that the proposed sale is improper, or that the proposed procedures favor the stalking horse disproportionately and will therefore chill the bidding process. See In re Twenver, Inc., 149 B.R. 954 (Bankr. D. Colo. 1992) (Bankruptcy court not approving bidding procedures after party's objection that proposed break-up fee of 10% was excessive and would hinder rather than promote the bidding process).

D. **Advantages of becoming a stalking horse bidder**: While there are many risks for a stalking horse, the stalking horse can, and often enjoys a competitive advantage over other bidders, exert significant influence over the structure of the sale. Some of the advantages of being a stalking horse bidder may include:

1. **Control over the bidding process**: Entering into a purchase agreement and agreeing to become the stalking horse can afford a significant advantage to a prospective purchaser. Perhaps most importantly, the initial purchase agreement plays a key role in setting the parameters of any subsequent sale because, the bidding procedures governing the process by which other buyers will be able to bid will have already been determined. Thus, the stalking horse can influence the scope of the transaction, the timetable, who will be considered qualified bidders, the criteria for determining the best bid, and the compensation for the stalking horse in the event that it is outbid by another purchaser.

2. **The stalking horse has more leverage to negotiate favorable contract provisions**: The stalking horse has more leverage to negotiate favorable contract provisions and is in close contact with the debtor and the debtor's professionals, which enables the stalking horse to gain greater knowledge of the debtor's situation and to influence the mechanics of the auction. A bidder who is not a stalking horse lacks this negotiating leverage and risks becoming a party to a deal that it had little role in negotiating.

V. **Procedure and Timing for Sale by Motion**

As stated above, in appropriate circumstances, a debtor may sell assets prior to plan confirmation. The procedure that would be followed for a sale outside of a plan is as follows:

A. **Filing of Sale Motion**: The debtor commences the sale process by filing a motion for sale of assets under Section 363 of the Bankruptcy Code requesting court approval of the proposed sale. The sale motion should describe the sale, its business justification, the assets, the estate representative's efforts to market the assets, the process by which the present stalking horse bidder was obtained, the terms and conditions of the present offer, the bid protections, the bid procedures, the date, time and location for the auction, and the overall benefit of the sale to the estate. The definitive sale documents normally are attached to the motion. It is generally advisable to solicit support for the sale from key creditor constituencies before the motion is filed.

B. **Request for Approval of Overbid Procedures**: At or about the time of filing the sale motion, the debtor should request approval of the bid procedures negotiated between the parties. A hearing on this request should be held prior to the hearing on the sale motion. Notice to parties in interest is required. Bifurcation of the approval of the bid protections and the approval of the sale of the assets is important: until the court approves the bid protections, the purchaser has no protection from being overbid.

C. **Notice of the Sale and Approval Hearing**: Following the filing of the sale motion, the court will schedule the sale approval hearing. Ordinarily, the debtor must give at least 20 days notice of a sale. For significant sale transactions, the court is likely to require a longer notice period, unless the debtor can convince the bankruptcy court that it will suffer harm if the sale process is not expedited.

D. **Objections to the Sale**: Creditors and other parties in interest must be given an opportunity to object to the sale. Objectors may be given the opportunity to seek discovery regarding the proposed sale from the debtor and possibly from the purchaser. If substantial discovery is permitted, the approval hearing may be delayed.

E. **Sale Approval Hearing**: At the approval hearing the court will consider the objections and determine whether the sale should be approved. The court will also decide issues concerning other bids that may be presented. The principal focus at the hearing will be (i) whether the proposed sale provides fair consideration to the estate (a related question is whether the assets have been sufficiently marketed to assure the court that the purchase price represents market value), and (ii) whether a sale is an appropriate disposition of the estate's assets in light of other alternatives. See In re Blue Coal Corp., 168 B.R. 553 (Bankr. M.D. Pa. 1994) (holding that sale of debtor's assets for sum which was more than 75%

of assets' appraisal value would be confirmed, absent evidence of any bad faith, over objection of unsecured creditors).

F. **Length of time from filing of sale motion to sale approval hearing**: The length of time between the filing of the sale motion to the conclusion of the approval hearing will depend on a number of factors, including possible additional marketing required by the court, opposition to the sale, the presence or absence of multiple bidders and the court's calendar. In many cases, the approval hearing is concluded within 60 to 90 days following the submission of the sale motion.

VI. Sale Under a Plan

A. **Approval process under a plan is more complex**: If the sale is to be part of a plan, the approval process is more complex and often takes longer than a sale outside of a plan. Plan confirmation is a two step process. The first step involves a hearing to approve a disclosure statement. (The disclosure statement is the bankruptcy's counterpart to an SEC prospectus, and as such, is intended to provide creditors with adequate information when voting to accept or reject a plan.) The hearing to consider approval of the plan will not take place until after the disclosure statement has been approved and sent to creditors. 11 U.S.C. § 1125. Generally, disclosure statement and confirmation hearings are subject to separate consecutive notice periods of not less, and often more, than 25 days. Fed. R. Bankr. P. 2002(b).

B. **Confirmation of a plan requires the plan proponent to satisfy more requirements**: Confirmation of a plan requires the plan proponent to satisfy numerous requirements under the Bankruptcy Code and to overcome a broader range of objections than typically would be the case for approval of a sale outside of a plan. The focus at confirmation is not only on whether the sale is a fair and appropriate disposition of the debtor's assets, but also on whether the plan allocation of consideration among creditors satisfies the requirements of the Bankruptcy Code. 11 U.S.C. § 1129. If there are substantial disagreements among creditors as to the allocation of the sale proceeds (issues that often are separate and distinct from the desirability of the sale), approval of the sale as part of the plan might be considerably delayed. Furthermore, there is a risk that a plan may not receive the necessary votes for confirmation and, therefore, the sale may likewise not be approved. As a result, it is often in a purchaser's interest to have the sale occur by motion pursuant to 11 U.S.C. § 363 and not under a plan.

C. ***Sub Rosa* (aka "Creeping") Plan is not permitted**: The *sub rosa* doctrine applies when the proposed asset sale or other transaction impermissibly dictates the terms of any future plan of reorganization. A debtor's proposal to sell all or substantially all of its assets without the benefit of a confirmed plan or court-approved disclosure statement could be considered a *sub rosa* plan that might be denied by the court. The rationale behind disallowing a *sub rosa* plan is that such a process denies creditors the procedural protections of the chapter 11 reorganization scheme, such as disclosure requirements, voting requirements, the best interest of creditors test, and requirements regarding the priority of distributions to the debtor's creditors. In general, if a sale transaction merely transforms the composition of the debtor's assets into cash, and does not dictate the terms of a future plan or attempt to restructure the rights of creditors, the bankruptcy court will likely determine that the sale transaction does not constitute an impermissible *sub rosa* plan. In re Continental Air Lines, Inc., 780 F.2d 1223, 1225 (5th Cir. 1986); PBGC v. Braniff Airways, Inc. (In re Braniff Airways, Inc.), 700 F.2d 935 (5th Cir. 1983) ("The debtor and the Bankruptcy Court should not be able to short circuit the requirements of chapter 11 for confirmation of a reorganization plan by establishing the terms of a plan *sub rosa* in connection with a sale of assets.").

VII. Other Considerations

A. **Executory Contracts and Unexpired Leases**: A bankruptcy sale provides greater ability to transfer executory contracts and unexpired leases of the seller than is the case outside of a bankruptcy context. In most cases, assignments can be approved by a bankruptcy court without the consent (and over the objection) of the non-debtor parties to the contracts. With certain limited exceptions, as long as existing defaults are cured and adequate assurance of future performance is provided, the debtor should be able to transfer any executory contracts or unexpired leases if such an assignment would, in the debtor's business judgment, benefit the estate. 11 U.S.C. § 365. This power will not permit the parties to rewrite contracts or, for example, to avoid restrictive covenants in real property contracts, and after closing, the buyer will be obligated under the assigned contracts to the same extent as the debtor was prior to the assignment. (The assignment rights do not apply to "personal service" contracts and other contracts that, as a matter of applicable nonbankruptcy law, cannot be assigned. In addition, the debtor's ability to assign freely intellectual property license agreements is uncertain and has been the subject of litigation.) Sale documentation can also be employed to help protect a purchaser from unexpected liability for defaults under assigned contracts. This protection can be accomplished by establishing a "bar date" requiring non-debtor parties to the assigned contracts to identify, prior to the sale, amounts owed under the contracts. Fed. R. Bankr. P. 3003(c).

B. **Transfer Free and Clear of Claims**: As a general rule, a purchaser of assets through a bankruptcy court process can acquire the debtor's assets free and clear of existing claims. 11 U.S.C. § 363(f). This is true whether the sale is part of a plan or by motion. Exceptions to this rule exist, including with respect to many environmental claims, some employee-related obligations, and claims that are premised on state law successor liability doctrines. In the case of valid secured liens on the assets, the bankruptcy court has the jurisdiction to order that the assets be transferred free and clear of liens, with the liens to attach to the proceeds of the sale. This result is unquestionably proper when the sale proceeds are greater than the secured indebtedness, where the liens can attach to the sale proceeds. The power to sell free and clear is less certain when the secured debt exceeds the proceeds generated from sale of the property. Many courts will order the sale free and clear of liens even in this situation if they are satisfied that the sale price is adequate. A secured creditor can partially protect itself in such an undersecured situation by exercising its right to submit a competing "credit bid," up to the amount of its claim. The right to credit bid exposes the purchaser to the risk of being outbid by the debtor's secured lenders who are not required to bid cash. See Folger Adam Security, Inc. v. DeMatteis/MacGregor JV, 209 F.3d 252 (3d Cir. 2000) (holding that adequate notice is a condition to a sale free and clear of any interest in property).

C. **Representations, Warranties and Related Considerations**: From the perspective of a buyer, sale documentation should be largely the same as the documentation that would be appropriate for a comparable non-bankruptcy sale. However, because the sale proceeds are likely to be distributed to creditors not long after the sale, the buyer has no certainty that it has a solvent party to remedy breaches of warranties or to cover indemnity obligations. A hold-back mechanism is one way to deal with these concerns. For example, the purchase agreement can provide for the escrow of indemnity funds, to be taken out of the purchase price, which would be available for the satisfaction of any indemnity claims asserted by the purchaser after the close of the bankruptcy case (including claims for breach of representations and warranties, taxes, environmental liabilities, etc.). The debtor and its creditors can be expected to push for a "where is – as is" sale.

D. **Control of the Sale Process**: The debtor normally sets the agenda for the sale process. Only the debtor is authorized to file a motion under Section 363 requesting approval of a sale transaction. The same is true for a sale under a plan during the period of time when the debtor has the exclusive right to submit a reorganization plan. This exclusive period exists during the first 120 days after the bankruptcy filing, and can be extended by the court. 11 U.S.C. § 1121(b), (d). Once the exclusive period ends, creditors can propose a sale as a part of a plan of reorganization. The creditors' influence over the debtor and thus of the sale process itself varies greatly from case to case. In some cases the greatest influence is wielded by the secured creditors, and in others it is the official creditors' committees.

E. **Insider Participation and Joint Bids**: Sometimes, the debtor's senior management or equity holders are interested in being the purchaser or in participating in a sale with another bidder. Such insider participation is not prohibited, but will be subjected to rigorous scrutiny to ensure the overall fairness of the proposed sale, including whether the assets in question have been sufficiently marketed and whether the proposed purchase price represents fair value for the assets. In addition, Section 363(n) prohibits collusion as to price in bankruptcy sales, and gives the court considerable discretion to remedy collusive sales. 11 U.S.C. §363(n). Thus, caution is required whenever potential bidders join with insiders (or with each other) to submit a joint bid.

F. **Appellate Considerations**: To provide finality to bankruptcy sales under Section 363, the Bankruptcy Code protects a purchaser by providing that an appeal of the order authorizing a sale will be dismissed if the purchaser is a good faith buyer and closes in reliance on the court's order. 11 U.S.C. § 363(m). An appellant thus must obtain a stay of the sale approval order or face the likely dismissal of its appeal. Most courts require a bond as a condition to staying a sale order pending appeal. Because a buyer is given this protection, the debtor can be expected to insist that the sale not be delayed by the existence of an appeal. 11 U.S.C. § 363(m); <u>Licensing by Paolo, Inc. v. Sinatra (In re Gucci)</u>, 126 F.3d 380 (2d Cir. 1997) (holding that court of appeals cannot take any action that affects the judicially authorized sale if the purchaser acted in good faith and no stay was granted).

VIII. Conclusion

In many cases, it may be in a party's interest to become a stalking horse bidder for a debtor's assets. While there are substantial risks for a stalking horse, the federal bankruptcy system can provide varying degrees of protection to the stalking horse that provide the stalking horse a competitive advantage over other prospective purchasers and allow the stalking horse to exert significant influence over the structure of the sale.