

## Sales Pursuant to Section 363 of the Bankruptcy Code — the Perspective of the “Stalking Horse”

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### I. Introduction

A sale of assets in Chapter 11, whether pursuant to a plan of reorganization or a motion under Section 363 of the Bankruptcy Code, presents different challenges than a sale outside of bankruptcy. In Chapter 11, each of the bankruptcy “constituencies” brings its own, separate agenda to the sale process. Sometimes these agenda overlap; sometimes they collide.

The debtor’s agenda is, or ought to be, to maximize and realize the value of the asset. When the asset is diminishing in value because of ongoing operating losses, depreciation, adverse or declining market conditions, or other factors, however, the need to conclude a transaction quickly and with the fewest contingencies can outweigh the need to extract the “last dollar” from a purchaser. Needless to say, in evaluating competing offers, the debtor must take into account the nature of the offered consideration (cash, promissory notes, shares of the acquiring entity, etc.) as well as, if the consideration involves more than simply cash, the perceived ability of the acquiring entity to honor its future obligations. The potential need to reject executory contracts and leases (which often arises in the case of a sale to an entity that intends to move the business), and the diluting effect that the resulting “rejection claims” may have upon the creditor class, may also be a factor that should be considered in connection with the evaluation of competing bids. While the debtor must always act in accordance with its fiduciary duties, considerations regarding future employment for management and existing employees may sometimes play a role in the debtor’s decisional process.

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The secured creditor is, first and foremost, interested in achieving a sale price that satisfies its secured claim in full, without regard to the rights of junior creditors or equity security holders. Like the debtor, however, where the assets are depreciating in value, the secured creditor may be willing to sacrifice a portion of its claim in order to expedite and assure the consummation of the transaction.

The unsecured creditors, represented by a committee, may be willing to sacrifice both speed and deal certainty in order to maximize price. In circumstances in which they are otherwise “out of the money,” they have little or no incentive to do anything else. They will often use whatever leverage they may have to delay or block a sale in order to extract economic concessions from senior classes of creditors. They will be skeptical of, and give intensive scrutiny to, proposed sales to entities in which management or equity has an interest or relationship.

The United States Trustee seeks to insure that the process is fair and that the weakened bargaining position of a debtor with a diminishing asset does not cause it to agree to sale terms and conditions that are inimical to the interests of creditors and the estate. If there is no unsecured creditors committee, or the committee is inactive, or circumstances appear to have deprived the debtor and committee of sufficient leverage to resist the unreasonable demands of the “stalking horse,” the United States Trustee may give intense scrutiny to, and ultimately oppose, unreasonably restrictive sale terms and procedures.

In this article, we focus on some of the principal legal and practical considerations that flow from the assertion by the stalking horse purchaser of its particularized interest during the sale process.

## **II. The Decision to Purchase the Assets through the Bankruptcy Process**

### **A. Competing Considerations: the Stalking Horse's Dilemma**

If the selling entity is a bankruptcy debtor, the proposed stalking horse has little choice but to acquire the assets through the bankruptcy process. If the selling entity is not already a bankruptcy debtor, however, the buyer may often have to decide whether to acquire the assets in a “private” transaction outside of bankruptcy or to insist upon the protections afforded by a bankruptcy court order approving a sale free and clear of liens and encumbrances.

While “conventional wisdom” would suggest that the mere fact that the seller is a debtor in a bankruptcy case depresses the value of its assets, such conventional wisdom may often be wrong. The public auction process upon which bankruptcy courts, the United States Trustee and creditor constituencies generally insist often brings competing bidders into the courthouse and creates a vibrant bidding environment that would not otherwise exist. The “stalking horse” buyer must weigh its very clear and direct interest in preventing the creation of such an environment with the attendant risk that the price will increase and/or the assets will be sold to another party (as well as the delays and costs associated with the bankruptcy process) against its real or perceived need to “cleanse” the assets of any liens, encumbrances, successor liability claims and/or later fraudulent conveyance claims (based upon the allegation that the purchaser paid less than fair or reasonably equivalent consideration for the assets).

In making this analysis, the prospective purchaser must initially consider the risk that such claims may later be asserted. Its analysis will necessarily depend upon the type of claim at issue. In considering the susceptibility or vulnerability of the transaction to later attack on *fraudulent conveyance* grounds, the purchaser must take into account such factors as, without limitation: (i) the relationship, if any, between the seller and the purchaser; (ii) the duration, nature and extent of the pre-contract marketing effort; (iii) the likelihood that the subject marketing effort “reached” likely or logical strategic and “financial” purchasers; (iv) the extent to which any such possible purchasers were given a meaningful opportunity to conduct appropriate due diligence from the standpoint of both access to necessary financial and other information and the time necessary to analyze that information; and (v) of course, the fairness of the purchase price. Needless to say, even if the sale is the result of an arm’s length negotiation, to a good-faith, unrelated third party, and at a fair price, a disgruntled creditor of the seller may nonetheless seek to avoid the transaction by initiating a fraudulent conveyance action.

In considering the susceptibility or vulnerability of the transaction to later attack on *successor liability* grounds, the purchaser must take into account such factors as, without limitation: (i) the nature of the seller’s business (whether it was the kind of business that might give rise to the assertion of future claims by a presently unknown group of plaintiffs — asbestos, aircraft, chemical, etc.); (ii) the extent to which there will be a real or apparent identity between the seller and the purchaser (common or overlapping ownership, common management, same business name, same location, same employees, etc.); and (iii) the extent of the potential liability if a court were to apply the doctrine of successor liability.

After the prospective buyer has considered the risk that such claims will later be asserted, the likely cost of defending the claims, the amount of the possible claims and the likelihood that the claims will be successful, it should weigh the benefits and detriments associated with acquiring the assets through various judicial and non-judicial mechanisms. The non-judicial approaches include a traditional merger and/or acquisition transaction, acquisition through an assignee for the benefit of creditors or a private sale under the Article 9 of the Uniform Commercial Code. All of the non-judicial mechanisms can be accomplished more quickly, in a less “public” fashion and on a far less costly basis than a bankruptcy court-authorized sale. The extent of the protection afforded by these alternative mechanisms varies greatly, however. Moreover, while one non-judicial approach may provide an entirely satisfactory level of insulation from one type of later claim, it may provide an ineffective shield against another. For example, if a private foreclosure sale is conducted in accordance with the requirements of Article 9 of the Uniform Commercial Code, it will probably serve effectively to eliminate the liens and encumbrances of any and all junior lienholders. It will not necessarily insulate the purchaser from successor liability or fraudulent conveyance claims, however. While these non-judicial approaches may provide varying measures of protection against successor liability and fraudulent conveyance claims, one fact is undeniable — *none of these approaches provides the quality of title and level of insulation from future litigation that is generally provided by a bankruptcy court order*. If appropriate notice of the sale was given, in the absence of fraud or collusion, the bankruptcy court order approving a sale free and clear of liens and encumbrances will almost certainly extinguish all liens, encumbrances, and fraudulent conveyance claims. It should, but will not necessarily, extinguish successor liability claims as well. As the following discussion reveals, the protections provided by a bankruptcy court order with respect to the latter category of claims may not be absolute.

## B. Successor Liability

“Traditionally, a corporation purchasing the assets of another corporation does not, by reason of the purchase of the assets, become liable for the debts and liabilities of the selling corporation.”<sup>1</sup> Successor liability is a judicially-created equitable exception to this general rule. By and large, successor liability has its roots in state law, and the doctrines of successor liability vary from state to state. Most state courts hold that a purchaser of assets does not assume the liabilities of the seller unless (1) there is an express or implied agreement of assumption;<sup>2</sup> (2) the transaction amounts to a consolidation or merger of the two corporations;<sup>3</sup> (3) the purchasing corporation is a “mere continuation” of the seller;<sup>4</sup> or (4) the transfer of assets to the purchaser is for the fraudulent purpose of escaping liability for the seller’s debts. In addition, a fifth exception, referred to as the “product line” exception,<sup>5</sup> has been recognized by a minority of states.<sup>6</sup>

1. *Stoumbos v. Kilimnik*, 988 F.2d 949, 961 (9th Cir. 1993).
2. See, e.g., *Kessinger v. Grefco, Inc.*, 875 F.2d 153, 154 (7th Cir. 1989) (asset purchaser impliedly assumed a seller’s unforeseen liability for certain tort claims where the purchaser agreed “to pay, perform and discharge all debts, obligations, contracts and liabilities” of the seller).
3. This exception has been invoked where one corporation takes all of another’s assets without providing any consideration that could be made available to meet claims of the other’s creditors or where the consideration consists wholly of shares of the purchaser’s stock, which are promptly distributed to the seller’s shareholders in conjunction with the seller’s liquidation. See, e.g., *Marks v. Minn. Mining & Mfg. Co.*, 187 Cal. App. 3d 1429, 1435-36 (1986) (four-factor test for de facto merger: (i) the purchaser continues the same enterprise after the sale; (ii) shareholders of the seller corporation become shareholders of the purchaser; (iii) the seller liquidates; and (iv) the buyer assumes the liabilities of the seller necessary to carry on the business).
4. Decisions holding that a corporation acquiring the assets of another corporation is the latter’s mere continuation and therefore liable for its debts have imposed such liability only upon a showing of one or both of the following factual elements: (1) no adequate consideration was given for the predecessor corporation’s assets and made available for meeting the claims of its unsecured creditors, and (2) one or more persons were officers, directors, or shareholders of both corporations. *Ray v. Alad Corp.*, 19 Cal.3d 22, 29 (1977).
5. Under the “product line” exception established in *Ray*, 19 Cal.3d at 31, a purchaser may be held to have successor liability for claims against the seller where: (1) the sale of assets totally or virtually extinguishes the tort remedies against the seller; (2) the buyer continues to manufacture the same product lines under the same product names; (3) the buyer continues to use the seller’s name or identity, trading on the seller’s goodwill; and (4) the buyer represents to the public that it is an ongoing enterprise. Subsequent cases have emphasized that the “product line” exception applies only to the narrow facts present in *Ray*. In order for the *Ray* exception to apply, the asset sale to the successor corporation must “contribute to the destruction of the plaintiff’s remedies.” *Nelson v. Tiffany Indus., Inc.*, 778 F.2d 533, 536 (9th Cir. 1985) (in order for the *Ray* exception to apply, (1) the plaintiff must lack an effective remedy against the predecessor, and (2) “the successor corporation [must] actually have played some role in curtailing or destroying the plaintiffs’ remedies.”) On the other hand, where the lack of a remedy against the predecessor is the result of the predecessor’s voluntary filing for bankruptcy, not the successor’s purchase of the assets, the *Ray* exception does not apply. *Id.* at 537.
6. The “product-line” exception has been adopted in eight states: California, Mississippi, New Mexico, New Jersey, New York, Pennsylvania and Washington. See *Ray v. Alad Corp.*, 19 Cal.3d 22 (1977); *Huff v. Shopsmith, Inc.*, 786 So. 2d 383 (Miss. 2001); *Garcia v. Coe Mfg. Co.*, 933 P.2d 243 (N.M. 1997); *Ramirez v. Amsted Indus., Inc.*, 86 N.J. 332 (N.J. 1981); *Hart v. Bruno Mach. Corp.*, 679 N.Y.S.2d 740 (N.Y. App. Div. 3d Dep’t 1998); *Dawejko v. Jorgensen Steel Co.*, 290 Pa. Super. 15 (P.A. 1981); *Martin v. Abbott Laboratories*, 102 Wash. 2d 581 (W.A. 1984). Twenty-three states and the District of Columbia have rejected the exception: Colorado, Connecticut, Florida, Georgia, Illinois, Iowa, Kansas, Maine, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, New Hampshire, North Dakota, Ohio, Oklahoma, Oregon, South Dakota, Texas, Vermont, Virginia, Wisconsin and the District of Columbia. See, e.g., *Jordan v. Hawker Dayton Corp.*, 62 F.3d 29 (1st Cir. 1995) (Maine); *Pesce v. Overhead Door Corp.*, 1998 U.S. Dist. LEXIS 20665 (D. Conn. 1998); *Harris v. T.I., Inc.*, 413 S.E.2d 605 (Va. 1992); *Jones v. Johnson Mach. and Press. Co. of Elkart, Ind.*, 320 N.W.2d 481 (Neb. 1982); *Hamaker v. Kenwel-Jackson Mach., Inc.*, 387 N.W.2d 515 (S.D. 1986); *Bullington v. Union Tool Corp.*, 328 S.E.2d 726 (G.A. 1985). See also *City of New York v. Charles Pfizer & Co.*, 688 N.Y.S.2d 23 (App. Div. 1999) (declining to adopt the product line theory of *Ray v. Alad*); *Young v. Fulton Iron Works Co.*, 709 S.W.2d 927 (Mo. Ct. App. 1986); *Griggs v. Capitol Mach. Works, Inc.*, 690 S.W.2d 287 (Tex. App. 1985); *Stratton v. Garvey Int’l, Inc.*, 676 P.2d 1290 (Kan. Ct. App. 1984); *Goucher v. Parmac, Inc.*, 694 P.2d 953 (Okla. Ct. App. 1984); *Pelc v. Bendix Mach. Tool Corp.*, 314 N.W.2d 614 (Mich. Ct. App. 1981).

As discussed below, federal courts of appeal are split on the issue of whether a section 363 sale transfers the sale property free and clear of successor liability claims.<sup>7</sup> The courts that have rejected such successor liability claims have held that the Bankruptcy Code preempts successor liability principles because the latter violate the priority scheme established by the Code and diminish creditor recoveries by depressing the value of the debtor's assets. Other courts have rejected successor liability claims for the reason that successor liability is an "interest" of which the property was sold free and clear.

Courts that have held that successor liability claims are *not* extinguished by a section 363(f) sale have held that (1) successor liability claims are not an "interest in the property" under section 363(f); (2) the bankruptcy court lacks jurisdiction over successor liability claims because such claims are not "claims" over which the bankruptcy court approving the sale could exercise "related to" bankruptcy jurisdiction; or (3) due process principles prohibit sales free and clear of successor liability claims where the holders of such claims did not have adequate notice of the sale and an opportunity to participate therein.

Several courts have taken a "middle ground" position on the issue, holding that if a claim is one that could have been brought in the debtor's bankruptcy case, the claimant is precluded from asserting a successor liability claim.<sup>8</sup>

Although some of the decisions are inconsistent with one another, if one considers the body of case law on this subject as a whole, one should conclude that a successor liability claim is likely to be extinguished by a section 363(f) sale where (1) the claim arose prior to the conclusion of the bankruptcy case; (2) the subject claim was either *in rem* or had a substantial connection to the assets being sold; and (3) adequate notice was provided to the claimant whose claim is to be extinguished.

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7. Bankruptcy Code Section 363(f) permits a trustee or debtor in possession to sell property of the estate free and clear of any entity's interest in the property if any of the following five conditions are 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.
- 11 U.S.C. § 363(f).

8. See, e.g., *Ninth Ave. Remedial Group v. Allis-Chalmers Corp.*, 195 B.R. 716 (N.D. Ind. 1996) (finding that if the claim could have been a claim in bankruptcy against the debtor, the bankruptcy court had the equitable power to discharge the claim against the asset purchaser independently of section 363(f); *In re All American of Ashburn, Inc.*, 56 B.R. 186 (Bankr. N.D. Ga. 1986) (Where product liability claimants elected not to file proof of claim against estate of debtor manufacturer of defective product, court found that claimants could not assert successor liability against purchase of debtor's assets under 11 U.S.C. § 363 on ground that claimants did not receive notice of sale as required under Bankruptcy Rule 2002 because lack of notice resulted from initial decision not to file claim).

**1. Several Courts Have Held that Successor Liability is Preempted by Section 363(f) because the Imposition of Such Liability Conflicts with the Broad Objectives of the Bankruptcy Code.**

Some courts have specifically held that section 363(f) preempts an otherwise valid successor liability claim.<sup>9</sup> Some courts have reasoned that the imposition of successor liability on a purchaser of assets in a Section 363(f) sale rearranges the priority scheme established by the Bankruptcy Code and has a negative impact on the trustee's ability to sell assets of the estate at a fair price.<sup>10</sup> The court in *WBQ Partnership* noted:

*It stands to reason that the purpose behind the "free-and-clear" language is to maximize the value of the asset, and thus enhance the payout made to creditors. Without the "free-and-clear" language, prospective buyers would be unwilling to pay a fair price for the property subject to sale; instead, the price would have to be discounted, perhaps quite substantially, to account for the liabilities that the buyer would face simply as a result of acquiring the asset [citations omitted]. A discounted price would reduce the return to the estate to the detriment of the creditors involved in the case. The "free-and-clear" language avoids this kind of prejudice by providing the buyer with what is essentially a fully marketable title.*<sup>11</sup>

Nevertheless, at least two courts have rejected as "illusory" the purpose-and-objective theory accepted by the court in *WBQ Partnerships*.<sup>12</sup>

**2. Generally, Courts Have Held that Successor Liability Claims Constitute "Interests" of which Property is Sold Free and Clear where Such Claims are In Rem or are Otherwise Specifically Related to the Assets Purchased.**

Section 363(f) provides that "[t]he trustee may sell property under Section (b) or (c) of this section free and clear of any *interest in such property* of an entity other than the estate..." [*italics added*]. Courts have not yet settled upon a precise definition of the phrase "interest in such property."<sup>13</sup>

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9. See, e.g., *Volvo White Truck Corp. v. Chambersburg Beverage, Inc.*, 75 B.R. 944, 950-51 (Bankr. N.D. Ohio 1987) (holding that the Bankruptcy Code, the purposes of which include final resolution and discharge of corporate debt, preempts an otherwise valid successor liability claim).
10. *In re All American of Ashburn, Inc.*, 56 B.R. at 190; *WBQ Partnership v. Commonwealth of Virginia Department of Medical Assistance Services (In re WBQ Partnership)*, 189 B.R. 97 (Bankr. E.D. Va. 1995) (bankruptcy sale free and clear of liens and encumbrances preempted state law authorizing state to collect depreciation payments from purchaser of assets and state permanently enjoined from pursuing purchaser of assets).
11. *WBQ Partnership*, 189 B.R. at 108.
12. See *Chicago Truck Drivers, Helpers and Warehouse Workers Union Pension Fund v. Tameskin, Inc.*, 59 F.3d 48, 50 (7th Cir. 1995) (criticizing these policy arguments as granting bankruptcy purchasers undue protection since asset purchasers would face the risk of successor liability outside of the bankruptcy context and because the priority order established in the bankruptcy case becomes irrelevant after the case is completed); *Western Auto Supply Co. v. Savage Arms, Inc.* (In re *Savage Indus., Inc.*), 43 F.3d 714, 720 (1st Cir. 1994) (finding such policy concerns to be "unwarranted" and "more illusory than real").
13. See *Ninth Ave. Remedial Group*, 195 B.R. at 730-32 ("The courts have not defined 'free and clear of any interest in such property' under 11 U.S.C. Section 363(f)"; see also *Yadkin Valley Bank & Trust Co. v. McGee (In re Hutchinson)*, 5 F.3d 750, 756 n.4 (4th Cir. 1993) ("[C]ourts have recognized that general, unsecured claims do not constitute 'interests' within the meaning of § 363(f)"; *Volvo White Truck Corp. v. Chambersburg Beverage, Inc. (In re White Motor Credit Corp.)*, 75 B.R. 944, 948 (Bankr. N.D. Ohio 1987) ("General unsecured claimants including tort claimants, have no specific interest in a debtor's property. Therefore, Section 363 is inapplicable for sales free and clear of such claims."). See also *Comm'n v. Wolverine Radio Co. (In re Wolverine Radio Co.)*, 930 F.2d 1132, 1147 n.23 (6th Cir. 1991), cert. dismissed, 112 S. Ct. 1605 (1992).

Some courts have held that Section 363(f) applies only to *in rem* interests in the property being sold.<sup>14</sup> Others, however, have found that *in personam* claims are interests in property where such claims have a significant connection to the property that is to be sold free and clear of claims.<sup>15</sup>

**3. In General, Courts Have Held that a Section 363 Sale Does Not Transfer the Property Free and Clear of Successor Liability for Future Claims where (1) the Plan Does Not Provide for Such Claims and (2) the Claimant Did Not Have an Opportunity to File its Proof of Claim against The Debtor during the Course of the Bankruptcy Case.**

In general, courts have held that a Section 363 sale does not extinguish successor liability for future claims where (1) the plan does not provide for such claims and (2) the claimant did not have an opportunity to file its claim against the debtor during the course of the bankruptcy case. Some courts have based a refusal to bar successor liability for future claims on the ground that such claims are not “claims” over which the bankruptcy court approving the sale could exercise “related to” bankruptcy jurisdiction.<sup>16</sup> As discussed below, other courts have declined to preclude successor liability for future claims on due process grounds because future claimants received inadequate notice that their claims would be foreclosed by the sale.

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14. *Fairchild Aircraft Corp. v. Cambell (In re Fairchild Aircraft Corp.)*, 184 B.R. 910, 917-19 (Bankr. W.D. Tex. 1995) (holding that Section 363(f) applies only to “in rem interests which have attached to the property,” by way of either “the debtor’s consent to a security interest or the creditor’s attachment of the property resulting in a lien”); see also *Ninth Ave. Remedial Group*, 195 B.R. at 729-32 (observing that a few courts have held that Section 363(f) applies only to *in rem* interests, while numerous other courts have interpreted the statute more broadly, applying it, for example, to product liability and employment discrimination claims); *Zerand-Bernal Group, Inc. v. Cox*, 23 F.3d 159, 163 (7th Cir. 1994) (Posner, C.J.) (finding that sale pursuant to Section 363(f) may cleanse assets of liens and other encumbrances, but not successor product liability claims); *Wilkerson v. C.O. Porter Machinery Co.*, 567 A.2d 598 (N.J. Super. 1989) (finding that Section 363(f) does not address successor liability claims); see also *Western Auto Supply Co. v. Savage Arms, Inc. (In re Savage Indus., Inc.)*, 43 F.3d 714 (1st Cir. 1994) (explicitly reserving question of whether Section 363(f) enables extinguishment of state law successor “product-line” liability claims, while holding that because of inadequate notice to such claimants, their claims survived against both the debtor and asset purchaser); *In re White Motor Credit Corp.*, 75 B.R. at 948 (holding that Section 363(f) only authorizes sales free and clear of specific interests in property being sold, but is inapplicable to sales free and clear of tort claims or other general unsecured claims, as such claimants have no specific interest in property; but that authority for sale free and clear of successor liability may be found in Section 105(a), and is coextensive with power to discharge claims under plan of reorganization).
15. *P.K.R. Convalescent Centers v. Commonwealth of Virginia, Dep’t of Medical Assistance Servs. (In re P.K.R. Convalescent Centers)*, 189 B.R. 90, 92-94 (Bankr. E.D. Va. 1995) (holding that Section 363(f) permitted a sale free and clear of Virginia’s depreciation-recoupment interest in the debtor’s property, although that “interest” was unsecured by a lien or otherwise); *In re Leckie Smokeless Coal Company*, 99 F.3d 573, 582 (4th Cir. 1996) (“Because there is therefore a relationship between (1) the Fund’s and Plan’s rights to demand premium payments from [the purchasers] and (2) the use to which [the purchasers] put their assets, we find that the Fund and Plan have interests in those assets within the meaning of Section 363(f)”).
16. See, e.g., *Zerand-Bernal Group, Inc.*, 23 F.3d at 163 (finding bankruptcy court lacked jurisdiction to enjoin a successor liability suit against the purchaser of the debtor’s assets where the plaintiff was not injured until years after the consummation of the bankruptcy); *Matter of Mooney Aircraft Inc.*, 730 F.2d 367, 375 (5th Cir. 1984) (decided under the old Bankruptcy Act of 1898 and stating, in dicta, that bankruptcy court cannot sell assets free and clear of all claims asserted by product liability plaintiffs when their claims did not arise until five years after the bankruptcy proceedings closed); *Fairchild Aircraft, Inc.*, 184 B.R. at 921-34 (holding that the claimants’ successor liability action was not a “claim” within the meaning of the Bankruptcy Code).

#### **4. A Section 363 Sale Does Not Transfer Property Free And Clear Of Successor Liability Claims that Arise after The Bankruptcy Case Has Closed.**

In those cases in which courts have concluded that a sale free and clear under Section 363(f) precludes successor liability, the subject claimants either participated in or had notice and the opportunity to participate in the bankruptcy case.<sup>17</sup> In other words, the creditors in these cases had filed or should have filed their claims against the asset seller, the predecessor, in the bankruptcy court.

By contrast, in the few cases where the successor liability claim did not arise until the bankruptcy case had been closed, courts have declined to hold that the sale order entered pursuant to Section 363(f) barred assertion of the claim against the successor.<sup>18</sup>

Nevertheless, in *White Motor Credit Corp.* and *In re Paris Industries Corp.*, the courts held that property could be sold free and clear of future claims that were or might be claims against the debtor, even if such claims arose after the closing of the bankruptcy case. The court in the latter case explained:

*I thus disagree with Mooney Aircraft Corp. v. Foster, 730 F.2d 367 (5th Cir. 1984), which held that a bankruptcy court cannot approve the sale of estate assets free and clear of all claims that might arise in the future, but only free of claims then existing. Id. at 375. To conclude that a bankruptcy court cannot approve the sale of assets free and clear of such future claims against a purchaser from the debtor significantly impairs the bankruptcy court's ability to administer bankruptcy estates. Every sale must then be discounted by the risk the purchaser sees of future claims. The result will be decreasing assets for those later-filed claims that can be brought against the purchaser.*<sup>19</sup>

#### **5. A Lack of Sufficient Notice to Holders of Claims May Preclude a Section 363(f) Sale from Extinguishing Successor Liability Claims.**

Some courts have held that successor liability may attach where the holders of claims did not receive sufficient notice that the sale would extinguish their claims.<sup>20</sup> In *Savage Industries*, the debtor was in the business of manufacturing firearms and, during the course of its bankruptcy case, sold substantially all of its assets to Savage Arms. The debtor never attempted to serve notice of the sale upon its wholesale and retail distributors. Prior to the sale, an individual was injured by a debtor-manufactured firearm. After the asset transfer was consummated, he brought suit against the debtor and the retail distributor, who added the asset purchaser as a party defendant. The court rejected the arguments

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17. See *In re P.K.R. Convalescent Centers, Inc.*, 189 B.R. 90 (Bankr. E.D. Va. 1995) (bankruptcy court enjoins creditor before the court from suing asset purchaser before approving the sale); *In re WBQ Partnership*, 189 B.R. 97 (Bankr. E.D. Va. 1995) (same); *In re White Motor Credit*, 75 B.R. 944 (successor liability denied where claim arose before debtor filed for bankruptcy and creditor could have filed a claim against the bankruptcy estate in the bankruptcy case); *In re All American of Ashburn, Inc.*, 56 B.R. 186 (Bankr. N.D. Ga. 1986) (successor liability precluded where creditor did not file a claim against debtor even though the claim ripened before bankruptcy and creditor knew that debtor had filed for bankruptcy); *Rubinstein v. Alaska Pacific Consortium (In re New England Fish)*, 19 B.R. 323 (Bankr. W.D. Wash. 1982) (no successor liability where creditor had filed suit against debtor before the latter filed for bankruptcy); see also *Paris Mfg. Corp. v. Ace Hardware (In re Paris Indus. Corp.)*, 132 B.R. 504 (W.D. Maine 1991) (enjoining creditors from filing a suit against the asset purchaser when they can file a claim against the predecessor in the bankruptcy court); *Forde v. Kee-Lox Mfg. Co.*, 437 F. Supp. 631 (W.D. N.Y. 1977) ("The plaintiffs' remedy in this case was to file a claim with the trustee in bankruptcy," when the cause of action accrued before the debtor filed for bankruptcy).

18. See *Chicago Truck Drivers, Helpers and Warehouse Workers Union (Indep.) Pension Fund v. Tameskin, Inc.*, 59 F.3d 48 (7th Cir. 1995) (holding that the Bankruptcy Code cannot preclude assertion of a successor liability claim where the bankruptcy case was closed well before the claim was brought before the court).

19. *In re Paris Indus. Corp.*, 132 B.R. 504, 510 n.14.

20. See, e.g., *In re Savage Indus., Inc.*, 43 F.3d at 721.

that the sale extinguished successor liability claims and that direct notification would have imposed exorbitant financial and logistical burdens upon the debtor, noting that the identity of distributors probably appeared in the debtor's records and that the asset purchase agreement disclosed the existence of 44 product liability claims at the time of communication of the sale.

However, other courts have rejected lack of actual notice to future claimants as a basis for allowing successor liability.<sup>21</sup>

In *Paris Mfg. Corp.*, the court noted that “[t]he purpose of notice to creditors and other parties-in-interest when bankruptcy assets are to be sold, see Bankruptcy Rule 2002(a), is to ensure that the sales price is fair and that the funds flowing into the bankrupt estate for distribution among creditors or for other purposes are the most that could be realized from the assets sold.” The court then rejected the claimants’ argument that a lack of notice of the sale entitled them to seek a remedy against the successor, and explained as follows:

*Ace and Hesse lost nothing by virtue of the sale. Before the sale they had no claim against Leander but only an inchoate claim against the Debtor. (Leander had no relationship to either the Debtor or Ace, Hesse and the Pabsts.) Ace and Hesse still have their claim against the Debtor (now the estate) regardless of the sale. Furthermore, the liquidation of the assets and their replacement with cash (which was then apparently distributed to a secured creditor) has not affected Ace’s and Hesse’s ability to recover on their claim. The irony of Ace’s and Hesse’s argument is that they would not even be able to make their claim against Leander were it not for the sale, for it is only by the sale of assets and the doctrine of successor liability that they can even assert such a claim.*

*In sum, I conclude that Ace and Hesse were in no way prejudiced by the lack of notice and their inability to appear and argue their position on the sale. They have made no showing that, if they had been notified and had appeared, they could have made any arguments to dissuade the bankruptcy court from issuing its order that the assets be sold free and clear of all claims. Since they have shown no prejudice, there was no need for the bankruptcy court to vacate its earlier order as it applies to Ace and Hesse.*<sup>22</sup>

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21. See *Sequa Corp. v. Christopher (In re Christopher)*, 28 F.3d 512, 516 (5th Cir. 1994) (noting that due process generally requires “notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections”) (quoting *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1950)); see also *Conway v. White Trucks*, 885 F.2d 90, 96 (3d Cir. 1989) (noting that lack of notice “primarily provides a justification for permitting [a creditor] to file a late proof of claim with the bankruptcy court or to avoid the discharge . . . rather than a justification for imposing successor liability on [the bankruptcy purchaser]”); *Ninth Ave. Remedial Group*, 195 B.R. at 734-35 (explaining that, in bankruptcy context, “constructive notice, provided through publication . . . is sufficient for unknown potential creditors”); *In re Paris Indus. Corp.*, 132 B.R. at 509 (explaining that due process rights of products liability plaintiffs were not impaired and that plaintiffs were not prejudiced by lack of notice because, in absence of bankruptcy sale, plaintiffs would hold no claims against purchaser).

22. *In re Paris Indus. Corp.*, 132 B.R. at 509-510.

**6. Courts are Split as to whether a Bankruptcy Court has Jurisdiction to Enjoin a Successor Liability Suit after the Bankruptcy Case has Closed.<sup>23</sup>**

Inadequate notice to future claimants precludes injunctive relief.<sup>24</sup>

**III. The Sub Rosa Plan Issue**

In the event the stalking horse concludes that it should proceed in the bankruptcy court, it should address numerous additional issues, including the issue of whether to conclude the sale under Section 363 or a plan of reorganization. In their desire to expedite the sale process, the debtor and stalking horse purchaser will generally prefer to accomplish the sale under Section 363, rather than under a plan of reorganization. They will prefer this course of action because the plan confirmation process involves a host of procedures, issues and potential delay factors that are not present in the Section 363 context.

In emergent circumstances, in which assets are either perishable or otherwise rapidly diminishing in value, courts have almost uniformly permitted expedited Section 363 sales of all or substantially all assets. Historically, as discussed more fully below, in the absence of such emergent circumstances, courts found such sales to be problematical because they effectively sought to dispose of the estate without all of the protections afforded by the plan confirmation provisions of the Bankruptcy Code. In recent years, however, the courts have generally adopted a more lenient view with respect to proposed, non-emergent sales of all or substantially all of the assets of the debtor.

“A sub rosa plan is a transaction or agreement that allegedly sidesteps the protections of the reorganization process as those protections are embodied in the plan confirmation process.”<sup>25</sup> The term “sub rosa” was used in this context in *Pension Benefit Guaranty Corp. v. Braniff Airways, Inc.* (*In re Braniff Airways, Inc.*).<sup>26</sup> Other courts have used the terms “de facto plan,”<sup>27</sup> “creeping plan of reorganization”<sup>28</sup> or “piecemeal plan doctrine”<sup>29</sup> to describe the same problem. The underlying concern that courts have expressed is the concern that, while the sale transaction is at the heart of the debtor’s restructuring, it is accompanied by few of the substantive and procedural requirements and safeguards of the plan confirmation process. As one court has noted, the sub rosa plan has “the

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23. *Compare Zerand-Bernal Group, Inc.*, 23 F.3d 159 (finding lack of jurisdiction) and *In re Fairchild Aircraft Corp.*, 184 B.R. 910 (finding lack of jurisdiction), *vacated by*, 220 B.R. 909 (Bankr. W.D. Tex. 1999) (vacating judgment on equitable grounds, but standing behind rationale of original judgment); cf., with *In re White Motor Corp.*, 75 B.R. 944 (finding jurisdiction).

24. *In re Savage Indus., Inc.*, 43 F.3d at 714; *In re Fairchild Aircraft Corp.*, 184 B.R. at 934 n. 28 (“[S]ection 105 is not limitless. That section does not, of itself, authorize a court to eliminate future rights of persons who are not in any way before the court. Allowing this would be tantamount to allowing a party to obtain a declaratory judgment that their adversary’s rights were barred without giving the adversary notice of the proceeding, an action that is precluded by accepted legal principles.”).

25. Craig A. Sloane, *The Sub Rosa Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 Bankr. Dev. J. 37, 39-40 (1999).

26. 700 F.2d 935, 940 (5th Cir. 1983).

27. *In re Lion Capital Group*, 49 B.R. 163, 175 (Bankr. S.D. N.Y. 1985).

28. *Institutional Creditors of Continental Airlines, Inc. v. Continental Airlines, Inc.* (*In re Continental Airlines, Inc.*), 780 F.2d 1223, 1227 (5th Cir. 1986).

29. *In re Work Recovery*, 202 B.R. 301, 304 (Bankr. D. Ariz. 1996).

practical effect of dictating some of the terms of any future reorganization plan” and will “short circuit the requirements of Chapter 11 for confirmation of a reorganization plan.”<sup>30</sup> The *Braniff*<sup>31</sup> and *Lionel*<sup>32</sup> cases essentially frame the sub rosa plan discussion.

In *Braniff*, the debtor sought to sell all of its assets — airplanes, terminal leases, landing slots — to another airline in exchange for travel scrip, unsecured notes and profit sharing in another airline. The appellate court held that Section 363(b) did not authorize the transaction and that the transaction was, in essence, a reorganization of the debtor’s estate that did not “scale the hurdles erected in Chapter 11.”<sup>33</sup> The court reasoned that the proposed transaction encroached upon the plan confirmation process because it (i) “changed the composition of Braniff’s assets,” with the “practical effect of dictating some of the terms of any future reorganization plan,” (ii) dictated that the secured creditors vote their deficiency claim in favor of any proposed plan approved by a majority of the unsecured creditors’ committee, effectively placing restrictions on creditors’ plan voting rights, and (iii) would grant the debtor, its officers, its directors, and the secured creditors a release of all claims by all parties, thereby altering creditors’ rights.<sup>34</sup>

In *Lionel*, the debtor sought to sell its principal asset — an 82 percent equity stake in a profitable corporation — for \$50 million prior to confirmation.<sup>35</sup> The bankruptcy court approved the sale, with no findings on the record, other than that the unsecured creditors’ committee insisted on the sale and that failure to permit the sale would delay the debtor’s restructuring process one year or longer. The Committee of Equity Security Holders and the SEC objected to the sale and appealed the bankruptcy court’s decision on grounds that the sale deprived creditors of the safeguards of the plan confirmation process and divested the debtor of a profitable asset, “which could serve as a cornerstone for a sound plan.”<sup>36</sup> After examining the extensive history of sales and use of property outside the ordinary course of business under previous and current iterations of the Bankruptcy Code, the appellate court rejected the “requirement that only an emergency permits the use of § 363(b)” and “the view that § 363(b) grants the bankruptcy judge carte blanche.”<sup>37</sup> The appellate court reasoned that an emergency<sup>38</sup> was not required before sale of assets would be permitted and that the asset sale process itself provides sufficient procedural protections; nevertheless, the appellate court declined to approve the asset sale on grounds that the debtor did not advance a business justification for the sale other than the appeasement of the debtor’s major creditors.<sup>39</sup>

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30. *In re Braniff Airways, Inc.*, 700 F.2d at 940.

31. 700 F.2d 935.

32. *Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2d Cir. 1983).

33. *In re Braniff Airways, Inc.*, 700 F.2d at 940.

34. *Id.* at 939-940.

35. *In re Lionel Corp.*, 722 F.2d at 1065.

36. *Id.* at 1066.

37. *Id.* at 1069.

38. See generally *In re Brookfield Clothes, Inc.*, 31 B.R. 978 (S.D. N.Y. 1983) (reasoning that Section 363(b) asset sales could dispose of substantially all of the debtor’s property, preplan, assuming appropriate showing of exigency made); *In re Delaware & Hudson Ry. Co.*, 124 B.R. 169 (D. Del. 1991) (relying on Bankruptcy Act case law, including *Solar Mfg. Corp.*, 176 F.2d 493, 495 (3d Cir. 1949) and recognizing that delays inherent in the chapter 11 process could themselves constitute the emergency to authorize such a sale).

39. *In re Lionel Corp.*, 722 F.2d at 1071.

While the Lionel appellate court rejected the sale motion, it nonetheless articulated certain standards for the approval of such transactions. Specifically, the debtor must provide “some articulated business justification” for using, selling or leasing property outside the ordinary course of business before the disposition may be authorized under Section 363(b). The bankruptcy judge must “expressly find from the evidence presented before him at the hearing a good business reason” to approve a Section 363(b) sale.<sup>40</sup> The court then enunciated the following non-exhaustive list of other factors a bankruptcy court might consider in evaluating a Section 363(b) transaction:

*In fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders alike. He might, for example, look to such relevant factors as 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-a-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. This list is not intended to be exclusive, but merely to provide guidance to the bankruptcy judge.*<sup>41</sup>

The recent case law has generally been in accordance with the Lionel doctrine, in that courts have permitted asset sales outside of a plan of reorganization if the debtor can establish a reasonable business justification. In analyzing whether a debtor has established such a reasonable business justification, one court has advocated consideration of the following six factors: (1) Has the debtor articulated a business justification for the request? (2) Is the debtor exercising sound business judgment in proposing to enter into the subject transaction? (3) Will the proposed transaction further the diverse interests of the debtor, creditors and equity holders alike? (4) Is the asset increasing or decreasing in value? (5) Does the proposed transaction specify terms for adoption of the reorganization plan? (6) Will approval of the proposed transaction effectuate a *de facto* reorganization in such a fundamental fashion as to render creditors’ rights under the other provisions of chapter 11 meaningless?<sup>42</sup>

#### **IV. Sale Contract and Procedure Terms of Special Interest to the Stalking Horse**

The negotiation of an asset purchase agreement and related sale procedures can be a contentious process in which the stalking horse bidder seeks to erect a variety of substantive, procedural and practical impediments to the meaningful participation of potential overbidders. Depending upon the terms and circumstances, these requested “impediments” may or may not be reasonable. The sought-for impediments may include, without limitation:

- Financial Qualification/Earnest Money Deposit. The stalking horse may seek to condition participation by a potential overbidder on a number of conditions, including financial qualifications and the posting of an earnest money deposit greater than that posted by the stalking horse.

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40. *Id.*

41. *Id.*

42. *In re Work Recovery, Inc.*, 202 B.R. at 304

- **Shortened Marketing Period.** While the stalking horse may have itself enjoyed a lengthy “due diligence” period, it may insist upon a highly truncated period between the time of execution of the asset purchase agreement and the sale hearing. Often, otherwise-interested potential overbidders may drop out of the process because they simply do not have adequate time to conduct necessary due diligence and address financing and business integration issues. Needless to say, if the asset is diminishing in value, the shortened period may be necessary or desirable and may, in effect, offset the detriment of diminished participation by potential overbidders.
- **Break-up Fees and Expense Reimbursement.** Commonly, the stalking horse will insist upon the receipt of a break-up fee and/or expense reimbursement to compensate it for its lost opportunity cost and out-of-pocket expenses in the event that it is not the successful purchaser of the assets. Although such fees may be reasonable, they inherently create barriers to participation by driving up the acquisition cost that must be paid by a potential overbidder.
- **Initial Required Bid Increment.** Although the establishment of an initial minimum bid increment helps to foster an efficient and healthy auction environment, the stalking horse may seek to heighten the cost of, and hence restrict, an overbidder’s participation by demanding the establishment of an unduly high minimum overbid.
- **Bundling of Assets.** The stalking horse often demands that the sale-procedures order preclude bidding on fewer than all of the assets to prevent a group of bidders, or “smaller players,” from effectively participating. Such a restriction may be unreasonable in circumstances in which the debtor can assemble a group of non-overlapping competitive bidders for the same collection of assets. In other circumstances, however, it can be justified. The latter circumstances include those in which the presence of piecemeal or overlapping bids makes it impossible to determine who has made the higher and better offer and the stalking horse’s entitlement to any break-up fee and expense reimbursement.
- **“No Shop” Clauses.** The stalking horse will attempt to limit the ability of the debtor to market the assets to potential overbidders. As discussed more fully below, the validity of these provisions will almost certainly depend upon their breadth.

## V. Stalking Horse Lock-up Provisions in Bankruptcy Asset Sale Agreements

### A. Lock-up Provisions

#### 1. Break-up Fees

A “break-up fee” is a payment made by the seller to a proposed buyer with whom the seller fails to consummate a proposed transaction. A break-up fee, as defined here, is alternatively characterized as a termination fee and may or may not conclude an expense reimbursement component.<sup>43</sup> There is also a variation of the termination fee known as a topping fee, which is a percentage of the difference between the stalking horse bid and the successful bid.<sup>44</sup>

Break-up fees are one of many deal protection or lock-up mechanisms commonly found in the world of corporate mergers and acquisitions. From the buyer’s perspective, break-up fees are designed to compensate the failed buyer for expenses incurred in its attempt to acquire the asset in question. Some expenses may be direct and tangible, such as costs of due diligence, costs to obtain financing commitments, and professional fees paid to negotiate and draft agreements. Other expenses may be less direct and tangible, but no less meaningful to the buyer. These expenses may include opportunity costs, and the time, energy and resources of the buyer’s management. Furthermore, in using the term break-up fees, we denote only contractually made obligations, which are distinguishable from all available claims that can be made subsequent to conducting the auction, pursuant to Section 503(b).<sup>45</sup>

The first reported case addressing the issue of break-up fees in the realm of bankruptcy was decided in 1989, *In re 995 Fifth Avenue Associates, L.P.*<sup>46</sup> Since that time, bidders of assets of bankruptcy estates have been more frequently proposing break-up fees in their offers. Meanwhile, courts have struggled to find a suitable analytical framework for evaluating the propriety of break-up fees. In *Fifth Avenue*, the court adopted the jurisprudence of corporate takeovers saying that the analytic principles had “vitality by analogy.”<sup>47</sup> *Fifth Avenue* and its progeny<sup>48</sup> have essentially applied a deferential standard, used elsewhere in the bankruptcy context, that has been termed the “business judgment rule.” Other courts have been unwilling to follow such a deferential, obsequious course, and have

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43. Courts have traditionally attempted to sort the outlay incurred through a break-up fee into one of the above stated categories (termination fees or expense reimbursements) based on rights-based claims, e.g., the first bidder in an auction can make a claim to recompense for their due diligence incurred in making that initial bid, if the expense is transferred to subsequent bidders - enhancing the overall value of the sale. However, that analysis fails to accurately capture the issue from the standpoint of economic efficiency, for reasons that are outlined hereinafter. As such, all “break-up fees” will be treated as a unit in this piece.

44. If the stalking horse bid is Z and the asset sells to the successful bidder for Z + X (X being the premium on the sale), a topping fee would be a percentage of X. Topping fees are frequently capped at some fixed amount.

45. See generally *In re Diamonds Plus, Inc.*, 233 B.R. 829 (Bankr. E.D. Ark. 1999) (denying break-up fee claim because there was no agreement, but approving expense reimbursement under 503(b)).

46. 96 B.R. 24 (Bankr. S.D. N.Y. 1989). Indeed, *Fifth Avenue* appears to be the first time a bankruptcy court ruled on a lock-up provision of any kind.

47. *Id.* at 28.

48. See e.g., *In re RSL COM Primecall, Inc. & RSL COM USA, Inc.*, 2002 Bankr. LEXIS 367, \*31 (Bankr. S.D. N.Y. 2002) (“Approval of the Break-Up Fee is particularly warranted . . . where the Purchaser has negotiated a complex agreement that can serve as a floor for other parties to bid against.”); *In re Integrated Resources, Inc.*, 135 B.R. 746 (Bankr. S.D. N.Y. 1992) (approving motion for order allowing debtor to agree to break-up fees); *In re Twenver, Inc.*, 149 B.R. 954, 956 (Bankr. D. Colo. 1992) (holding that the proposed “topping fee” (in conjunction with a minimum bid limit) “would serve to hamper, rather than enhance, any prospects for a higher bid.”); *In re Marrose Corp.*, 1991 Bankr. LEXIS 2177, \*15 (Bankr. S.D. N.Y. 1991) (“[T]he strategy used must enhance the bidding to benefit the creditors of the estate.”).

adopted a standard that asks if the break-up fee is in “the best interest of the estate.”<sup>49</sup> A new thread has developed recently where courts have pursued an altogether different inquiry, asking whether the breakup-fee qualifies as an administrative claim under Section 503(b) of the Bankruptcy Code.<sup>50</sup>

## **2. No-Shop/Window-Shop Provisions**

A “no-shop” clause prohibits the debtor from “shopping” the asset to other potential buyers, thus limiting competition from potential overbidders. A typical no-shop clause provides as follows:

Except with the prior written consent of the [buyer], the debtor shall refrain from (a) initiating or soliciting any inquiries or making any proposals with respect to, or engaging in negotiations concerning or (b) except as required by a court of competent jurisdiction, providing to any person (other than a governmental entity) any confidential information relating to any business combination with the debtor or any lease, acquisition or purchase of all or any significant portion of the assets of the debtor.

Only once has a court ruled on such a no-shop provision in a published opinion, *In re Big Rivers Elec. Corp.*<sup>51</sup> There, the court struck down the contract as violative of public policy, explaining that the no-shop provision restricted the debtor from procuring the highest value for its asset, which could potentially force the directors to breach their fiduciary duties.<sup>52</sup>

A “window shop” clause is a variant on the no-shop clause. Under such a provision, while continuing to restrict by agreement the ability of the debtor to attract or seek competing bids, the directors are permitted to communicate with, and provide financial information to, unsolicited bidders, thus fulfilling their duty to secure the highest value. In theory, the ability to communicate with the unsolicited bidder regarding certain provisions of the proposed deal alleviates any fiduciary conflict. However, in apparently the only reported bankruptcy court decision to rule on such a provision, *In re Bidermann Industries U.S.A., Inc.*,<sup>53</sup> an agreement to a window-shop clause was found to violate the directors’ fiduciary duties to the company, making the agreement null and void.<sup>54</sup>

While courts uniformly deplore traditional “no-shop” provisions, they recognize that the superior bargaining power of the stalking horse often permits it to insist that such a clause be included in the contract. Recognizing this commercial fact of life, many courts will grudgingly approve a “watered down” variant of the “window shop” clause that requires publication of proposed sale terms and procedures, notice to likely overbidders, and sharing of financial and other information with qualified overbidders.

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49. See *In re S.N.A. Nut Co.*, 186 B.R. 98 (Bankr. N.D. Ill. 1994); *In re America West Airlines*, 166 B.R. 908 (Bankr. D. Ariz. 1994).

50. See *Calpine Corp. v. O’Brien Envtl. Energy, Inc. (In re O’Brien Envtl. Energy, Inc.)*, 181 F.3d 527, 533 (3rd Cir. 1999) (affirming bankruptcy court’s denial of break-up fee on basis that the bid did nothing to preserve the value of the estate).

51. 233 B.R. 726 (Bankr. W.D. Ky. 1998).

52. *Id.* at 735-36.

53. 203 B.R. 547, 553 (Bankr. S.D. N.Y. 1997)

54. Yet, *Bidermann* may be easily distinguishable in that the transaction in question in that case was an insider sale tainted by “manifest self-dealing.”

### **3. Bid Protection (Fixed Incremental Bids)**

Frequently employed in auctions, “bid protection” provides for a “fixed” minimum increment in any subsequent offer — in effect, setting a minimum bid level. The “lock-up” occurs when the initial bid increment discourages overbidders from participating. Most experienced practitioners would agree that the establishment of a minimum bid increment fosters a more expeditious and orderly auction process. All would agree that the initial increment must be sufficient to cover any break-up fee and expense reimbursement to which the stalking horse may become entitled. The issue concerns the amount by which that amount should be exceeded.

While all would agree that the appropriateness of the increment must be determined in relation to the size of the transaction, it is difficult to establish any “bright line” test or “rule of thumb.” The increment should not be such that competitive bidding is discouraged.

As noted above, three competing frameworks for analyzing the propriety of bidding incentives have evolved in the courts. Legal commentators have, likewise, attempted to synthesize a doctrinal basis for each of these frameworks. Given that the origin of lock-up provisions is in corporate mergers and acquisitions, it is perhaps no surprise that the *Fifth Avenue* court, the first known bankruptcy court to confront a lock-up provision, simply adopted the test developed under corporate law, a test known as the business judgment rule. Later, in *Integrated Resources*, an analysis based on the business judgment rule was set forth as the following three-part test: (1) Was the negotiation of the lock-up provision tainted by self-dealing or manipulation? (2) Does the clause discourage rather than encourage bidding? (3) Is the provision unreasonable relative to the proposed purchase price?<sup>55</sup> Commentators coming down in favor of the business judgment rule have approached this issue from both a law-and-economics perspective<sup>56</sup> and an auction-theory perspective.<sup>57</sup>

Several years after the *Fifth Avenue* court adopted the business judgment rule, the *Hupp* court declined to follow such a deferential review.<sup>58</sup> There, the court acknowledged the presumed validity of a lock-up provision outside of bankruptcy, but said that a bankruptcy court must take into consideration any detrimental effect on the debtor’s estate.<sup>59</sup> Shortly thereafter, an article sharply criticizing the use of lock-up provisions in bankruptcy cases was published.<sup>60</sup> The article was extremely influential.

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55. See *In re Hupp*, 140 B.R. 191 (Bankr. N.D. Ohio 1992); *In re Integrated Resources*, 135 B.R. 746.

56. Mark F. Hebbeln, Note & Comment, *The Economic Case for Judicial Deference to Break-up Fee Agreements in Bankruptcy*, 13 Bank. Dev. J. 475 (1997).

57. Kermit Roosevelt III, *Understanding Lockups: Effects in Bankruptcy and the Market for Corporate Control*, 17 Yale J. on Reg. 93 (2000).

58. *In re Hupp*, 140 B.R. 191.

59. *Id.*

60. Bruce A. Markell, *The Case Against Breakup Fees In Bankruptcy*, 66 Am. Bankr. L.J. 349 (1992).

and its reasoning was explicitly adopted in a case that set forth a new standard known as the “best interest of the estate” test, *In re America West Airlines, Inc.*<sup>61</sup> This standard has enjoyed widespread appeal, amongst both courts<sup>62</sup> and commentators.<sup>63</sup>

The Third Circuit became the first federal appeals court to analyze a lock-up provision.<sup>64</sup> In *O’Brien*, the court evaluated how previous courts had reviewed requests for break-up fees and expense reimbursement provisions, but ultimately determined that an application for a break-up fee and expense reimbursement should be treated no differently from other applications for administrative expenses under Section 503(b) of the Bankruptcy Code.<sup>65</sup> Consequently, the court held that the determination whether to approve a break-up fee or expense reimbursement “must be made in reference to general administrative expense jurisprudence.”<sup>66</sup> Practically speaking, this determination is similar to the “best interest of the estate” test - the requesting party must demonstrate that the expenses “were actually necessary to preserve the value of the estate.”<sup>67</sup>

More importantly, however, the *O’Brien* court offered a counterintuitive approach to the timing of the bankruptcy court analysis. It held that it would evaluate the appropriateness of a proposed break-up fee and expense reimbursement only *after* the sale had been completed.

In *O’Brien*, the debtor decided to sell all or substantially all of its assets rather than to pursue the emergence of the company as a going concern. In accordance therewith, the debtor conducted an organized marketing process under which it contacted over 300 potential buyers, organized due diligence rooms and solicited offers. Ultimately, the debtor elected to move forward with an offer presented by Calpine Corporation (“Calpine”). Shortly thereafter, the debtor filed a motion seeking approval, subject to overbid, of a purchase agreement that provided for a \$2 million break-up fee and up to approximately \$2 million in expense reimbursement. The bankruptcy court refused to approve the break-up and expense reimbursement on the grounds that they would “perhaps chill or at best certainly complicate the competitive bidding process.”<sup>68</sup> Instead, the bankruptcy court indicated that it would be willing to permit Calpine to seek a breakup fee and expense reimbursement at the end of the process. After initially refusing to move forward on this basis, Calpine ultimately agreed to do so pursuant to a provision in the sale procedures order that provided that “Calpine’s right to request approval from the Court of the allowance and payment of a break-up fee and break-up expense is

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61. 166 B.R. 908.

62. See, e.g., *In re Wintz Cos.*, 230 B.R. 840 (B.A.P. 8th Cir. 1999) (test is whether fee is in the best interest of the estate); *In re APP Plus, Inc.*, 223 B.R. 870, 875 (Bankr. E.D. N.Y. 1998) (authorizing break-up fee and analyzing whether addition of a “topping fee” would similarly “encourage rather than discourage the bidding, and whether it would enhance rather than detract from the ultimate maximum recovery to the estate.”); *In re Tiara Motorcoach Corp.*, 212 B.R. 133 (Bankr. N.D. Ind. 1997); *S.N.A. Nut*, 186 B.R. at 105 (holding that “absent compelling circumstances which clearly indicate that payment of the fee would be in the best interest of the estate, break-up fees should not be awarded in bankruptcy auction sales”).

63. See, e.g., John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 *Stan. L. Rev.* 307 (2000); Paul B. Lackey, *Note: An Empirical Survey and Proposed Bankruptcy Code Section Concerning the Propriety of Bidding Incentives in a Bankruptcy Sale of Assets*, 93 *Colum. L. Rev.* 720 (1993).

64. *O’Brien*, 181 F.3d at 533.

65. *Id.* at 535

66. *Id.*

67. *Id.*

68. *O’Brien.*, 181 F.3d at 529

hereby reserved ... [and that] should the [Calpine Contract] be terminated pursuant to Section 14.1(g) thereof, or the Court confirm a plan-based Bid other than Calpine's ... [various entities] shall support the allowances and payment of such break-up fee and break-up expense.”

Ultimately, the bankruptcy court approved an overbid made by a third party, and the sale to the third party was consummated. Thereafter, Calpine filed a motion seeking the allowance and payment of a \$2 million break-up fee and a \$2.25 expense reimbursement. The bankruptcy court denied both requests. Calpine then appealed both the bankruptcy court's decision not to approve the break-up fee and expense reimbursement at the time of the entry of its sale procedures order and the bankruptcy court's order denying Calpine's post-sale request for allowance and payment of a break-up fee and expense reimbursement.

With respect to the first order, the Third Circuit held that Calpine, as a prospective purchaser lacking any claim against the estate or a court-approved agreement, did not have standing under the “person aggrieved” standard to appeal the bankruptcy court's decision not to approve the break-up fee and expense reimbursement presented by the debtor at the time of the entry of the sale procedures order. With respect to the second order, the Third Circuit analyzed a list of nine factors identified by the bankruptcy court as relevant to the allowance of a break-up and expense reimbursement and determined that these factors did not support the conclusion that the requested break-up fee and expense reimbursement were necessary to preserve the value of the debtor's estate as required under Section 503(b)(1)(A).

Initially, practitioners and commentators feared that *O'Brien* would dramatically alter the manner in which assets were sold in Chapter 11.<sup>69</sup> Many feared that bankruptcy courts would shy away from approving break-up fees and expense reimbursements prior to the conclusion of the transaction, and that this would cause many prospective “stalking horse” purchasers to shy away from pursuing the acquisition of assets in Chapter 11, particularly in those instances in which the sale involved significant expense and a high opportunity cost, thereby degrading the value of the debtor’s assets.

The decision, however, has had a far less significant impact than initially predicted. Indeed, bankruptcy courts have routinely continued to approve break-up fees and expense reimbursement provisions in connection with the approval of sale procedures. Debtors have come to sale procedure hearings prepared to satisfy the Section 503(b)(1)(A) standard by presenting evidence (or a proffer of evidence) establishing the following: (i) the process by which the proposed stalking horse was identified, and the contract negotiated was fair and in the best interests of the estate; (ii) the protections offered to the stalking horse confer a meaningful benefit to the estate; (iii) absent such protections, the stalking horse will not move forward with the contemplated transaction; and (iv) the use of the stalking horse bid will establish a better marketplace for the sale of the assets. Where the factors can be satisfied and serve to preserve value for the estate, courts generally approve break-up fees and expense reimbursement provisions in connection with the establishment and approval of sale procedures.

## **VI. Good Faith Findings**

Section 363(m) of the Bankruptcy Code prevents the modification or reversal of a bankruptcy court order authorizing the sale of a debtor’s assets from affecting the validity of the sale *if* the purchaser acted in good faith and the appellant failed to obtain a stay of the sale order.<sup>70</sup> In short, Section 363(m) protects the reasonable expectations of a good faith third-party purchaser by preventing the appellate court from overturning a completed sale absent a stay, thereby safeguarding the finality of the sale.<sup>71</sup> By reason of the foregoing, an advance finding of “good faith” is critical to every stalking horse. Indeed, most would-be purchasers will not agree to consummate the proposed transaction in the absence of such a finding.

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69. Robert T. Kugler, *In Search of the Elusive Break-up Fee*, 2000 ABI JNL. LEXIS 72 (2000); Jeff J. Friedman, *3d Circuit Rules Break-Up Fees Permissible Only if Legitimate Administrative Expense*, *The Bankruptcy Strategist* (Sept. 1999); Marvin Krasny and Kevin J. Carey, *3rd Circuit Opinion Puts the Brakes on Break-up Fees in Bankruptcy Sale*, *The Legal Intelligencer* (August 6, 1999); Michael D. Sirota and Warren A. Usatine, *Buyer and Seller Beware! How three court decisions affect asset sales in bankruptcy proceedings*, N.J. L.J. (Feb. 7, 2000).

70. 11 U.S.C. § 363(m) provides that:

*The reversal or modification on appeal of an authorization under Subsection (b) or (c) of this section 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.*

71. See *In re Paulson*, 276 F.3d 389, 392 (8th Cir. 2002) (“sales in bankruptcy cases are not subject to modification by an appellate court unless the appellant receives a stay pending appeal”); *United States v. Salerno*, 932 F.2d 117, 122-23 (2d Cir. 1991) (where sale order not stayed and sale consummated, appeal is moot); *In re The Charter Co.*, 829 F.2d 1054, 1056 (11th Cir. 1987) (“Because [Section 363(m)] prevents an appellate court from granting effective relief if a sale is not stayed, the failure to obtain a stay renders the appeal moot.”) (citations omitted); *In re Vista Del Mar Assoc., Inc.*, 181 B.R. 422, 424 (B.A.P. 9th Cir. 1995) (“When an appellant fails to obtain a stay from an order that permits a sale of the debtor’s asset, the appeal will be rendered moot regardless of whether the purchaser has taken irreversible steps following the sale.”) (citation omitted).

The policy behind Section 363(m) is to promote finality of judgments and to encourage the obtaining of maximum value of assets notwithstanding the risks associated with bankruptcy sales.<sup>72</sup> “Without the degree of finality provided by the stay requirement, purchasers are likely to demand a steep discount for investing in the property.”<sup>73</sup> The purpose of Section 363(m) is “to overcome people’s natural reluctance to deal with a bankrupt firm whether as purchaser or lender by assuring them that, so long as they are relying in good faith on a bankruptcy judge’s approval of the transaction, they need not worry about their priority merely because some creditor is objecting to the transaction and is trying to get the district court or the court of appeals to reverse the bankruptcy judge.”<sup>74</sup> These protections extend to a good-faith purchaser whether the property is sold by a bankruptcy trustee or debtor-in-possession.<sup>75</sup>

Interestingly, there is no definition of “good faith” in either the Bankruptcy Code or Bankruptcy Rules.<sup>76</sup> Courts have generally defined a “good-faith purchaser” as one who purchases (1) in good faith, (2) for value and (3) without knowledge of adverse claims.<sup>77</sup> Good faith may be demonstrated where the sale is “in the best interest of all creditors and parties in interest.”<sup>78</sup> Conversely, lack of good faith may be shown where the purchaser committed fraud during the course of the sale, colluded with another party to suppress the sale price artificially, or attempted to take unfair advantage of other bidders.<sup>79</sup>

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72. See *In re Paulson*, 276 F.3d 389, 392 (8th Cir. 2002) (“[Section 363] protects the finality of bankruptcy sales and the reasonable expectations of third-party purchasers.”); *In re Stadium Management Corp.*, 895 F.2d 845, 847 (1st Cir. 1990) (“the primary goal of the mootness rule is to protect the interest of a good faith purchaser . . . of the property thereby assuring finality of sale”) (citation omitted); *Miami Ctr. Ltd. P’ship v. Bank of New York*, 838 F.2d 1547, 1553-54 (11th Cir. 1988), cert. denied, 488 U.S. 823 (1988) (“[Bankruptcy’s mootness rule] is premised upon considerations of finality, protection of the integrity of the foreclosure sale process and the court’s inability to rescind the sale and grant relief on appeal even if the purchaser of the property is a party to the appeal . . .”).

73. *In re Sax*, 796 F.2d 994, 998 (7th Cir. 1986) (noting that finality increases value).

74. *Matter of EDC Holding Co.*, 676 F.2d 945, 947 (7th Cir. 1982) (discussing parallel provision Section 364(e) dealing with priority of good faith lenders); see also *Matter of Chung King, Inc.*, 753 F.2d 547 (7th Cir. 1985) (holding that a bankruptcy court may vacate a prior order confirming a sale in only the most limited of circumstances, such as fraud or mistake. According to the court, although mere inadequacy of price or minor errors might justify a refusal to approve a sale, these would be insufficient to justify vacating approval previously granted.)

75. See *In re 255 Park Plaza Assoc Ltd. P’ship*, 100 F.3d 1214 (6th Cir. 1996) (“bankruptcy’s mootness rule applies whenever a party in a bankruptcy proceeding fails to obtain a stay from an order permitting the sale of a debtor’s assets and is not limited to conveyances by trustees”).

76. See *In re Rock Indus. Mach. Corp.*, 572 F.2d 1195, 1197 (7th Cir. 1978) (“neither the Rule itself nor the Committee Notes appended thereto provide a definition of the phrase ‘good faith’ purchaser”).

77. *Id.* at 1197 (“[T]he traditional equitable definition of a ‘good faith purchaser’ is one who purchases the assets for value, in good faith, and without notice of adverse claims.”); see also *Ewell v. Diebert (In re Ewell)*, 958 F.2d 276, 281 (9th Cir. 1992) (“courts generally have followed the traditional equitable principles in holding that a good faith purchaser is one who buys in good faith and for value”); *Greylock Glen Corp. v. Cmty. Sav. Bank*, 656 F.2d 1, 4 (1st Cir. 1981) (same).

78. See *Ewell v. Diebert*, 958 F.2d at 281 (finding that sale was in good faith because it generated sufficient funds to pay all of the debtor’s creditors and lien holders).

79. See *In re Rock Indus.*, 572 F.2d at 1198 (“Typically, the misconduct that would destroy a purchaser’s good faith status at a judicial sale involves fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders.”); *In re Andy Frain Servs., Inc.*, 798 F.2d 1113, 1125 (7th Cir. 1986) (same); *In re Abbotts Dairies of Pa., Inc.*, 788 F.2d 143, 147 (3d Cir. 1986) (same); *Willemain v. Kivitz*, 764 F.2d 1019, 1023 (4th Cir. 1985); *In re Bel Air Assocs., Ltd.*, 706 F.2d 301, 305 (10th Cir. 1983) (same).

This article is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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Most courts agree that only those events that occur before the time of entry of the order confirming the sale are relevant to the issue of good faith.<sup>80</sup> The post-closing acts or omissions of the purchaser are irrelevant to the issue of its good faith in this context. Moreover, any actions by the purchaser that were not directly related to the sale process have been determined to be irrelevant for the purpose of challenging the purchaser's good faith on appeal.<sup>81</sup>

While a bankruptcy judge is not likely to approve a sale that does not appear to be in good faith, an actual finding of good faith is not an essential element of an order approving a sale under Section 363(b).<sup>82</sup> Nonetheless, few stalking horse bidders would agree to consummate a sale in the absence of such a finding. Thus, a bankruptcy court may, in the absence of a well-developed factual record, prefer to take the cautious approach of either refusing to make good faith findings or limiting remarks about good faith to the nonspecific observation that the court has no reason to doubt that the parties are proceeding in "good faith."<sup>83</sup>

Where good faith has been challenged, however, the debtor and/or would-be purchaser must adduce facts to obtain the protections accorded by Section 363(m).<sup>84</sup> Unless and until good faith has been determined, the appeal is not moot under Section 363(m) even in the absence of a stay.<sup>85</sup> Thus, if a bankruptcy court has failed to make specific findings of good faith when approving the sale, the appellate court will typically remand the case to the bankruptcy court for the limited purpose of determining whether the sale was conducted in good faith.<sup>86</sup>

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80. See *Dick's Clothing & Sporting Goods v. Phar-Mor, Inc.*, 212 B.R. 283 (N.D. Ohio 1997) ("the acts relevant to purchasing property pursuant to a judicial order necessarily would take place either before or at the time of the judicial authorization for the sale"); see also *Licensing by Paolo v. Sinatra (In re Gucci)*, 126 F.3d 380, 394 (2d Cir. 1997) ("intended use of the assets purchased is not relevant to the good faith inquiry"). But see *In re F.A. Potts and Co., Inc.*, 93 B.R. 62 (E.D. Pa. 1988), *aff'd without opinion*, 891 F.2d 280 (3d Cir. 1989) (evaluating events occurring subsequent to the confirmation order in determining whether the sale was made in good faith).

81. See *In re Rock Indus.*, 572 F.2d at 1198 ("The requirement that a purchaser act in good faith, of course, speaks to the integrity of his conduct in the course of the sale proceedings."); *In re Gucci*, 126 F.3d at 394 (holding that generalized allegations of bad faith in prior dealings with the estate or creditors will not constitute sufficient grounds for setting aside the validity of a court-authorized sale).

82. *Onouli-Kona Land Co. v. Estate of Richards (In re Onouli-Kona Land Co.)*, 846 F.2d 1170, 1174 (9th Cir. 1988) (ruling that a finding of good faith need not be made at the time of sale). But see *In re Abbotts Dairies of Pa., Inc.*, 788 F.2d 143, 149-50 (3rd Cir. 1986) (holding that good-faith finding is required where collusion is suspected).

83. *In re Thomas*, 287 B.R. 782, 785 (B.A.P. 9th Cir. 2002).

84. See *In re M Capital Corp.*, 290 B.R. 743, 752 (B.A.P. 9th Cir. 2003) ("Boilerplate good faith findings in orders will not suffice, and bankruptcy courts should avoid the temptation to sign such orders without an evidentiary foundation.").

85. *In re Colony Hill Assocs.*, 111 F.3d 269, 272-74 (2d Cir. 1997) (holding that a bankruptcy court's factual finding of whether a sales transaction was in good faith for purposes of Section 363(m) is not subject to the mootness doctrine and is reviewable on appeal); *In re Ewell*, 958 F.2d 276, 279 (9th Cir. 1992) (same); See *Dick's Clothing & Sporting Goods v. Phar-Mor, Inc.*, 212 B.R. 283, 290 (N.D. Ohio 1997) ("[b]y the very terms of Section 363(m), an appeal is not moot even in the absence of a stay if the purchaser did not purchase the property in good faith").

86. See, e.g., *In re Thomas*, 287 B.R. at 786 (remanding case to bankruptcy court for limited purpose of entertaining motion to determine whether buyer purchased subject property in good faith); see also *In re Abbotts Dairies of Pa., Inc.*, 788 F.2d 143, 147 (3d Cir. 1986) (reversing District Court's finding that an appeal from a bankruptcy court order approving the sale of a debtor's assets to insiders under 11 U.S.C. § 363(b) was moot, and remanding case to the bankruptcy court to determine whether the insiders had acted in good faith); *Valucci v. Glickman, Berkovitz, Levinson & Weiner (In re Glickman, Berkovitz, Levinson & Weiner)*, 204 B.R. 450 (E.D. Pa. 1997) (vacating sale order and remanding case because bankruptcy court failed to make a determination regarding whether sale was in good faith); *In re Perona Bros.*, 186 B.R. 833 (D. N.J. 1995) (same); *In re Wieboldt Stores, Inc.*, 92 B.R. 309 (N.D. Ill. 1988) (denying purchaser's motion to dismiss appeal as moot and remanding case to bankruptcy court to decide whether purchaser was a good faith purchaser under Section 363(m)). But see *T. C. Investors v. Joseph (In re M Capital Corp.)*, 290 B.R. 743 (B.A.P. 9th Cir. 2003) (refusing to remand issue of good faith because the seller and buyer withdrew a contested motion pending before the bankruptcy court seeking Section 363(m) good faith findings).