"Take My Assets – Please!"

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In last month's article, which was entitled "Coming Soon to a Bankruptcy Court Near, *or Perhaps Not-So-Near*, to You," I addressed one of today's hotly debated bankruptcy law controversies – whether the bankruptcy venue law should be amended to prevent the rampant forum shopping in which debtor's lawyers typically engage. This month's article addresses another topic of rampant current controversy – the use or alleged "misuse" of chapter 11 as a setting within which to sell all or substantially all of the assets of a financially-beleaguered company.

Let me put this debate into both a historical and a legal context. In recent years, relatively few chapter 11 cases have resulted in "stand-alone" bankruptcy reorganizations, from which a debtor emerges pursuant to a confirmed "plan of reorganization" under which the liabilities of the compnay are restructured through payment term modifications and the pre-existing ownership of the company remains intact. A very large percentage of today's chapter 11 cases are "liquidating 11" cases that follow a very different pattern – the business is not reorganized; the debtor in possession sells all or substantially all of its assets to a strategic or financial purchaser in a bankruptcy court-approved sale (sometimes called a "363 Sale" because such sales are conducted pursuant to section 363 of the Bankruptcy Code); the secured creditors are fully or partially repaid out of the proceeds of sale; and the bankruptcy court later enters an order confirming a "liquidating plan of reorganization" under which any remaining proceeds of sale and any other assets (litigation claims, etc.) are distributed to creditors by a liquidating trust in accordance with statutory bankruptcy priorities.

I strongly suspect that the trend is principally related to the high amount of debt that businesses have undertaken in recent years. By the time these highly-leveraged entities first approach bankruptcy counsel, they are effectively (although not technically) owned by their secured lenders. The companies have no cash with which to meet necessary payroll expenses and to pay trade creditors, much less to make contractually-mandated payments of interest and principal to their secured lenders. Moreover, all of their assets are encumbered by liens, often by multiple liens in favor of multiple lenders. In short, the beleaguered companies need immediate concessions from their lenders if they are to survive another day.

In many cases, those lenders have entered into multiple past forbearance agreements with their borrowers, are utterly disenchanted with management, whose competence and financial projections they no longer trust, and are anxious to extract themselves quickly from their bad loan. As a condition to providing debtor in possession financing ("DIP financing") to fund a bankruptcy case, the secured lenders often insist that the debtors make enforceable commitments to engage in immediate post-bankruptcy sale processes or agree to promulgate plans of reorganization that have been pre-approved by the lenders. Since the debtors cannot survive without additional advances from the lenders (which the lenders are not legally obligated to make) and since the sheer amount of secured debt makes the "cram down" of stand-alone plans of reorganization over the objection of the lenders impossible, the secured lenders effectively control the course of the case.

Another reason for the proliferation of bankruptcy sales is the "quality of title" that can be delivered by sellers in bankruptcy cases. In today's world, in which courts often hold buyers and other successors liable for the acts and omissions (including tort and environmental liabilities) of their predecessors, purchasers justifiably want to acquire assets free and clear of any and all liens and claims. While the entry of a duly-obtained bankruptcy court order authorizing a sale of assets free and clear of liens and claims and enjoining the assertion of claims against the purchaser may not constitute an absolute guarantee that the buyer will incur no successor liability, it is undoubtedly the best obtainable protection against such later surprises.

One may ask why, if a sale of the business is necessary or appropriate, the sale is not conducted under Chapter 7 of the Bankruptcy Code, which is entitled "Liquidation" and which applies to corporations and partnerships as well as individual debtors. By contrast, Chapter 11 of the Bankruptcy Code is entitled "Reorganization." It is a question that many bankruptcy scholars and purists are asking.

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The answer involves some discussion of legislative history. In 1978, Congress substantially re-wrote the bankruptcy laws of the United States by adopting the United States Bankruptcy Code. Superseding the Bankruptcy Act, which had been the law since 1898, the Code has been amended on several occasions since 1978. The basic structure and content of the Code and most of its principal business (as distinguished from consumer) provisions have remained largely undisturbed during the ensuing 30 year period, however.

While, in many respects, the Code represented a significant departure from the Act, in other respects it followed and continued the existing law. The former liquidation or "straight bankruptcy" provisions of Chapter VII (note the use of the Roman Numeral for 7) of the Act became Chapter 7 of the Code. Similarly, the provisions of Chapter XI (the Roman Numeral for 11) of the Act, which related to plans of arrangement, and which allowed for a debtor to remain in possession and control of its property during the duration of its Chapter XI case, became a part of Chapter 11 of the Code, which deals with reorganizations.

Under Chapter XI of Act, sales by a debtor in possession of all or substantially all of its assets were permitted in only rare circumstances. Indeed, in the major reported case addressing the right of a debtor to conduct a sale of all of its assets under that chapter, the United States Court of Appeals held that such a sale could be conducted only in an emergency, when an immediate sale was necessary to avert substantial harm to the estate through a diminution in value of the assets. Nothing in the language of the Code or in the legislative history surrounding the enactment of the Code changed this law. Yet, in cases under chapter 11 of the Code, "363 Sales" of entire companies have become exceedingly common.

Legal scholars and bankruptcy "purists" are troubled by this practice. They argue that, in circumstances in which a sale is appropriate, the case should be administered under chapter 7, in which an independent trustee is automatically appointed to manage the sale process. These critics are concerned principally about the potential for abuse and resultant harm to creditors if the debtor in possession is permitted to control this process. They fear that, in the absence of an independent trustee, the sale process will be chilled or stunted in order to facilitate "bargain" sales to insiders.

The critics' concerns are not without merit. There are a number of ways in which the robustness of the sale process can be subtly and inconspicuously damaged by insiders. Among other things, the publication of the sale itself and outreach to logical potential competing bidders can be too limited, the information that is assembled and provided to potential bidders can be insufficient or tainted, the time period allowed for potential bidders to conduct necessary diligence and arrange for financing may be too short, the amount of the proposed "break-up" fee may be too high, and proposed future employment contracts to insiders can erode the purchase price. The critics also suggest that debtors and their counsel seek to avoid the appointment of a trustee for fear that the trustee will uncover and prosecute potential causes of action against existing insiders that are less likely to be unearthed in a chapter 11 case in which the debtor remains in possession and control of the assets, business, and case.

The defenders of the 363 Sale process respond by arguing that existing management is best qualified to market the assets in an expeditious and cost-efficient manner. There is no time-consuming and costly learning curve that a newly-appointed trustee must necessarily climb. They maintain that the appointment of a trustee (as well as attorneys, accounts, and financial advisors to the trustee) adds multiple, unnecessary, layers of administrative expense onto an already expensive process. They insist that a diligent and capable creditors committee and bankruptcy court can monitor the sale process to insure that it is both fair and as robust as possible. These arguments, too, have merit.

One fact is certain -- the process flourishes, especially in the bankruptcy courts of New York and Delaware, where most of the large, complex chapter 11 cases reside.

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