Section 363 Sales Topics

Hon. Robert D. Drain, Moderator
U.S. Bankruptcy Court (S.D.N.Y.); White Plains

Barry E. Adler
Bernard Petrie Professor of Law and Business
New York University School of Law

Donald S. Bernstein
Davis Polk & Wardwell LLP; New York

Stephen Karotkin
Weil, Gotshal & Manges LLP; New York

Richard G. Mason
Wachtell, Lipton, Rosen & Katz; New York

Harvey R. Miller
Weil, Gotshal & Manges LLP; New York

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Bidding Procedures — Stalking-Horse Protections and Collusion

Richard G. Mason*
Saish R. Setty

Wachtell, Lipton, Rosen & Katz
New York, New York

*Mr. Mason is a Partner, and Mr. Setty is an Associate, in the law firm of Wachtell, Lipton, Rosen & Katz. The views expressed are those of the authors only, and not those of the Firm or its clients.

I. Introduction

In recent years, Chapter 11 cases have tended to move away from traditional restructurings, wherein the debtor's operations and business are fixed and debt obligations are adjusted pursuant to a Chapter 11 plan, and toward a sale of the business under Section 363 of the Bankruptcy Code. There are multiple reasons for this trend, including:

1. An eighteen-month limit on the debtor's exclusive period for filing a Chapter 11 plan;
2. The prevalence of secured debt, which limits the debtor's DIP financing alternatives;
3. The presence of hedge funds as debtholders who may be more interested in, and structurally suited for, quick sales of the debtor rather than a long-term restructuring; and
4. The increasing sophistication of strategic and financial purchasers who are less concerned about the "taint" of bankruptcy on the debtor's assets.

Thus, while traditional business reorganizations have by no means become a thing of the past, at the margin, debtors today have less time to spend in Chapter 11, less money to finance their stay, and more potential bidders interested in acquiring their business.

In cases where the debtor's assets are to be sold, a competitive auction allows the debtor and its creditors to test the market and obtain a sale price that is potentially higher than what could be obtained through other means. As the sale price must typically reflect the "highest and best offer," courts in Chapter 11 bankruptcy proceedings usually require an auction to be conducted as part of a sale under section 363.[1]

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[1] *In re Moore*, 608 F.3d 253, 263 (5th Cir. 2010). *See, e.g.*, *In re GSC, Inc.*, 453 B.R. 132, 169 (Bankr. S.D.N.Y. 2011); *In re Atlanta Packaging Prods., Inc.*, 99 B.R. 124, 130 (Bankr. N.D. Ga. 1988) ("It is a well-established prin-

Typically, the first part of a 363 sale process involves an agreement to sell to a stalking-horse bidder that is subject to (a) the receipt of better offers in the auction and (b) approval of the bidding procedures in the auction. The second part consists of the auction itself and a hearing to approve the final sale. This outline will discuss two particular aspects of these auctions, (i) protections afforded to stalking-horse bidders and (ii) collusion between bidders during the auction.

II. Stalking-Horse Protections

A. Stalking-Horse Bidders

The term "stalking-horse" bidder refers to a party to whom the debtor-in-possession agrees to sell assets in a court-supervised auction. Such agreements are exposed to better bids in the auction but serve a debtor's interests since, among other reasons, they set a floor price for the auction. Of course, the stalking-horse bidder is vulnerable to higher bids and may not be the winning bidder.[2]

As such, both sellers and purchasers are incentivized to agree to stalking-horse protections. To the purchaser, such protections offer compensation for fees and expenses incurred in connection with due diligence and negotiating the sales agreement, for their time and efforts, and for the risk of missing other opportunities while the bidding process is underway.[3] Additionally, without these protections, "bidders would be reluctant to make an initial bid for fear that their first bid will be shopped around for a higher bid from another bidder who would capitalize on the initial bidder's (*i.e.*, "stalking-horse's") due diligence."[4] Meanwhile, sellers are also inclined to offer

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ciple of bankruptcy law that the objective of bankruptcy rules and the trustee's duty with respect to such sales is to obtain the highest price or greatest overall benefit possible for the estate.").

[2] *See, e.g.*, *In re SpecialtyChem Products Corp.*, 372 B.R. 434, 436 (E.D. Wis. 2007).

[3] *See In re APP Plus, Inc.*, 223 B.R. 870, 874 (Bankr. E.D.N.Y. 1998).

[4] *In re Hupp Indus., Inc.*, 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992).

such protections as they may encourage initial bids at a time when there are no other competing bids, discourage bidding strategies that hold back competitive bids until the very end of the process, and help to negotiate a strong initial bid and floor price for the auction.[5] However, such protections must carefully balance these benefits with the prospect of having overly protective provisions chilling the bidding process.

As discussed below, common stalking-horse protections include (i) breakup fees, (ii) topping fees, (iii) lock-out agreements and (iv) other protections in the bidding process.

B. Breakup Fees

Breakup fees are those fees paid to a proposed purchaser by the seller if the transaction fails to be consummated for a number of reasons, including, acceptance of a higher bid.[6] Although breakup fees are established in the stalking-horse's sale agreement, the debtor's agreement to pay the fees is not binding until the court approves them, typically at a bid procedures hearing that is held on notice to creditors, third parties and the public; thus, the initial bidder could be vulnerable if another bidder emerges prior to the bid procedures hearing. While some courts have characterized such fees as "being concessions extracted by aggressive friendly bidders,"[7] others view them as compensation for a failed bid.[8] Nevertheless, although these fees are presumptively valid outside of bankruptcy, their validity is subject to scrutiny in bankruptcy sales and they must be specifically approved by the court.[9]

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[5] *See In re APP Plus, Inc.*, 223 B.R. at 874.
[6] *See id.*; *In re Integrated Res., Inc.*, 147 B.R. 650, 653 (S.D.N.Y. 1992).
[7] *In re Hupp Indus., Inc.*, 140 B.R. at 194.
[8] *In re Integrated Resources, Inc.*, 147 B.R. at 653.
[9] *Id.*

The type of scrutiny applied to breakup fees varies by jurisdiction.[10] While some courts rely on the business judgment standard of review, others have adopted a standard that looks to the best interests of the estate. Meanwhile, other courts subject breakup fees to an analysis under section 503(b) of the Bankruptcy Code.

1. Business Judgment Review

Jurisdictions that ascribe to this standard of review, including the Southern District of New York, apply the business judgment standard absent a "showing of bad faith, self-interest, or gross negligence."[11] These jurisdictions often espouse favorable views of breakup fees, even going so far as to suggest that because "the directors of a corporation have a duty to encourage bidding, breakup fees can be necessary to discharge the directors' duties to maximize value."[12]

These courts take a three-prong approach, looking to (1) the relationship of the parties who negotiated the fee and whether such negotiations were tainted by self-dealing or manipulation, (2) the fee's reasonableness in comparison to the total purchase price and (3) whether the fee chills or encourages bidding.[13]

In cases where the first prong is not satisfied and the transaction is tainted by self-dealing, some courts have suggested that fees "bear[ing] a reasonable relationship to the bidders' efforts" may nonetheless be approved.[14] Otherwise, approval of the fee is subject to the remaining two prongs. As to the second prong, breakup fees consisting of less than 3% of the purchase price

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[10] *See In re Hupp Indus., Inc.*, 140 B.R. at 194 ("One court considered such fees framed solely in the form of expense reimbursement for out-of-pocket expenses relating to costs incurred during a due diligence period, while another court allowed reasonable break-up fees wholly independent of the transaction costs.").
[11] *In re Integrated Res., Inc.*, 147 B.R. at 656.
[12] *Id*. at 659-60.
[13] *See, e.g.*, *In re Bidermann Indus. U.S.A., Inc.*, 203 B.R. 547, 552 (Bankr. S.D.N.Y. 1997); *In re Integrated Res., Inc*., 147 B.R. at 657.
[14] *In re Bidermann Indus. U.S.A., Inc.*, 203 B.R. at 553.

are typically approved.[15] Meanwhile, in examining the third prong of this test, courts look to whether the breakup fee served a useful function, including whether the fee helped to attract or retain a potentially successful bid, whether it established a minimum bid for other bidders and if it attracted other bidders.[16] These are fairly lenient standards, as breakup fees would certainly encourage stalking-horse bidders in some way. As such, provided that the breakup fee encouraged bidding and was reasonable, it would likely be enforceable.[17]

2. Best Interests of the Estate

Other jurisdictions take a more exacting view of breakup fees and scrutinize the fees within the context of the whole bankruptcy, deferring not to the debtor's business judgment but looking to whether "the best interests of the debtor's estate, creditors and equity holders are furthered" by the fee.[18] These courts are critical of breakup fees and appear fairly reluctant to allow them—often finding that where sales had been marketed widely, a fee would do little to induce additional bidding and would instead act to chill bidding and divert resources away from the estate.[19] Other courts relying on this best interests analysis have also refused to approve fees without evidence of the purchaser's "time, effort, expense and risk"[20] to determine if the fee is justified and whether such fee "correlated to any transactional cost or expense incurred by the negotiating

[15] *See id.* (criticizes a breakup fee equal to 4.4% and notes that the purchase price used to make such calculation should "exclude from the value the monies which are to be generated from the debtors' own assets"); *In re Integrated Resources, Inc.*, 147 B.R. at 654 ("average break-up fee in the industry is 3.3 percent").
[16] *In re Integrated Res., Inc.*, 147 B.R. at 662-63.
[17] *Id*. at 659-60.
[18] *In re Tiara Motorcoach Corp*., 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997). *See also In re Am. W. Airlines, Inc.*, 166 B.R. at 912 (Bankr. D. Ariz. 1994).
[19] *In re Am. W. Airlines, Inc.*, 166 B.R. at 913 (finding that in this situation "payment of the contemplated break-up fee, in any amount, is not in the best interest of the estate, the creditors or the equity holders" while noting that reimbursement for expenses "are in the best interests of the estate" and would be approved.).
[20] *In re Tiara Motorcoach Corp*., 212 B.R. at 138.

bidder."[21] As such, while expense reimbursement may be permitted under a best interests analysis, breakup fees must "make economic sense for all [parties] concerned."[22]

3. Breakup Fees as Administrative Expenses

Other jurisdictions have opted to subject breakup fees to scrutiny under the standards of section 503(b) of the Bankruptcy Code. The Third Circuit in particular has noted that:

> [W]e decline the invitation to develop a general common law of break-up fees. We instead consider whether any provision of the Bankruptcy Code, as it is currently written, authorizes the award of break-up fees and expenses to an unsuccessful bidder at the plan-based sale of a debtor's assets. . . . Further, claims that arise after the date on which the debtor petitioned for bankruptcy protection ("post-petition claims") are generally allowed, if at all, only as administrative expenses pursuant to 11 U.S.C. § 503. We, therefore, treat [the bidder]'s arguments as addressing whether it is entitled to receive break-up fees and expenses under that provision.[23]

As such, the Third Circuit requires stalking-horse bidders to justify breakup fees by "demonstrating that the costs and fees for which it seeks payment provided an actual benefit to the estate and that such costs and expenses were *necessary* to preserve the value of the estate assets."[24] Rele-

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[21] *In re Am. W. Airlines, Inc.*, 166 B.R. at 912-14.
[22] *Id*.
[23] *In re O'Brien Envtl. Energy, Inc.*, 181 F.3d 527, 532 (3d Cir. 1999). *See also In re Reliant Energy Channelview LP*, 594 F.3d 200, 206 (3d Cir. 2010) ("We held that courts do not have the authority to create new ways to authorize the payment of fees from a bankruptcy estate, and the methods of recovering fees from an estate are limited to the procedures established by the Bankruptcy Code.").
[24] *In re O'Brien Envtl. Energy, Inc.*, 181 F.3d at 533 (emphasis added).

vant points of inquiry around this analysis are whether "the bidder would have bid even without the break-up fee" and if a fee was needed to ensure that the stalking-horse bidder would not drop out of the process.[25] As such, parties seeking approval of a breakup fee in the Third Circuit should do so as early as possible to avoid the impression that the fee was not a prerequisite to their bid.[26] Nevertheless, despite this high standard, the Third Circuit has suggested that it would approve a breakup fee commensurate with the costs incurred by the prospective purchaser in researching the value of the debtor if such research benefited the estate by providing other bidders with a valuation figure on which they could rely, thereby increasing the probability that the assets would sell for a price better reflecting their true worth.[27]

Meanwhile, other jurisdictions that examine breakup fees as administrative expenses under section 503 rely on multifactor tests. *In re Hupp Industries Inc.*[28] looked to the following seven factors:

> (1) Whether the fee requested correlates with a maximization of value to the debtor's estate; (2) Whether the underlying negotiated agreement is an arm's-length transaction between the debtor's estate and the negotiating acquirer; (3) Whether the principal secured creditors and the official creditors committee are supportive of the concession; (4) Whether the subject break-up fee constitutes a fair and reasonable percentage of the proposed purchase price; (5)

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[25] *In re Reliant Energy Channelview LP*, 594 F.3d at 206-08.
[26] *In re O'Brien Envtl. Energy, Inc.*, 181 F.3d at 537.
[27] *Id.* at 537. *See also In re Tropea*, 352 B.R. 766, 768 (Bankr. N.D. W.Va. 2006) (suggesting that a breakup fee would be allowed where a stalking-horse bidder fronted the debtor sums to cover its tax deficiency, thereby preventing a tax sale and foreclosure).
[28] 140 B.R. at 196. *See also* David H. Kleiman, Alternatives for Awarding Break-Up Fees to Stalking-Horse Bidders, AM. BANKR. INST. J., October 2010, at 26, 90.

> Whether the dollar amount of the break-up fee is so substantial that it provides a "chilling effect" on other potential bidders; (6) The existence of available safeguards beneficial to the debtor's estate; and (7) Whether there exists a substantial adverse impact upon unsecured creditors, where such creditors are in opposition to the break-up fee.

In addition, other courts have also considered whether "the unsuccessful bidder placed the estate property in a sales configuration mode to attract other bidders to the auction," inquiring into whether the stalking-horse's bid attracted other bidders and spurred an auction where there may have otherwise been none.[29] In relying on such multifactor inquiries, some courts have approved breakup fees as administrative expenses even where there was "no evidence . . . to decide if the amount of the break-up fee is reasonable or if the application properly accounted for the reasonable expenses incurred."[30]

4. Breakup Fees Overview

As the various standards of review described above illustrate, breakup fees in bankruptcy still occupy an area with muddled case law. For example, despite the Southern District of New York's reliance on the business judgment standard of review, at least one court within the district has also applied the administrative expense analysis to a breakup fee.[31] However, the court's scrutiny was still very deferential, finding that the fee was an actual and necessary cost merely by being "a component of what induced" the stalking-horse bidder to establish a floor bid.[32] As

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[29] *In re Tama Beef Packing, Inc.*, 290 B.R. 90, 97 (B.A.P. 8th Cir. 2003).
[30] *Id*. at 98.
[31] *In re Fortunoff Fine Jewelry & Silverware, LLC*, 2008 WL 618983, *1 (Bankr. S.D.N.Y. Feb. 22, 2008).
[32] *Id*.

such, parties may be best served by focusing less on specific standards of review and more on recognizing which jurisdictions are generally deferential to breakup fees and which will subject such fees to more rigorous scrutiny.

C. Topping Fees

Unlike breakup fees, topping fees are not a fixed amount; rather, they are usually equal to a percentage of the difference between the winning bid and the stalking-horse's bid.[33] While there is limited case law on topping fees, courts typically subject such fees to analyses similar to those applied to breakup fees. One court even explicitly referred to the different standards applied to breakup fees and then combined those standards to review a topping fee.[34]

D. Lock-out Arrangements

Lock-out arrangements and no-shop clauses are protections where debtors agree not to solicit, initiate or encourage other offers from potential bidders.[35] Given the natural tendency of such procedures to greatly chill bidding, courts tend to look upon such provisions rather disfavorably.[36] Nevertheless, arrangements where debtors were prohibited from initiating, soliciting or

[33] *In re APP Plus, Inc.*, 223 B.R. at 874.
[34] *Id*. at 875 ("Due to a dearth of cases dealing solely with topping fees and although the bankruptcy courts in Integrated Resources, Hupp Industries and America West were grappling with break-up fees, this Court has been guided by their analysis in determining whether to approve a Topping Fee in this case. That is to say, in addition to the three-part test enunciated in Integrated Resources, this Court has also analyzed whether the proposed Topping Fee is unduly burdensome to the estate in view of the specific facts and circumstances of this case and whether it is in the best interest of the bankruptcy estate, the creditors, and the equity holders.").
[35] *See In re Bidermann Indus. U.S.A., Inc.*, 203 B.R. at 552; *In re Big Rivers Elec. Corp*., 233 B.R. 726, 738 (W.D. Ky. 1998) (finding that "No-Shop Clauses, such as this one, which prohibit a debtor from fulfilling its fiduciary duties are per se illegal in Chapter 11 proceedings"), *aff'd*, 233 B.R. 739 (W.D. Ky. 1998).
[36] *Id. See also In re Metaldyne Corp.*, 409 B.R. 661, 670 (Bankr. S.D.N.Y. 2009) ("Bidder protections are granted when a bidder provides a floor for bidding by expending resources to conduct due diligence and allowing its bid to be shopped around for a higher offer.").

encouraging other offers for a limited period of time, namely, until the bid procedures were approved, have been permitted.[37]

E. Other Protections in the Bidding Process

Often, stalking-horse protections are built into the bidding procedures governing the auction process. Such protective procedures benefit stalking-horse bidders by exempting them from such requirements, allowing them greater information than other parties, or by creating procedures that inherently favor an initial bidder.

Some commonly used procedures include requiring:

- bidders to submit competing bids in advance of the auction and having such bids shared with the stalking-horse;
- bidders to bid on terms substantially identical to those of the stalking-horse's offer;
- substantial bid increments;[38]
- deposits from competing bidders;
- financial screening for bidders;
- confidentiality agreements; or

[37] *In re Nortel Networks Inc*., 2011 WL 1661524 (Bankr. D. Del. May 2, 2011) (approving a stalking-horse arrangement where the debtors agreed to not "initiate, solicit, encourage or induce the submission or announcement" of any alternate offer until the bid procedures were approved).
[38] *E.g.*, *In re Hupp Indus., Inc.*, 140 B.R. at 195 (finding that the "proposed asset bid increment limitation in the amount of $300,000, however, is arbitrary and unreasonably high and otherwise has not been justified" where the total purchase price was approximately $4 million).

- bids to be evaluated in terms of net cash; that is, a requirement that bidders must exceed the stalking-horse's bid by at least the amount of any proposed breakup fee or topping fee.

Other forms of bid protection include DIP lenders' tying available financing to their bid—for example, by allowing acceleration of (or at least termination of additional funding under) the DIP facility if assets are sold to another party. Such an arrangement would be unusual, but it could be justified if, for example, the DIP lenders were providing ongoing financing to the debtor and have a reasonable concern about the viability of the debtor's business if another stalking-horse is selected. Another unique stalking-horse protection was used in Lehman Brothers' sale of its Neuberger Berman investment management unit. There, the debtor's proposed sale procedures allowed the stalking-horse bidder to solicit the consent of Neuberger Berman's customers to the proposed sale even though the stalking-horse bid was subject to higher and better offers. Still, despite the great advantage afforded to the stalking-horse, the court approved the procedure because customers had been fleeing Neuberger Berman until the stalking-horse bid was announced. Withdrawal of the stalking-horse bid, conditioned on approval of the procedures, would have destroyed value unless another bidder immediately stepped up.

III. Collusion

A. Overview of Section 363(n)

Bankruptcy courts will scrutinize any proposed section 363 transaction to ensure that the conduct of both the debtor and the proposed purchaser were in "good faith."[39] A finding of "good faith"

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[39] *In re Chrysler LLC*, 576 F. 3d 108, 113 (2d Cir. 2009), *vacated as moot*, *Indiana State Police Pension Trust* v. *Chrysler LLC*, 130 S. Ct. 1015 (2009).

is crucial since it significantly reduces appellate review of a sale. Under section 363(m), so long as the acquisition is found to be in good faith and the sale order is not stayed pending appeal, a reversal or modification of the sale order on appeal will not, in most instances, affect the validity of the sale.[40] As such, 363(m) seeks to maximize the sales price by ensuring finality to bidders.[41]

A critical aspect of "good faith" is an inquiry into whether there was "collusion between the purchaser and other bidders or the trustee."[42] Collusive bidding is also explicitly prohibited by section 363(n), which allows a court to decline to approve a sale of assets where the "sale price was controlled by an agreement among potential bidders at such sale."[43] Additionally, it permits an approved sale to be avoided, or for damages to be obtained from a bidder, if a collusive agreement among bidders deprived the estate of value.[44] While section 363(n) also allows for punitive damages if a purchaser acted in willful disregard of its prohibitions, no reported decision has awarded such damages.

For conduct to violate 363(n), bidders entering into an agreement must do so with the intention of controlling the price of the asset—the purportedly collusive action must "control" rather than incidentally affect the sales price.[45] As such, agreements that have the unintended consequence of affecting the sales price would not constitute a violation of 363(n).[46]

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[40] 11 U.S.C. § 363.
[41] *In re GSC, Inc.*, 453 B.R. at 180.
[42] *In re Gucci*, 126 F.3d 380, 390 (2d Cir. 1997).
[43] 11 U.S.C. § 363(n).
[44] 11 U.S.C. § 363(n). *See also In re Gucci*, 126 F.3d at 391.
[45] *See In re N.Y. Trap Rock Corp.*, 42 F.3d 747, 752-53 (2d Cir. 1994) (noting that "[t]he influence on the sale price must be an intended objective of the agreement, and not merely an unintended consequence," but finding that the collusion claim could be sustained where a bidder dropped out in exchange for sharing of marginal bid value).
[46] *In re N.Y. Trap Rock Corp.*, 42 F.3d at 752.

B. Procedures to Avoid Violating Section 363(n)

While violations of 363(n) have serious consequences, there are few cases interpreting the provision. Purchasers should act very cautiously when entering into arrangements with other bidders in connection with a possible asset purchase. For example, the existence of a group should be disclosed to the seller.[47] Even though full disclosure of a bidding agreement may not preclude a finding of improper collusion, a failure to disclose may prove fatal to an arrangement that may have otherwise survived section 363(n) scrutiny.[48] In particular, group members should avoid any agreement under which a member plans to withdraw or withhold its bid with the expectation that it will nonetheless share in the assets sold.[49]

C. Collaboration or Collusion?

It is fairly commonplace for potential bidders to bid jointly, and collaboration is often beneficial to the debtor—especially when a pool of assets is too large or too diverse to be of interest to any single bidder. A bid for only part of the assets in such a situation would be disfavored as the estate would be left with orphaned remains of lesser value.[50] Given the difficulties inherent in dis-

[47] *See In re GSC, Inc*., 453 B.R. at 182-83.
[48] *See, e.g.*, *In re Colony Hill Assocs.*, 111 F.3d 269, 277 (2d Cir. 1997) ("Many courts ruling on challenges to a purchaser's good faith status have focused on whether the acts about which the appellant complained were disclosed to the bankruptcy court…. Although full disclosure to the bankruptcy court may not always neutralize conduct that would otherwise constitute bad faith, disclosure should certainly weigh heavily in a bankruptcy court's decision on that issue.").
[49] *See Boyer* v. *Gildea*, 374 B.R. 645, 660 (N.D. Ind. 2007) (in deciding whether the trustee put forth sufficient evidence for a claim under 363(n), the court noted that a reasonable trier of fact could infer collusion from the fact that one potential bidder did not submit a bid but purchased the assets from the highest bidder shortly after the sale).
[50] *See* Ilene Knable Gotts & Franco Castelli, *Special Antitrust Issues Raised by Private Equity Minority Investments*, The Threshold, Vol. III, No. 3 (Summer 2008), at 15-22.

tinguishing between collaboration and collusion, courts often turn to a fact-intensive examination that focuses on matters including the parties' motivation to join together in a bid.[51]

Further, without joint bidding, certain transactions may not even be able to occur. In these situations, it is unclear as to how courts will apply section 363(n). Factors likely to be considered include whether (i) the members of the bidding group have the financial ability to bid individually for the entire business, (ii) the members of the bidding group only have a strategic interest in select assets regardless of their financial capability, (iii) the bidding group's bid is higher than what any individual bid by the members would have been, (iv) there are other competitors bidding (that is, whether the group consists of all parties interested in the assets), and (v) whether the group timely communicated its desire to bid together and its rationale for forming itself to the relevant interested parties.[52]

The sale of Nortel Network's portfolio of over 6,000 mobile telecommunications patents through a 363 sale is a prime example of the benefits of collaborative bidding and the use of appropriate protections against collusion. Given that intellectual property portfolios are often owned by consortiums with members cross-licensing patents to one another, the auction procedures expressly contemplated group bids. The procedures allowed for group bids, provided that bidders disclose any and all relationships with other bidders and expressly affirm that they had not engaged in any collusive behavior. Over the course of the Nortel auction, individual bidders who had dropped out earlier would later resurface as part of a larger group. Ultimately, the group that won the auction had placed a bid larger than what any individual member of the group would have been

[51] *See In re Edwards*, 228 B.R. 552, 565 (Bankr. E.D. Pa. 1998) (agreement between joint bidders not intended to control price).
[52] *See* Ilene Knable Gotts & Franco Castelli, *Special Antitrust Issues Raised by Private Equity Minority Investments*, The Threshold, Vol. III, No. 3 (Summer 2008), at 15-22.

willing to pay on its own. As such, the auction in Nortel was able to capture the benefits of collaboration while avoiding the risks of violating 363(n).

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Section 363 Sales and the Evolution to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

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Harvey R. Miller
Edward Wu

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Introduction

"Neither the [Bankruptcy] Code, nor the caselaw . . . requires waiting for the plan confirmation process to take its course when the inevitable consequence would be liquidation. Bankruptcy courts have the power to authorize sales of assets at a time when there still is value to preserve—to prevent the death of the patient on the operating table."

Honorable Robert E. Gerber, United States Bankruptcy Judge, *In re General Motors Corp.*, 407 B.R. 463, 474 (Bankr. S.D.N.Y. 2009)

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Introduction

- A sale under section 363 of the Bankruptcy Code potentially obviates the need for a business to remain in bankruptcy for a substantial period of time and decreases the associated reputational damage of operating under chapter 11 protection.
- It has been argued that 363 sales will predominate the future of bankruptcy cases as they often are mandated by secured lenders, may result in realizing going concern value, and eliminate the vicissitudes of extended chapter 11 procedures and conflicts.
- The perceived benefits of a 363 sale, however, come with corresponding tradeoffs. While a 363 sale may be swift and relatively streamlined from a procedural standpoint, it provides far fewer safeguards and rights to stakeholders than the traditional plan confirmation process.

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Introduction

- Throughout the evolution of non-plan asset sales, courts have grappled with the appropriate balance of safeguards to provide in connection with a sale, recognizing that fewer protections are warranted as certain exigencies pertaining to a sale are present.
- The Dodd-Frank Act represents a climax in the evolution of such sales, affording minimal due process to meet exigencies related not only to the value of the assets, but also to the health of the financial system.

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Pre 1978 Bankruptcy Reform Act: Bankruptcy Act of 1867

- The Bankruptcy Act of 1867 provided that, prior to final liquidation of estate, the court may order the sale of property that is of "perishable nature, or liable to deteriorate in value[.]" Bankruptcy Act of 1867, ch. 176, 14 Stat. 517, 528 (1867).
- The concept of "perishable" was not limited to the physical nature of the object. It also applied to the value obtainable at sale.
  - "Unquestionably a cargo of bananas would be perishable, but [so is] a cargo of rifles for which belligerents will pay an increased price if immediate delivery can be made, but which will be practically valueless if delivery be delayed." *In re Pedlow,* 209 F. 841, 842 (2d Cir. 1913).

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Pre 1978 Bankruptcy Reform Act: Chandler Act of 1938

- Under the subsequent Chandler Act of 1938, a court was permitted to authorize a sale "upon cause shown" through "such notice as the judge may prescribe[.]" Chandler Act of 1938, ch. 575, 52 Stat. 883 (1938).
- While unrequired by the express wording of the statute, certain courts continued to apply the "perishable" standard.
  - Vats, kettles and brewing machinery would deteriorate in value without refrigeration. *In re V. Loewer's Gambrinus Brewery Co.*, 141 F.2d 747, 748 (2d Cir.1944).
  - Partially constructed hotel near upcoming World's Fair was wasting asset. *In re Sire Plan Inc.*, 332 F.2d 497, 499 (2d Cir. 1964)

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Pre 1978 Bankruptcy Reform Act: Chandler Act of 1938 *(continued)*

- Certain courts applied the more stringent "emergency" standard, permitting sale outside of a plan only upon "imminent danger" of lost value. *In re Solar Mfg. Corp.*, 176 F.2d 493, 494 (3d Cir. 1949).
  - Manufacturing business with unprofitable yet improving operations did not satisfy "emergency" standard. *Id.*
- Other courts, in the context of a "perishable" asset, approved sales upon a finding that the sale was in the "best interest of the estate"
  - Value of business was likely to substantially deteriorate in near future and proposed sale was in best interest of estate. *In re Equity Funding Corp. of Amer.*, 492 F.2d 793, 794 (9th Cir.1974).
  - Sale of stock with rapidly declining value. *In re Dania Corp.*, 400 F.2d 833, 835–37 (5th Cir.1968).

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1978 Bankruptcy Reform

- Section 363(b) of the Bankruptcy Code provides that, after notice and a hearing, property of the estate may be sold outside the ordinary course of business. 11 U.S.C. § 363(b).
- Contrary to its predecessor, the statutory text of section 363(b) does not require a showing of "cause" or even any other showing.
- The evolution of case law post November 1979, the effective date of the Bankruptcy Code, as to section 363 reflects the efforts by courts to restrain the unfettered authority under the express wording of section 363 that could permit the circumvention of the plan process.

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1978 Bankruptcy Reform: White Motor Credit Corp.

- In re White Motor Credit Corp. was one of the earliest cases interpreting a sale of substantially all assets under section 363. 14 B.R. 584 (Bankr. N.D. Ohio 1981).
- Reviewing the legislative intent, the court held that allowing a debtor, at its option, to deny parties in interest the major protections of the chapter 11 plan process was impermissible. *Id*. at 588.
  - As an example, the court stated that section 1129 requires a confirmation hearing while section 363 requires only the mere opportunity, without the necessity, of a hearing. *Id*.
- However, the court held that the "emergency" doctrine under prior law was still applicable. *Id*.

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1978 Bankruptcy Reform: Braniff Airways, Inc.

- In the case of *In re Braniff Airways, Inc.*, the court refused to authorize a 363 sale where the purchaser would obtain airline assets (including planes and landing slots) for travel scrip (entitling holder to travel on airline), certain notes, and profit participation in the purchaser's enterprise. *In re Braniff Airways, Inc.*, 700 F.2d 935, 940 (5th Cir. 1983).
- The Court stated that the sale would have effectively dictated the terms of a chapter 11 plan without the protections of
  - a disclosure statement
  - the voting process
  - the best interest of creditors test
  - the absolute priority rule

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1978 Bankruptcy Reform: *In re Lionel Corp.*

- The seminal case addressing the legal standard under section 363 is *In re Lionel Corp.,* 722 F.2d 1063 (2d. Cir. 1983). The Second Circuit rejected a proposed sale of shares owned by the debtor in a third-party company where such shares were not wasting away and was expected to retain its value through plan confirmation.
- The Second Circuit held that a sale under section 363(b) requires articulated business justification.
  - The court rejected the view that section 363(b) grants a judge *carte blanche* approval authority, which would circumvent the chapter 11 plan safeguards. *Id.* at 1070.
  - Similarly, the view that only an emergency permits the use of section 363(b) was rejected based on the reasoning that a court should have the freedom to address the variety of circumstances arising in a bankruptcy case. *Id.*

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1978 Bankruptcy Reform: *In re Lionel Corp. (continued)*

- The Second Circuit provided a non-exclusive list of seven factors to consider in approving a 363 sale:
  - proportionate value of asset to the estate as a whole
  - amount of elapsed time since the filing
  - likelihood that a plan of reorganization will be proposed and confirmed in the near future
  - effect of the proposed disposition on future plans of reorganization
  - 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
  - perhaps most importantly, whether the asset is increasing or decreasing in value

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1978 Bankruptcy Reform: *In re Loral Space and Communications*

- *In re Loral Space & Communications, Ltd.,* Case No. 03-41710 (Bankr. S.D.N.Y. 2003).
  - Case Illustrates recognition of expanded power under 363(b) post Lionel. A primary purpose for the commencement of the chapter 11 cases was to effectuate the almost immediate sale of five satellites pursuant to a pre-chapter 11 sales agreement.
  - The purchaser conditioned the sale upon bankruptcy court approval to avoid any post-closing litigation as to value, etc.
  - The creditors' committee opposed the sale as giving away the "crown jewels" of the debtors' and thereby prejudicing reorganization and creditors' recoveries.
  - After a contested evidentiary hearing, the court authorized the sale.
  - The Loral decision was based upon Lionel and the facts found by the court that in its business judgment warranted the sale. 313 B.R. 577 (Bankr. S.D.N.Y. 2004).

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1978 Bankruptcy Reform: General Motors Corp.

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1978 Bankruptcy Reform: General Motors Corp.

- The General Motors case involved an unprecedented level of involvement from governmental authorities to structure a 363 sale to curtail the effects of systemic risk for the national economy.
- The potential consequences of a liquidation of General Motors played a major role in the evolution of the sale. Suppliers and automobile dealerships throughout the country would have failed if General Motors and Chrysler were closed and liquidated. Approximately 235,000 employees of General Motors alone would have lost their jobs. These liquidations would have sent the fragile economy into a far deeper trough with significant negative impact on many states.
- The Court approved the sale of substantially all of the debtors' assets to a purchaser sponsored by the U.S. Government, pursuant to section 363. It averted the consequences of a liquidation that would have had severe economic and political consequences domestically and internationally.

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1978 Bankruptcy Reform: General Motors Corp. *(continued)*

- The U.S. Government as sponsor directed a 363 sale on a tight time frame as a condition to providing DIP financing of billions of dollars.
- The 363 sale was subject to higher and better offers, but, in reality, it was known that there would be no other purchasers, and no one else able to provide DIP financing in the deepening financial crisis.
- The Court found that the *Lionel* standard for a 363 sale, articulated business justification, was met.
  - Bondholders argued the sale deadline imposed by the U.S. government was fictitious and the U.S. government would not let GM liquidate.
  - The Court stated that it should not play Russian Roulette
    - "This is hardly the first time that this Court has seen creditors risk doomsday consequences to increase their incremental recoveries . . ." 407 B.R. 463, 493 (Bankr. S.D.N.Y. 2009).

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Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5301 *et seq.* (July 21, 2010):

THE PROPOSED SOLUTION TO THE RESOLUTION OF DISTRESSED SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS – A NON BANKRUPTCY CODE OPTION

"Virtually every large financial firm in the world was in significant danger of going bankrupt . . . We would be facing, potentially, another depression of the severity and length of the Depression in the 1930s. And that this was not at all hypothetical."

Ben Bernanke, Chairman of the Federal Reserve

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Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5301 *et seq.* (July 21, 2010):

- Title II of the Dodd-Frank Act introduced the Orderly Liquidation Authority with the intended goal of resolving distress of SIFIs to avoid systemic consequences without using tax payer dollars.
- According to the United States Treasury, the only options it had during the recent financial crisis to deal with a non-bank financial company in severe distress such as Lehman Brothers Holdings, Inc., was to either
  - stabilize the financial company with outside capital or funding from the US government at taxpayer expense, such as the case with AIG, or
  - allow the financial company to fail and be liquidated under the Bankruptcy Code.

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Dodd-Frank Act: Asset Transfers

" Our only hope is a merger so we can become too big to fail. "

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Dodd-Frank Act: Asset Transfers

- Title II contemplates a non-Bankruptcy Code federal receivership of a distressed SIFI with the FDIC acting as receiver and judge overseeing the receivership. The FDIC is endowed broad and expansive powers, including, the ability to sell all or substantially all assets outside of the ordinary course of business with broad discretion and no court supervision.
  - Assets can be sold “without obtaining any approval, assignment, or consent with respect to such transfer.” See §210(a)(1)(G).
  - In contrast to a 363 sale, creditors do not have opportunity to object to sale by the FDIC.
- The FDIC is authorized to form a “bridge financial company.” §210(h)(1)(A).
  - At any time after the establishment of the bridge financial company, the FDIC may transfer any assets and liabilities of the covered financial company to the bridge financial company without obtaining any approval under federal or state law, assignment or consent. See §210(h)(5)(A), (D).
  - The FDIC may operate the bridge financial company for up to 5 years. *See* §210(h).

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Dodd-Frank Act: Orderly Liquidation Fund

- Dodd-Frank provides for the creation of an Orderly Liquidation Fund (“OLF”) in the United States Treasury to be managed by the FDIC.
- During the 30 days immediately following a financial company being placed into receivership (or until regulators calculate the total consolidated assets of the company that are available for repayment), regulators may not issue or incur any obligation that would exceed 10 percent of the total consolidated assets of the covered financial company. §210(n)(6)
- Thereafter, regulators can only issue an amount that (in the aggregate with prior obligations incurred) does not exceed 90 percent of the “fair value of the total consolidated assets of each financial company that are available for repayment[.]” §210(n)(6)
  - It is unclear how total consolidated assets are tabulated. Presumably, regulations may illuminate how consolidated assets shall be valued.

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FDIC's Single Point of Entry (SPOE) Strategy

- "Single point of entry" - An FDIC concept to avoid destabilization of financial markets
  - Only the bank holding company of the systemically important financial company (SIFI) is placed into Title II receivership.
  - Assets of bank holding company (investments in subsidiaries and loans to subsidiaries) are then transferred to the bridge holding company.
  - Long-term debt and equity of bank holding company remain in receivership.
    - Other liabilities may or may not pass to bridge holding company.

- Subsidiaries of bank holding company continue to operate outside of receivership.
  - Loans to subsidiaries by the bank holding company are forgiven to recapitalize subsidiaries.
  - Bridge holding company serves as "source of strength" to provide necessary funding to subsidiaries, including through use of the OLF—tax payer funds
  - Conceptually, short-term creditors would not engage in bank runs as subsidiaries are recapitalized and provided with liquidity to meet liabilities.

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FDIC's Single Point of Entry (SPOE) Strategy *(continued)*

- SPOE effectively accomplishes a reorganization. After the bridge financial company is stabilized, the company is returned to the private sector:
  - Holders of claims against receivership may receive new debt obligations or equity interests in the reorganized entity or be discounted or expunged
  - Holders of equity interests against the receivership will likely be wiped out

- Objective- Eliminate taxpayer bailouts

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Potential Problems with SPOE

- Preferential treatment of short-term creditors may result in SIFI's overreliance on short-term funding
  - Cost of short-term credit will decrease for SIFIs
  - Creates moral hazard as short-term creditors have less incentive to monitor SIFIs due to creditor bailout
  - Creates competitive advantage for SIFIs over smaller financial companies in calm and turbulent economic environments
  - FDIC says short-term creditors cannot expect favored treatment since other resolution regimes may be invoked. If true, then SIFIs still subject to runs.

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Potential Problems with SPOE

- Accelerates failure of a distressed SIFI
  - SPOE requires bank holding company to hold substantial long-term debt that must be serviced (and refinanced if maturing)
  - As SIFI becomes distressed or where extent of losses at subsidiaries is uncertain, the cost of debt for bank holding company will dramatically increase
    - Potentially precludes new private sector financing (both debt and equity) to recapitalize bank holding company during crisis
    - Decline in value of debt and equity will signal distress and receive considerable media attention
  - Short-term creditors may encourage SIFI failure to benefit from SPOE recapitalization of subsidiaries

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Potential Problems with SPOE

- Cross-default provisions, change of control provisions, and intercompany guarantees present challenges to SPOE
  - Dodd-Frank prevents a counterparty of a SIFI's subsidiary from terminating a contract due to a cross-default provision triggered by the failure of the SIFI's bank holding company. Dodd-Frank Act § 210(c)(16)(A); 12 C.F.R. § 380. However, counterparties of a SIFI's foreign subsidiary may still invoke cross-default provisions if the contract is governed under foreign law.
  - If a subsidiary guarantees the obligations of a bank holding company, the guarantee may impede the recapitalization of the subsidiary under SPOE and undermine the critical premise of SPOE by making taxpayer bear the costs rather than creditors and equity holders

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Potential Problems with SPOE

- SPOE effectuates a financial restructuring that may be insufficient to ensure viability of subsidiaries
  - Asset values may continue to decline and losses may continue, particularly in a financial crisis
  - Since subsidiaries are not placed in receivership, subsidiaries are still subject to litigation and massive judgments for events related to SIFI failure (such as mortgage back securities litigation)
  - Departure of key talent and business may continue
  - Will FDIC direct bridge financial company to support subsidiaries that are or later become insolvent?

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Potential Problems with SPOE

- SPOE will result in bailout of minority shareholders of a subsidiary that is not wholly owned by the bank holding company
- Simultaneous Dodd-Frank receiverships of multiple SIFIs presents challenges
  - After Bear Stearns collapsed, market zeroed in on Lehman as next most likely to fail
  - In certain instances, SPOE may deter runs on subsidiaries, but does not deter failure of bank holding company
  - Ability of FDIC to manage multiple receiverships is questionable

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Potential Problems with SPOE

- SPOE requires bank holding company to hold substantial long-term debt that must be serviced (and refinanced if maturing)
  - If long-term debt (or equity) issued by bank holding company is held by other financial companies, use of SPOE can still lead to contagion
  - Another financial company's issuance of credit default swaps as to long-term debt of bank holding company can lead to contagion
- Questions remain as to cross-border application of SPOE
  - Will work only if the host country (where a foreign subsidiary of a SIFI is located) abstains from first initiating its own resolution process for subsidiary in its host country

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Potential Problems with SPOE

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Potential Problems with SPOE

- While Dodd-Frank provides that taxpayers shall "bear no losses" (§ 214(c)), just because the statute says it does not make it so!!!
  - Dodd-Frank also provides that utilization of the Orderly Liquidation Authority result in covered financial companies being "liquidated" (§ 214(a))
    - Statutory language has not prevented FDIC from advocating SPOE, which is essentially a reorganization rather than a liquidation

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Potential Problems with SPOE

- Dodd-Frank provides that amounts funded through Orderly Liquidation Authority shall bear interest at a spread over treasuries for corporate bond yields (§ 210(n)(5)(C))
  - Statute does not clarify whether corporate bond yield should reflect AAA or junk rating
    - Regulators are not likely to demand a high interest rate as it would impede viability of the SIFI
    - This itself constitutes a government subsidy

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Potential Problems with SPOE

- While Dodd-Frank provides for industry-wide assessments on certain financial companies to repay obligations under the Orderly Liquidation Fund within 60 months (§ 210(o)(1)):
  - Repayment period may be delayed indefinitely by FDIC to avoid "serious adverse effect on the financial system" (§ 210(o)(1)(C))
  - Assessments may be influenced by economic conditions so as to increase or decrease depending on changed conditions (§ 210(o)(4)(A))
  - Statute does not indicate amount of interest on assessment, if any, necessary to make government whole
- Any industry-wide assessment will surely be deducted by financial companies for income tax purposes – resulting undoubtedly in a burden on taxpayers

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Potential Problems with SPOE

- Emergency lending authority under section 13(3) of the Federal Reserve Act (the "FRA"), 12 U.S.C. 343, is still available for regulators to provide assistance to the financial industry.
- Due to amendments by the Dodd-Frank Act, section 13(3)
  - Must be to provide "liquidity to the financial system, and not to aid a failing financial company." DFA § 1101(a)
    - If regulators provide section 13(3) support early enough to prevent firms from failing, it is questionable whether the Orderly Liquidation Authority may be needed during a financial crisis.
  - Must not be available for insolvent financial companies. *Id.*
    - The Federal Reserve is to establish procedures to screen insolvent borrowers. The Dodd-Frank Act provides that such procedures may include a certification from the chief executive officer of the borrower that the borrower is not insolvent.

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Potential Problems with SPOE

- Requires that the Federal Reserve assign a lendable value to all collateral for such assistance. *Id.*
  - Unclear how rigorously regulators will scrutinize and analyze a financial institution during a potential financial crisis to determine eligibility for assistance.
- Has Title II (OLA) ended too big to fail?

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Potential Problems with SPOE

“How much would you pay to avoid a second Depression?”

Ben Bernanke, Chairman of the Federal Reserve

39th Annual Lawrence P. King and Charles Seligson Workshop
on Bankruptcy & Business Reorganization (September 18-19, 2013)

Section 363 Sales and the Evolution to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

Harvey R. Miller
Edward Wu
Weil, Gotshal & Manges LLP
New York, New York

Bankruptcy has a unique history. First conceived as a punitive measure subjecting debtors who failed to pay their debts to public humiliation and sometimes physical harm, bankruptcy was once perceived merely as a vehicle to achieve creditor recoveries.[1] With the passage of time, the perceptions and goals of bankruptcy began to evolve. As the United States matured and its commerce enlarged, failing commercial enterprises became increasingly viewed as a routine by product of a well-functioning competitive economy. In addition, the social value of discharge of debt for the honest, overburdened individual debtor evolved.

The Bankruptcy Act of 1898[2] contemplated the surrender by the bankrupt debtor of all of its properties to a trustee in bankruptcy. That trustee was charged with the responsibility of liquidating and converting that property into cash for distribution to holders of allowed claims, subject to the order of priorities set forth in the Bankruptcy Act. In exchange, the individual honest debtor received a discharge and the opportunity to pursue a "Fresh Start."[3]

From 1898 to the emergency legislation adopted by Congress in the 1930s in response to the so-called Great Depression, the Bankruptcy Act did not provide for the reorganization and rehabilitation of commercial debtors. Essentially all bankruptcy cases were conducted as liquidations through the forced sale of the debtor's assets. Such sales generally produced minimal to no recoveries for general unsecured creditors. The concept of a fresh start for commercial businesses was nonexistent under the 1898 Act.

With the onset of the Great Depression and the massive rate of unemployment at that time as commercial enterprises failed and ceased operations, the national legislature turned to finding a means to rehabilitate failed or failing commercial enterprises so that they would be in a position to offer employment and stimulate the economy. The germ of the Fresh Start concept for commercial businesses infected the reform thinking.

A reorganization paradigm had developed outside the purview of bankruptcy law in connection with the resolution of the financial distress of railroads that were in the process of spanning the United States, an expansion that began after the Civil War and continued into the 20th Century. The construction of the railroad was based upon leverage and a philosophy that if you build it, they will come, similar to the expansion and building of worldwide cable networks during the 1990s, e.g. Global Crossing.[4]

The premise of the railroad reorganization paradigm, or as it was then called, railroad equity receiverships, was federal court oversight of the railroad under the control of a court-appointed trustee while the economic stakeholders, through the use of protective committees and their financial advisors, developed a plan to restructure the railroad's finances and operations. Essentially, the railroads had encountered unforeseen adversities in construction and operations and had borrowed excessively. As highly leveraged entities, they were unable to meet their debt service obligations to complete or continue their railroad operations.

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1 Charles Warren, Bankruptcy in United States History 3-40 (Da Capo Press Reprints in American Constitutional and Legal History, Da Capo Press 1972) (1935).

2 Bankruptcy Act 1898, ch. 541, 30 Stat. 544 (1898).

3 Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

4 In re Global Crossing LTD., Case No. 02-40188 (Bankr. S.D.N.Y. 2002).

The financial wizards of the time, primarily led by J. P. Morgan, developed a paradigm that encompassed the formulation of protective committees of bondholders and other claimants to represent the debt holders. The committees and their representatives would negotiate with the railroad trustee to construct a plan of reorganization. As part of the process, claimants would deposit their bonds with a protective committee to facilitate negotiations for the comprehensive plan that would put the railroad on a firm financial footing. This usually involved the writing out of equity interests, or discounting or swapping of debt instruments and was effectuated through the transfer of the railroad's assets to a new entity as the successor in interest but with sharply reduced debt obligations. The railroad equity receivership or railroad reorganization paradigm and the transfer of the debtor's assets to the successor entity pursuant to the plan enabled a fresh start by the railroad.

The elements of the railroad reorganization paradigm were adopted as part of the 1938 Chandler Act with the enactment of Chapters X (Corporate Reorganization), XI (Arrangements) and XII (Wage-Earners). The objective of reorganization and rehabilitation of distressed debtors rather than liquidation was the predominant theme and principle of the reorganization chapters of the Chandler Act. Many of the underlying reorganization principles were derivative from railroad equity receiverships and the precedents established in those proceedings, including absolute priority, due process and transparency.

The Chandler Act also continued the power of the bankruptcy court to approve the sale of debtor assets outside of a plan, subject to court approval. Ultimately, that power was included in section 363 of the Bankruptcy Code as enacted in 1978. As such, it is applicable in the reorganization chapters of the Bankruptcy Code, unless otherwise provided.

Since the power of sale was incorporated into the bankruptcy law, it has had a checkered past insofar as it related to reorganization cases. The sale of all or substantially all of the assets of a debtor outside of a reorganization plan pursuant to a generally applicable provision of the Bankruptcy Code was questioned as being in conflict with the provisions and process of chapter 11 to rehabilitate a debtor and protect the interests of creditors and equity holders. It has been attacked as being used as a means to circumvent the orderly process and creditor protective provisions of the reorganization chapters of the Chandler Act and, thereafter, chapter 11.[5]

The simplicity of section 363(b) has been criticized as failing to establish the standards for a sale of substantially all of a debtor's assets. It was, nevertheless, recognized by courts and parties in interest that situations would and did arise that might justify a major non-plan sale of the debtor's assets that would terminate rehabilitation of the debtor's business.

<u>1938 – 1978</u>

During the pre-Bankruptcy Code era, the virtue of reorganization and rehabilitation of distressed commercial enterprises gained substantial support. Preservation of going-concern values was deemed a virtue. The reorganization chapters of the amended Bankruptcy Act facilitated that objective. Mandatory liquidation of a debtor's assets was considered a significant loss of value and employment opportunities. In contrast, reorganized businesses did provide jobs and bolstered local and national economies. Chapters X and XI of the former Bankruptcy Act enabled debtor businesses to maintain operations, retain employees and allow creditors to participate in the reor-

5 In re Braniff Airways, Inc., 700 F.2d 935, 940 (5th Cir. 1983).

ganization process.

As the reorganization process evolved, however, and in the contraction of operations that generally occurred after the commencement of a rehabilitation case, situations arose as to particular assets that required immediate attention or were not necessary to the reorganization effort. To deal with such situations, trustees, receivers and debtors-in-possession looked to the power of the bankruptcy court to authorize sales of assets outside the ordinary course of business, for cause, and not pursuant to a reorganization plan. Initially, the issue related to the nature of the particular assets. As far back as the Bankruptcy Act of 1867, the law recognized the need for expeditious disposition of assets of a "perishable nature or liable to deteriorate in value."[6]

Substantively, the underlying premise of such sales was to prevent the loss of value. This premise was incorporated into the concept of "perishable." If it could be demonstrated that delaying the sale of assets, even if physically stable, would cause a loss of value, court authority was obtainable under the encompassing definition of perishable.[7]

The Chandler Act of 1938[8] empowered the court to authorize non-plan sales of assets "upon such notice as the judge may prescribe and upon cause shown." In determining cause, courts generally resorted to the perishable standard.[9] That standard was determined by more conservative courts to be limited to an "emergency" and a requirement of immediate danger of lost value.[10] The split among courts as to the necessary evidentiary support resulted in dueling venues to govern reorganization cases.

After World War II and beginning in the 1950s, the economy began to expand. It was fueled by an increased access to credit during the years preceding the enactment of the Bankruptcy Reform Act of 1978. During that period, some courts adopted a new standard for considering the sale of assets outside of a reorganization plan, i.e. "best interests of the estate."[11] This standard provided more flexibility and discretion for courts. It introduced the concept of business judgment exercised, generally, to dispose of burdensome and onerous assets.

1978 – Present

Section 363(b) of the 1978 Bankruptcy Code reaffirmed the power of the bankruptcy court to authorize sales of assets in reorganization cases outside of a chapter 11 plan, but included a major change. Unlike the prior Bankruptcy Act, section 363(b) of the Bankruptcy Code did not include any requirement for cause to be shown to authorize a sale.[12] Some commentators and others interpreted the deletion of cause shown to liberalize non-plan asset sales on the exercise of the debtor's business judgment.

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6 Bankruptcy Act of 1867, ch. 176, 14 Stat. 517, 578 (1867).
7 In re Pedlow, 209 F. 841, 842 (2d Cir. 1913); see Slide #6.
8 Chandler Act of 1938, ch. 575, 52 Stat. 883 (1938).
9 In re V. Loewer's Gambrinus Brewery Co., 141 F.2d 747, 748 (2d Cir.1944); In re Sire Plan Inc., 332 F.2d 497, 499 (2d Cir. 1964); see Slide #7.
10 In re Solar Mfg. Corp., 176 F.2d 493, 494 (3d Cir. 1949); see Slide #8.
11 In re Equity Funding Corp. of Amer., 492 F.2d 793, 794 (9th Cir.1974); In re Dania Corp., 400 F.2d 833, 835-37 (5th Cir.1968); see Slide #8.
12 11 U.S.C. §363(b); see Slide #9.

Most of the early sale cases under the Bankruptcy Code did not involve the sale of substantially all of the debtor's assets outside of a plan. In 1980, White Motor Corp., an iconic manufacturer/assembler of heavy-duty trucks, and its affiliated credit corporation each commenced chapter 11 cases in the United States Bankruptcy Court for the Northern District of Ohio.[13] White was a major employer and valued contributor to local economies. However, as the global economy was becoming more pervasive, foreign competition, labor issues and excessive leverage had materially impaired White's viability. The chapter 11 cases were adversarial. The efforts to rehabilitate White as a going-concern business were unsuccessful. Consequently, the debtor's and the creditors' committee undertook to seek out a purchaser of substantially all of the debtors' assets pursuant to section 363(b) of the Bankruptcy Code. After extensive sale efforts, only one prospective purchaser surfaced, Volvo Motors. The proposed sale was vigorously challenged. After hearing, the bankruptcy court rejected the contention that section 363(b) had changed the pre-Code law. Nevertheless, the bankruptcy court approved the sale by charactering the situation as an "emergency."[14]

The *White* court recognized that failure to authorize the sale would result in a significant loss of value. In effect, the court found there was no realistic alternative but to authorize the sale or materially diminish prospective creditor recoveries.

Despite the *White* court's construction of section 363(b), the case was particularly noteworthy because it sanctioned a sale of all or substantially all of a debtor's assets outside of a chapter 11 plan and without a conversion to a case under chapter 7. In that respect, the decision was subject to critical comments.

White intensified the debate over the scope and substance of section 363(b) and in particular the propriety of selling in a chapter 11 case all or substantially all of the debtor's assets without compliance with the protective provisions of chapter 11 and the plan confirmation process. The issues came to the forefront in the chapter 11 cases of *Braniff Airlines* in 1982.[15] Soon after the chapter 11 cases were commenced, it became clear that the airline was not going to be rehabilitated. Time was of the essence, as Braniff's liquidity was quickly eroding and maintenance of the grounded fleet and facilities was very expensive. As a result, Braniff moved to sell substantially all of its assets pursuant to section 363(b). Purchasers and offers were solicited. Braniff quickly reached a comprehensive sale agreement with Pacific States Airline (PSA), a small point-to-point airline based in California. Under the sale agreement, PSA was to acquire planes, landing slots and other assets. In exchange, PSA, among other considerations, was to provide Braniff with travel scrip, notes, a profit participation going forward, all to be distributed to holders of allowed claims in connection with a subsequent Braniff plan of liquidation. The sale also provided for the adjustment of claim amounts and the voting of certain claims.

Objections to the sale were vigorously mounted. The case reached the Fifth Circuit Court of Appeals in 1983. The Fifth Circuit reversed the approval of the sale.[16] The Court noted that section 363(b) authority was limited and did not encompass a sale that dictated the terms of a chapter 11 plan and circumvented the creditor protections and primary objectives of chapter 11, including

13 In re White Motor Credit Corp., 14 B.R. 584 (Bankr. N.D. Ohio 1981); see Slide #10.

14 14 B.R. at 588.

15 In re Braniff Airways, Inc., Case No. 482-00369 (Bankr. N.D. Tex. 1982); see Slide #11.

16 In re Braniff Airways, Inc., 700 F.2d 935, 943-44 (5th Cir. 1983).

the voting process of chapter 11.[17] In effect, the Fifth Circuit viewed the proposed sale as a "sub rosa" chapter 11 plan.

The Fifth Circuit decision initially was viewed as the death knell for all encompassing section 363(b) sales. However, shortly after the Fifth Circuit decision, the Second Circuit issued its seminal decision construing section 363(b).[18]

In *Lionel*, the authorized sale of the controlling shares of common stock of an independent, partially owned unrelated subsidiary pursuant to section 363(b) was reversed.[19] The sale had been demanded by the creditors' committee in order to provide a cash distribution to creditors under a chapter 11 plan. The subsidiary was engaged in a separate and distinct business. The Lionel equity holders committee objected to the sale on the ground that the sale value did not benefit equity holders and evaded the statutorily mandated chapter 11 process.

In reversing the sale authorization, the Second Circuit noted that the shares of the subsidiary were not eroding in value and that the value would be retained through the chapter 11 plan confirmation process.[20] In other words, there was no danger of lost value or perishability.

The Second Circuit comprehensively reviewed section 363(b) and concluded that such a sale requires an articulated business purpose or justification.[21] The Second Circuit rejected (a) the contention that section 363(b) grants the court *carte blanche* approval authority; and (b) that section 363(b) was limited to emergency situations. In its discussion, the Second Circuit indicated that section 363(b) does provide a statutory basis for the sale of a debtor's assets outside of a chapter 11 plan for articulated business reasons, but that a court must consider the sale in the context of the protective provisions included in chapter 11 for the benefit of creditors. The Second Circuit provided a nonexclusive list of seven factors for courts to consider in authorizing a section 363(b) sale.[22] Of particular importance among the nonexclusive seven factors is a determination as to whether the asset is increasing or decreasing in value. This factor has been pervasive in the consideration of the sale of assets outside of a plan. It remains as the most important factor.

Notwithstanding the reversal of the sale authorization in *Lionel*, the Second Circuit decision is often cited as authority for the use of section 363(b) to expeditiously, and early in a reorganization case, sell all or substantially all of the assets of a debtor. The frequency of such sales increased in the years following the *Lionel* decision, as practitioners avoided the potential fatal sale flaws identified in *Braniff*.

Following *Lionel*, in the chapter 11 cases of *Loral Space & Communications Ltd*.,[23] the debtors moved immediately after the commencement of the cases for authority to sell a major portion of their assets pursuant to section 363(b) of the Bankruptcy Code. The sale agreement had been entered into pre-chapter 11 and consummation of the sale was conditioned upon bankruptcy court authorization. The condition was mandated by the purchaser to avoid any potential post-closing

17 Id. at 940; see Slide #11.
18 In re Lionel Corp., 722 F.2d 1063 (2d. 1983); see Slide #12.
19 Lionel, 722 F.2d at 1072.
20 Id.
21 Id. at 1070.
22 Id.; see Slide #13.
23 313 B.R. 577 (Bankr. S.D.N.Y. 2004); see Slide #14.

litigation. The creditors' committee opposed the sale as violative of the provisions of chapter 11 and a relinquishment of the debtors' "crown jewels." After a contested evidentiary hearing, the court found that the facts supported and justified the sale and the exercise of the court's business judgment to authorize it.

LBHI, General Motors Corp., & Chrysler Corp.

The zenith of section 363(b) sales occurred after the financial crisis of 2008. The collapse and ensuing chapter 11 bankruptcy of *Lehman Brothers Holdings Inc*.[24] presented within the first week of the case the propriety of a sale of Lehman's extensive North American Capital Markets business to Barclays PLC. Lehman's chapter 11 petition was filed on September 15, 2008 and, notwithstanding the enormity and complexity of the sale, court approval for the sale was obtained four days later on September 19, 2008. Authorization for the sale was granted over the objection of numerous highly agitated claimants. The bankruptcy court found that it had no realistic alternative and that sufficient business justification had been presented demonstrating the high potential of tremendous losses in value.[25]

In 2009, as the financial crisis deepened and the automotive industry was gripped in distress and contracting values, Chrysler Corporation and General Motors Corporation each commenced chapter 11 cases with immediate application to the respective bankruptcy courts to authorize the sale of substantially all of their respective assets.[26] In each case, the section 363(b) sales were authorized over aggressively litigated objections. The Chrysler Corporation's sale was completed in 41 days and the General Motor's sale was consummated in 39 days, each calculated from the commencement of the respective chapter 11 cases.[27]

In each case, it was argued that the proposed sales went beyond the scope of section 363(b), constituted *sub rosa* plans, violated the hierarchy of priorities under the Bankruptcy Code and various other objections. In each case, the sale was authorized and affirmed on appeal.[28]

The General Motors and Chrysler Corporation sales became the standard-bearers for the liberal and broad interpretation of section 363(b), as authority to sell all or substantially all of the assets of a debtor outside of a chapter 11 plan. It has become a predominant vehicle in chapter 11 cases, as business financing has changed and secured lenders dominate the prosecution of chapter 11 cases. The bankruptcy court has assumed the function of validating such sales and as a forum or auction house for such sales. Section 363(b) has become a primary tool to expedite creditor recoveries and satisfy the demand of secured lenders.

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24 In re Lehman Brothers Holdings Inc., Case No. 08-13555 (Bankr. S.D.N.Y. 2008).

25 *Order Under 11 U.S.C. §§ 105(a), 363, and 365 and Federal Rules of Bankruptcy Procedure 2002, 6004 and 6006 Authorizing and Approving (A) the Sale of Purchased Assets Free and Clear of Liens and Other Interests and (B) Assumption and Assignment of Executory Contracts and Unexpired Leases*, ECF No. 258, In re Lehman Brothers Holdings, Inc., No. 08-13555, 2008 WL 4385989 (Bankr. S.D.N.Y. Sept. 19, 2008); In re Lehman Bros. Holdings, Inc., 415 B.R. 77, 79 (S.D.N.Y. 2009).

26 In re Chrysler LLC, Case No. 09-50002 (Bankr. S.D.N.Y. 2009); In re Motors Liquidation Corp., Case No. 09-50026 (Bankr.S.D.N.Y. 2009).

27 In re Chrysler LLC, 576 F.3d 108, 111-12 (2d Cir. 2009); In re General Motors Corp., 407 B.R. 463, 479 (Bankr. S.D.N.Y. 2009).

28 In re Chrysler LLC, 576 F.3d at 111 (2d Cir. 2009); In re Motors Liquidation Corp., 430 B.R. 65, 99 (Bankr. S.D.N.Y.).

Dodd-Frank Wall Street Reform and Consumer Protection Act (7/21/10)

It is generally believed that periods of financial crisis tend to prompt the enactment of remedial legislation.[29] In response to the financial crisis that culminated in the bankruptcy of Lehman and in the effort to reinstate broader regulation of financial institutions and, in particular, systemically important financial institutions (SIFIs), the Dodd-Frank Wall Street Reform and Consumer Protection Act[30] was enacted on July 21, 2010.

A primary objective of Dodd-Frank is to eliminate the use of taxpayer funds to salvage or bailout failing financial institutions, but yet avoid a meltdown of financial markets as occurred in 2008/2009.[31] Title I of Dodd-Frank provides for increased oversight and regulation of financial institutions to reduce their potential for failure. Title II of Dodd-Frank–entitled *Orderly Liquidation Authority* (OLA)–creates a new resolution regime that is intended to liquidate a failed SIFI in an orderly manner by placing the SIFI into a federal receivership with the FDIC acting as receiver.

Notably, Title II incorporates the concept of early sales of all or substantially all of the assets of a SIFI, as determined by the FDIC as receiver. However, an FDIC receivership under the Dodd-Frank Act is not an open, transparent proceeding. Creditors do not have the standing afforded under the Bankruptcy Code or, indeed, any realistic opportunity to object to a sale directed by the FDIC.[32] In fact, no approval of the transfer directed by the DFIC is required.[33]

Since the enactment of Dodd-Frank, the FDIC and others have strained to develop a process to resolve a SIFI through Title II without causing systemic damage to the financial markets and the national economy. The current approach adopted by the FDIC is the Single Point of Entry (SPOE) process. It contemplates the receivership of only the parent holding company of the failing enterprise and the continued operation of its active subsidiaries so as not to destabilize financial markets. SPOE adopts a sale methodology and would provide for the sale/transfer of the operating subsidiaries of the holding company to a bridge holding company created by the FDIC. To the extent that the operating subsidiaries require financing, it would be provided by the bridge holding company through the use of the Orderly Liquidation Fund and, assumedly, if that Fund is inadequate, from the FDIC or the U.S. Treasury (taxpayer funds?).

For more detailed information as to SPOE and related issues under Title II of Dodd-Frank and SPOE, see slides 19-36.

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29 Charles Warren, Bankruptcy in United States History (Da Capo Press Reprints in American Constitutional and Legal History, Da Capo Press 1972) (1935).
30 12 U.S.C. §5301 *et. seq*.
31 See Slide#19.
32 Id.
33 12 U.S.C. §5390(a)(1)(G); see Slide #21.

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BLANKET LIENS AND THE ALLOCATION OF VALUE IN CHAPTER 11 SALES

Donald S. Bernstein
Darren S. Klein
Davis Polk & Wardwell LLP
New York, New York
September 17, 2013

Blanket Liens and the Allocation of Value in Chapter 11 Sales

Donald S. Bernstein and Darren S. Klein[1]

I. Introduction

In a forthcoming *Yale Law Journal* article, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, Professors Melissa B. Jacoby and Edward J. Janger discuss a topic that is increasingly at the forefront of large chapter 11 cases: the sale of substantially all of the debtor's assets pursuant to section 363 of the Bankruptcy Code where a secured creditor has a "blanket lien" on the debtor's assets.[2] Where such a lien exists, and the secured creditor will be the primary or exclusive beneficiary of the sale, they question the appropriateness of selling at the very outset of a bankruptcy case, rather than attempting to reorganize the business or waiting to sell the assets later, either under section 363 or under a plan of reorganization. Their focus is twofold – on the ability of the secured creditor to press for a rushed sale and also on the apportionment of the proceeds of such a sale between the secured creditor and unsecured creditors. This paper seeks to place the issues raised in *Ice Cube Bonds* in the context of a larger discussion about section 363 sales, blanket liens and the allocation of estate value at the 2013 ABI/NYU Bankruptcy Workshop.

A going concern sale under section 363 of the Bankruptcy Code can be a fast and cost-effective way to stabilize a distressed chapter 11 company, especially when delay in exiting bankruptcy might result in attrition in the value of the business or in liquidation. The benefit of a quick sale is usually encapsulated by the argument that the debtor is a "melting ice cube" – hence the title of the *Ice Cube Bonds* article. In many cases, it can legitimately be argued that the operating business is becoming less valuable every day it remains in bankruptcy, and value will therefore be maximized by selling the business as quickly as reasonably possible. A classic example of such a case is the company that is losing money on an operating basis before debt service. A quick sale after commencement of bankruptcy proceedings is likely to maximize the value of the estate, especially if the business had been "shopped" for an extended period of time prior to bankruptcy and potential bidders have had ample opportunity to complete due diligence and submit a bid.

Jacoby and Janger suggest, however, that not all cases are so clear-cut; in some cases the marketing process is truncated and the benefits of a quick sale may be outweighed by the costs. Specifically, they argue that (1) information is likely to be scarce in a highly accelerated process; (2) the available information is often

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[2] Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 Yale L.J. (forthcoming 2014), *available at* http://ssrn.com/abstract=2268662.

asymmetrically distributed; and (3) the prior two points enhance the leverage of lienholders who may be informationally advantaged and may behave opportunistically.[3] In short, they assert that a truncated sale process may undercut the realization of value, especially where the primary or sole beneficiary of the sale is the secured creditor.[4]

A classic example of how these questions arise is the administratively insolvent debtor. Imagine that a creditor is secured by substantially all of the debtor's assets (that is, has a "blanket lien") and its loans exceed the expected enterprise value of the company. This creditor, fearing further declines in value and the incurrence of administrative expenses, pushes for a quick sale, with a truncated marketing process, at the outset of the case. Unsecured creditors, who do not stand to receive any of the sale proceeds, argue that the process should be slowed down to see if there might be higher offers for the business or, alternatively, argue for a reorganization in which the court might determine that over the long run the value of the company will exceed the secured debt.

In this scenario, the bankruptcy judge is faced with the following question: are the parties pushing for the sale (typically, the secured creditors) taking advantage of the "emergency" or, even worse, fabricating one to permit them to misuse an informational advantage to extract a sweetheart deal at the expense of other creditors? Or are the opponents of the sale really just dissatisfied out-of-the-money creditors arguing for delay of a sale simply to give them leverage to extract hold-up value?

Apart from the problems associated with excessive speed, Jacoby and Janger suggest that there may be reasons the undersecured, blanket lienholder is not entitled to all of the sale proceeds. Among other things, they note that (i) a "blanket lien" may not really be blanket because the secured creditor may not have a lien on all of the debtor's assets, (ii) the secured creditor may have mistakenly failed to perfect its liens on some of the granted collateral and (iii) the debtor may have the ability to avoid some or all of the liens through the avoidance powers granted to debtors under chapter 5 of the Bankruptcy Code and state law. They also highlight the longstanding debate over whether secured creditors' entitlements should be limited to the liquidation value of their collateral rather than its reorganization value, and they raise the question of whether a portion of the value of the estate should be attributed to the benefits conferred by the bankruptcy process (for example, the ability to obtain a "free and clear" order) and allocated to the general estate.[5] If the section 363 sale process creates more value than could have been obtained in a sale outside of bankruptcy, should at least some of that incremental value be made available to unsecured creditors?

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[3] *See Id.* at 28.

[4] The risk of informational scarcity and asymmetry identified by Jacoby and Janger arises largely from the possibility that a quick sale (as opposed to a delayed one) will entail a truncated marketing process for the business. This risk is lower where it can be demonstrated that the business has been thoroughly shopped prior to bankruptcy.

[5] *See* Jacoby & Janger, *supra* note 2, manuscript at 48-52.

II. Section 363 Sales

Section 363(b) of the Bankruptcy Code allows a debtor, on notice and a hearing, to sell assets outside of the ordinary course of business.[6] The leading court decision interpreting section 363(b) is the Second Circuit's decision in the *Lionel* case, which held that such a sale requires a sufficient "business justification."[7] While the *Lionel* court denied the sale at issue for lack of a sufficient business justification, Jacoby and Janger point out that its holding has been the principal basis for determining the appropriateness of section 363 sales ever since, including for sales of substantially all of the assets of a debtor.[8] *Lionel* represented an evolution from pre-Bankruptcy Code law, under which sales of substantially all the debtor's assets outside of a plan of reorganization, even if not at the outset of the case, were generally permitted only if an emergency was shown to exist.[9] As Jacoby and Janger, and other commentators, have noted, section 363 sales of going concern businesses based on *Lionel's* business justification standard have become increasingly prevalent.[10]

While the *Lionel* standard prevails for section 363 sales generally, melting ice cube arguments continue to be made where the proponent of a sale (typically the debtor or secured creditors) seeks to justify a rushed, front-end loaded sale process. In effect, courts continue to consider whether there is an "emergency" need to sell as a factor in determining whether a sufficient business justification exists for a sale in an accelerated process.[11]

A. Maximizing Value vs. Apportionment of Proceeds

Especially since the *Chrysler* and *General Motors* bankruptcies, both of which included quick section 363 sales of very large companies, numerous commentators have

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[6] 11 U.S.C. § 363(b).

[7] *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.),* 722 F.2d 1063, 1070 (2d Cir. 1983).

[8] *See* Jacoby & Janger, *supra* note 2, manuscript at n.60 and accompanying text (noting that "[h]undreds of courts, and thousands of commentators, have cited *Lionel*").

[9] *See, e.g., In re Pure Penn Petroleum Co.*, 188 F.2d 851, 854 (2d Cir.1951) (requiring "the existence of an emergency involving imminent danger of loss of the assets if they were not promptly sold"); *In re Solar Mfg. Corp.*, 176 F.2d 493, 494 (3d Cir.1949) (requiring "imminent danger that the assets of the ailing business will be lost if prompt action is not taken").

[10] *See* Jacoby & Janger, *supra* note 2, manuscript at n.51.

[11] *See In re Lehman Brothers Holdings Inc*., 445 B.R. 143, 180 (Bankr.S.D.N.Y. 2011) ("The most important factor for the court in determining whether to approve a § 363 sale is whether the asset is decreasing in value. Thus, a sale should be approved when the court is faced with the situation of a so-called 'melting ice cube.'"); *In re Chrysler LLC*, 405 B.R. 84, 96 (Bankr.S.D.N.Y. 2009) ("Here, the Debtors have established a good business reason for the sale of their assets at the early stages of these cases. . . . The only other alternative is the immediate liquidation of the company"); *In re Chrysler LLC,* 576 F. 3d 108, 119 (2d Cir. 2009) ("With its revenues sinking, its factories dark, and its massive debts growing, Chrysler fit the paradigm of the melting ice cube"), *vacated, Ind. Police Pension Trust v. Chrysler LLC,* 556 U.S. 960 (2009).

criticized the process by which a debtor is able to sell substantially all of its assets through a section 363 sale, especially with a truncated sale process in the first days of the case.[12] Jacoby and Janger note a concern that the "melting ice cube" argument is overused and that using additional time for a more thorough sale process would not impair the sale price in a number of cases.[13]

The approval of such a quick sale does not, of course, determine the ultimate apportionment of sale proceeds. The proceeds are received by the debtor and often distributed later, pursuant to a liquidating plan of reorganization or after conversion of the case to chapter 7.[14] In connection with such distributions, the creditors maintain their statutory protections and priorities with respect to the ultimate distribution of estate property. However, as Jacoby and Janger note, by that point, the estate may consist solely of a fixed pile of cash, creditors will have lost the ability to support or oppose a sale through plan voting, and the sale itself will not have been subjected to the disclosure statement process or plan confirmation requirements.[15] The scope of the secured creditor's lien and the amount of sale proceeds determine whether unsecured creditors are in or out of the money.

In essence, the "Ice Cube Bond" proposed by Jacoby and Janger is a holdback of a portion of the sale proceeds of a quick section 363 sale that would remain available to be distributed to unsecured creditors unless the secured creditor proponent of the sale can demonstrate, among other things, that its liens entitle it to all the proceeds and that the quick sale for its benefit did not harm the estate. In Jacoby and Janger's view, the Ice Cube Bond will force better *ex ante* decision making because a secured creditor pushing for a sale would know that it will need to justify its right to the proceeds and the speed of the sale in order to receive the holdback.[16] Moreover, bankruptcy judges would know

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[12] *See, e.g.*, Gennady Zilberman, *Bankruptcy Section 363(b) Sales: Market Test Procedures and Heightened Scrutiny of Expedited Sales May Prevent Abuses and Safeguard Creditors Without Limiting the Power of the Courts*, 5 BROOK. J. CORP. FIN. & COM. L. 241 (2010); Kimon Korres, "*Bankrupting Bankruptcy: Circumventing Chapter 11 Protections Through Manipulation of the Business Justification Standard in § 363 Asset Sales, and A Refined Standard to Safeguard Against Abuse*," 63 FLA. L. REV. 959 (2011); Matthew A. Bruckner, "*Improving Bankruptcy Sales by Raising the Bar: Imposing a Preliminary Injunction Standard for Objections to § 363 Sales*," 62 CATH. U. L. REV. 1 (2012); Jessica Uziel, "*Section 363(b) Restructuring Meets the Sound Business Purpose Test with Bite: An Opportunity to Rebalance the Competing Interests of Bankruptcy Law*," 159 U. PA. L. REV. 1189 (2011).

[13] Jacoby & Janger, *supra* note 2, manuscript at n.15. Jacoby and Janger do recognize that in some cases there may be a "speed premium" or incremental value preserved by a quick sale that should be weighed against the increased chance of a valuation error due to the limited information available to parties early in the bankruptcy process. *Id.* at 48-52.

[14] *Id.* at 24. Sales that require the distribution of proceeds to certain creditors specifically run the risk of being illegal "sub rosa" plans of reorganization. *See In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983).

[15] *See* Jacoby & Janger, *supra* note 2, manuscript at n.38 and accompanying text.

[16] *Id.* at 69.

that a fund is set aside for general unsecured creditors in the event that the quick sale ultimately is determined not to have been value maximizing.[17]

With these types of concerns in mind, at least one court decision, *Gulf Coast Oil Corp.*, has sought to expand on the test for approving a section 363 sale.[18] The *Gulf Coast Oil* decision has been cited approvingly by a few other courts[19] and referred to by one commentator as the "sound business purpose test with bite."[20] The *Gulf Coast Oil* court held that a court approving a motion to sell substantially all of the debtor's assets must "weigh all of the facts and circumstances of the case and must determine whether safeguards are necessary to protect rights that could be exercised in the context of plan confirmation."[21] The court identified 13 factors relevant to this analysis.[22]

III. Apportioning the Value of a Debtor

Once the estate receives the proceeds of a section 363 sale, the bankruptcy process must determine how those proceeds are to be distributed among secured and unsecured creditors. In a simple example, if a secured creditor has a blanket lien on all of the debtor's assets, and the sale proceeds are insufficient to fully repay the debt, the secured creditor might assert an entitlement to all of the sale proceeds. However, it is possible that the secured creditor's collateral package is incomplete either through the intention of the parties, a mistake in perfection by the secured creditor, or through the debtor successfully asserting its avoidance powers under the Bankruptcy Code. In such a circumstance, the value of the estate can be apportioned between encumbered and unencumbered assets and distributed accordingly.

More interestingly, some commentators have argued that even a creditor with liens on all of a debtor's assets, including intangible assets, is not necessarily entitled to

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[17] *Id.* at 64.

[18] *In re Gulf Coast Oil Corp.*, 404 B.R. 407 (Bankr. S.D. Tex. 2009).

[19] *See, e.g.*, *In re Cloverleaf Enters., Inc.*, No. 09-20056, 2009 Bankr. LEXIS 3019 (Bankr. D. Md. Sept. 22, 2009); *In re On-Site Sourcing, Inc.*, 412 B.R. 817 (Bankr. E.D. Va. 2009); *In re Tidal Constr. Co.*, 446 B.R. 620, 623 (Bankr. S.D. Ga. 2009).

[20] Jessica Uziel, *Section 363(b) Restructuring Meets the Sound Business Purpose Test with Bite: An Opportunity to Rebalance the Competing Interests of Bankruptcy Law*, 159 U. Pa. L. Rev. 1189 (2011).

[21] 404 B.R. at 423.

[22] The 13 factors identified by the *Gulf Coast Oil* court are: (1) Is there evidence of a need for speed? (2) What is the business justification? (3) Is the case sufficiently mature to assure due process? (4) Is the proposed [purchase agreement] sufficiently straightforward to facilitate competitive bids or is the purchaser the only potential interested party? (5) Have the assets been aggressively marketed in an active market? (6) Are the fiduciaries that control the debtor truly disinterested? (7) Does the proposed sale include all of a debtor's assets and does it include the "crown jewel"? (8) What extraordinary protections does the purchaser want? (9) How burdensome would it be to propose the sale as part of confirmation of a chapter 11 plan? (10) Who will benefit from the sale? (11) Are special adequate protection measures necessary and possible? (12) Was the hearing a true adversary presentation? Is the integrity of the bankruptcy process protected? (13) Other factors that apply to the case at hand. *Id.* at 423-27.

all of the going concern value of the debtor.[23] This important issue arises not only in a section 363 sale process, but also under a plan of reorganization that does not involve a sale, since, in either case, the default rule is that the entire value of the reorganized company must be distributed to creditors in accordance with their entitlements.

The remainder of this paper provides a brief overview of how commentators and courts have viewed the issue of value apportionment between secured and unsecured creditors, especially in the circumstance where there is insufficient value to repay the secured creditor in full. For ease of reference, we will consider a hypothetical case involving a single secured creditor, but the discussion is equally applicable to situations with multiple secured creditors or even senior and junior secured creditors.

A. Who Should Get the Benefits of "Chapter-11-Created Value"?

Jacoby and Janger argue that there are sources of value to which a secured creditor is not necessarily fully entitled.[24] They assert that the chapter 11 process itself can increase the value of the enterprise, including by enhancing the debtor's ability to sell assets with clean title, overcoming the hold-out problem through plan voting and cram-down provisions, and providing incentives for third parties to provide financing. Additionally, the Bankruptcy Code provides an automatic stay that gives the debtor a "breathing spell" in order to restructure[25] and, in a sale context, the powerful ability to assume and assign executory contracts and unexpired leases notwithstanding anti-assignment provisions or breaches.[26]

As compared to a non-bankruptcy foreclosure sale, chapter 11 may provide a "going concern premium" that the secured creditor would otherwise be unable to realize through non-bankruptcy remedies such as foreclosure. Jacoby and Janger identify several factors that can complicate state law foreclosure actions.[27] State courts have historically been hostile to secured creditors. Foreclosure actions can be expensive, lengthy and result in little more than a quitclaim title. Depending on the location and nature of the assets, multiple foreclosure proceedings in varying jurisdictions may be necessary. Most importantly, foreclosing piecemeal on a debtor's assets typically results in a liquidation, which by definition eliminates any going concern surplus.[28]

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[23] *See* Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. Chi. L. Rev. 759 (2011); Owen W. Katz, *Valuation of Secured Claims in a Bankruptcy Reorganization: Eating with the Hounds and Running with the Hares*, 100 COM. L.J. 320 (1995).

[24] Jacoby & Janger, *supra* note 2, manuscript at 49-54.

[25] 11 U.S.C. § 362.

[26] 11 U.S.C. § 365(e).

[27] Jacoby & Janger, *supra* note 2, manuscript at 26-27.

[28] It is worth noting that, if the operating business is located in a subsidiary of the debtor, and the secured creditor has a lien on the stock of that subsidiary, it might be relatively quick and inexpensive to foreclose on the operating business, though in that circumstance the creditors of the operating business would ride through the foreclosure. *See* Comm. on Bankruptcy and Corporate Reorganization, New York

(….continued)

On the other hand, the historical foundation of our reorganization laws is the equity receivership, a mechanism that was specifically designed to permit secured creditors to realize the "going concern surplus," not foreclosure value.[29] This historical fact undercuts the idea that the "benefits of bankruptcy" are intended to go solely to unsecured creditors, and indeed suggests the contrary, so proponents of reallocation of the going concern surplus to the general bankruptcy estate are really arguing for a shift from the policies traditionally thought to underlie current law. The policy question nevertheless is an important one, regardless of the treatment historically or as a matter of current law.

Illustrating this tension, commentators favoring the baseline of a non-bankruptcy foreclosure have argued that the value of a secured claim should be determined on the basis of a commercially reasonable disposition of an asset rather than the retail or going concern value of the asset.[30] However, section 506(a) of the Bankruptcy Code provides that the value of a secured creditor's collateral "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."[31] As a result, the appropriate valuation method is, under current law, a contextual decision, suggesting that if the collateral is being valued for purposes of a going concern reorganization, the statute contemplates that the going concern value of the collateral be used.[32] Courts have accordingly tended to use a going concern, or fair market, valuation in the context of property being retained by the debtor in a reorganization.[33]

(continued….)

City Bar, *Non-Bankruptcy Alternatives to Restructurings and Asset Sales* (Nov. 2010), *available at* http://www.nycbar.org ("A [UCC] foreclosure can, in the right circumstances, provide a secured creditor with the opportunity to take control of or realize value for collateral with far greater speed and at much less expense than a bankruptcy sale"); *see also* Larry G. Halperin et al., *Strict Foreclosure Offers Out-of-Court Alternative to 363 Sales*, J. Corp. Renewal (June 2010), *available at* http://www.turnaround.org (strict foreclosure under the UCC is likely to succeed where all borrowed indebtedness is at a holding company and the operating assets are at the holding company's wholly owned subsidiary).

[29] *See* DAVID A. SKEEL, JR., DEBT'S DOMINION 56-60 (2001).

[30] *See* Katz, *supra* note 23.

[31] 11 U.S.C. § 506(a)(1). In contrast, in an individual bankruptcy case under chapter 7 or 13, the Bankruptcy Code requires that personal property securing a claim be valued "on the replacement value of such property as of the date of the filing of the petition without deduction for costs of sale or marketing." 11 U.S.C. § 506(a)(2).

[32] *See* COLLIER ON BANKRUPTCY, DETERMINATION OF SECURED CLAIM; VALUATION; § 506(a), 4-506 COLLIER ON BANKRUPTCY P 506.03 (16th ed. 2013) (many courts have recognized that "if the debtor proposes to retain and use collateral under a plan, the collateral should not necessarily be valued on a 'forced sale' basis for purposes of calculating the amount of the creditor's secured claim…On the other hand, if the debtor's prospects for a successful reorganization appear dim or nonexistent, the value of the creditor's collateral may best be determined on the basis of the value that the holder of the secured claim could obtain for the property upon a commercially reasonable foreclosure").

[33] *See, e.g.*, *Taffi v. United States (In re Taffi)*, 96 F.3d 1190, 1192 (9th Cir. 1996) *cert. denied*, 521 U.S. 1103 (1997) (rejecting a foreclosure valuation in the context of property the debtor retains under a plan of reorganization and stating that "when the proposed use of the property is continued retention by the debtor, the purpose of the valuation is to determine how much the creditor will receive for the debtor's

(….continued)

B. Should a Secured Creditor "Pay to Play"?

If the only party likely to benefit from the chapter 11 process is the secured creditor, the question arises as to whether the secured creditor should "pay to play" or otherwise compensate the estate for value created by chapter 11. Courts have come down on either side of this issue, incentivizing secured creditors to agree to a carve-out to pay estate professionals or unsecured claims in administratively insolvent situations.

In *Encore Healthcare Assoc.*,[34] the bankruptcy court was faced with a motion to sell a nursing facility for less than the amount of the debt secured by the facility. The court stated that section 363(b) did not grant the "bankruptcy judge *carte blanche* to approve a sale outside a plan of reorganization."[35] The court noted that no party other than the secured creditor would receive proceeds of the sale, and the only reason the chapter 11 was filed at all was the insistence of the purchaser that a bankruptcy court sale order be obtained, presumably for the benefits of clean title. The court denied the sale motion, holding that the sale would not advance any chapter 11 principles, as the secured party was not trying to save the operating business, but was merely seeking to realize the value of the nursing facility as real estate, something it could accomplish through a foreclosure. In short, the court decided that a chapter 11 proceeding should not be run for the sole benefit of a secured creditor, without any other objective.[36]

On the other hand, under different circumstances, the court in *GPA Technical Consultants Inc.* refused to dismiss a chapter 11 or convert it to a chapter 7 where the debtor was orderly unwinding its estate and the only potential beneficiaries were a secured creditor and counsel to the debtor.[37] The court reasoned that unsecured creditors stood neither to gain nor lose by the continuation of the chapter 11, and that the secured creditor stood to gain by its continuation through the debtor's greater ability to liquidate its assets and pursue causes of action.[38] The court held that in determining whether to dismiss or convert the case, the interests of creditors, including the secured creditor, should be taken into account.[39]

(continued….)

continued possession"); *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav. (In re Winthrop Old Farm Nurseries),* 50 F.3d 72, 75-76 (1st Cir. 1995) (valuing collateral retained by a debtor at fair market value and not foreclosure value).

[34] 312 B.R. 52 (Bankr. E.D. Pa. 2004).

[35] *Id.* at 55.

[36] *See also In re Fremont Battery Co.*, 73 B.R. 277 (Bankr. N. D. Ohio 1987) (denying a sale motion where no funds would remain after paying the secured creditor); *In re Gulf Coast Oil Corp*., 404 B.R. at 428 (denying sale motion when the "only effect of the bankruptcy process would be to transfer the debtors' assets to its secured creditor with benefits that the creditor could not achieve through foreclosure").

[37] 106 B.R. 139 (Bankr. S.D. Ohio 1989).

[38] *Id.* at 141.

[39] *Id.* at 142.

More recently, courts have had to consider whether an administratively insolvent debtor should be allowed to enter into a sale of assets that does not provide for the full payment of administrative claims.[40] In *Townsends*, the bankruptcy court refused to approve the debtors' proposed chapter 11 financing of their sale process because of the failure to provide for the full payment of section 503(b)(9) claims.[41] The bankruptcy court only agreed to approve the financing after the parties agreed to establish an escrow account that would pay section 503(b)(9) claims from the sale proceeds based on a sliding scale.[42] In contrast, the bankruptcy court in *Allen Family Foods*[43] approved a sale that did not provide for the full payment of all section 503(b)(9) claims, because although the sale primarily benefited the secured lender, the court was satisfied that the sale proceeds would be equitably distributed because the secured lender had agreed to pay certain prepetition claims of critical vendors, as well as post-petition trade payables and other operating expenses.

C. Bankruptcy Code Tools for Reallocating Value

A bankruptcy court has two primary tools for reallocating value between secured and unsecured creditors. Section 506(c) of the Bankruptcy Code allows a debtor to surcharge a secured creditor's collateral for the costs of maintaining the collateral, and section 552 of the Bankruptcy Code cuts off a secured creditor's liens on the petition date, other than, unless the equities of the case dictate otherwise, in respect of proceeds of prepetition collateral.

1. Section 506(c)

Section 506(c) of the Bankruptcy Code states that "[t]he trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property."[44]

Jacoby and Janger posit that a bankruptcy court could use this provision to charge a secured creditor for the expenses that the estate absorbs during a section 363 sale, including the cost of the possible risk of harm to the estate from a depressed sale price.[45]

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[40] This issue has been motivated in part by the expanded set of rights available to trade creditors under the new section 503(b)(9) that was added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

[41] *In re Townsends Inc.*, Case No. 10-14092 (CSS) (Bankr. D. Del. Jan. 21, 2011); *see also In re NEC Holdings Corp.*, Case No. 10-11890 (PJW) (Bankr. D. Del. July 13, 2010) (refusing to approve financing unless the lender was willing to provide for an administratively solvent estate).

[42] Bruce Nathan & Bruce Buechler, *Who Pays the Freight? Interplay Between Priority Claims and a Debtor's Secured Lender*, 30-9 A.B.I.J. 26 (Nov. 2011).

[43] *In re Allen Family Foods Inc.*, Case No. 11-11764 (KJC) (Bankr. D. Del. July 27, 2011).

[44] 11 U.S.C § 506(c).

[45] Jacoby & Janger, *supra* note 2, manuscript at 58.

In order to prevail on a claim under section 506(c) of the Bankruptcy Code, the debtor must show that the expense was reasonable and necessary and that the secured creditor benefited.[46] To our knowledge, no court has held that a cost as abstract as the possible discount to the sale price from a quick sale would meet the 506(c) standard. Indeed, the concept is somewhat counterintuitive in the context of the undersecured creditor receiving the proceeds of a sale to a third party because the undersecured creditor has already absorbed the cost of any "undervaluation" through the reduction of the proceeds of sale.

At the same time, at least one commentator has argued that section 506(c) can justify forcing a secured creditor to leave a carve-out for administrative and unsecured claims if the secured creditor wishes to take advantage of the chapter 11 process to realize upon its collateral.[47] The commentator notes that the purpose of section 506(c) is to prevent a windfall for secured creditors at the expense of the estate.[48] The commentator then argues that "a Chapter 11 plan for the sole benefit of secured creditors results in a windfall to the secured creditors, because they receive additional disbursement through maintenance of going concern value without bearing any additional cost."[49] Implicit once again in these arguments is the idea that the secured creditor is not intended to benefit from the bankruptcy process which, as noted above, is a debatable proposition under current law.

2. Section 552

Section 552(a) of the Bankruptcy Code provides that "[e]xcept as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case."[50] However, section 552(b) of the Bankruptcy Code provides the following exception: "[I]f the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise."[51] In other words, unless augmented through the provision of adequate protection, prepetition security interests do not extend to property acquired by

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[46] *See, e.g., Compton Impressions, Ltd. v. Queen City Bank N.A. (In re Compton Impressions)*, 217 F.3d 1256, 1260 (9th Cir. Cal. 2000).

[47] Deborah Thorne et al., RESOLVED: ADMINISTRATIVELY INSOLVENT CASES SHOULD NOT BE ADMINISTERED SOLELY FOR THE BENEFIT OF SECURED CREDITORS, ABI Vol. 7.

[48] *See In re Smith Int'l Enters. Inc.*, 325 B.R. 450, 453 (Bankr. M.D. Fla. 2005).

[49] Thorne, *supra* note 47 at 13.

[50] 11 U.S.C § 552(a).

[51] 11 U.S.C § 552(b)(1).

the debtor after the bankruptcy filing, other than the proceeds, products, offspring or profits of the previous collateral. Additionally, the court "based on the equities of the case" may cut off such lien from such proceeds.

Jacoby and Janger argue that section 552 places a limitation on the "going concern" value that a secured creditor may recover. Since the chapter 11 process itself creates some of this value, that portion of the sale proceeds should not be considered proceeds of any prepetition collateral. Moreover, they argue that a secured creditor's right to any going concern value should be "limited to market increase in the value of its collateral and any traceable proceeds."[52]

Courts have employed similar reasoning in using section 552 of the Bankruptcy Code to limit a secured creditor's entitlement to value created post-petition through a debtor's labor. For example, in the *Inman* case,[53] a bank's loan to a restaurant was secured by inventory and the proceeds thereof. The court ruled that the sales of the restaurant were primarily related to services and not inventory, so the money generated by sales was not proceeds of inventory and was therefore unsecured under section 552.[54]

On similar facts, the court in *Cafeteria Operators, L.P.*[55] took a more nuanced view of section 552. Recognizing that the restaurant's sales were primarily derived from services, but also had a component of inventory, the court ruled that the bank's security interest extended to a portion of the revenue as inventory proceeds.[56]

There is, of course, a chicken-and-egg quality to these arguments, especially in the context of a blanket lien. If the entire value of the enterprise, including intangible assets, is subject to a lien on the petition date, then the secured creditor is entitled to adequate protection of that value regardless of the operation of section 552. So the issue comes back to the question of what the secured creditor's entitlement was on the petition date. Viewed in this light, it is not clear that arguments based on section 552 add much to the allocation debate. On this more general question, Jacoby and Janger argue that, if a secured creditor does not have a lien on a debtor's labor or human capital, this limits the proportion of the debtor's going concern value to that to which the secured creditor is entitled.[57]

In contrast, however, at least one court has held that a secured creditor's "pervasive lien" that extended to "intangible assets" entitled the secured creditor to the full going concern value of a business in a sale.[58] This argument could of course be made

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[52] Jacoby & Janger, *supra* note 2, manuscript at 52.

[53] 95 B.R. 479 (Bankr. W.D. Ky. 1988).

[54] *Id.* at 481.

[55] 299 B.R. 400 (Bankr. N.D. Tex. 2003).

[56] *Id.* at 409.

[57] Jacoby & Janger, *supra* note 2, manuscript at 51.

[58] *In re Tele/Resources, Inc.*, 6 B.R. 628, 631 (Bankr.S.D.N.Y. 1980).

even absent section 552. The situation would be more complicated, of course, if the secured creditor's collateral package only included some, but not all, of the debtor's assets.

IV. Conclusion

The forthcoming article by Jacoby and Janger raises important issues regarding allocating value between secured and unsecured creditors in corporate bankruptcy cases. Both courts and commentators have suggested different ways of addressing the tensions created by these issues.

Apart from what current law, encumbered as it is with its equity receivership antecedents, may provide, the question of the appropriate allocation of value between secured and unsecured creditors should be determined by sound bankruptcy policy, which should be based on consideration of the legitimate expectations of contracting parties, efficient *ex ante* allocation of resources and credit, and fairness. The allocation question poses squarely the issue of whether the current value allocation rules, based on the historical development of our corporate reorganization laws and the absolute priority rule, should be changed. This question leads to a reexamination of the appropriateness of the absolute priority rule itself, which forces the date of reorganization to be a "date of reckoning" when a determination must be made as to who is and who is not "in the money."[59]

All of this being said, the debate over these issues engendered by *Ice Cube Bonds* is important and necessary, and Professors Jacoby and Janger deserve credit for posing the questions.

[59] *See* Casey, *supra* note 23.