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363 Asset Sales: Recent Decision Says "It Ain't Over 'til It's Over"

GABRIEL A. MORGAN

The author of this article discusses a recent decision by the U.S. Bankruptcy Court for the District of Wyoming, which reminds readers that auctions under Section 363 of the Bankruptcy Code generally do not end until the bankruptcy court approves the sale to a winning bidder.

Outside of bankruptcy, an auction typically ends when the seller determines it has received the highest and/or best offer and declares a winning bidder. A recent decision by the U.S. Bankruptcy Court for the District of Wyoming, however, reminds us that auctions under Section 363 of the Bankruptcy Code generally do not end until the bankruptcy court approves the sale to a winning bidder.[1]

BACKGROUND

On October 31, 2012, Western Biomass Energy, LLC filed a voluntary Chapter 11 petition with the U.S. Bankruptcy Court for the District of Wyoming. The debtor owned and operated an ethanol plant located in Upton, Wyoming.

Gabriel A. Morgan is an associate in the Business Finance & Restructuring Department at Weil, Gotshal & Manges LLP. He may be contacted at gabriel.morgan@weil.com.

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GEOSYN SALE — THE AUCTION BEGINS

On May 2, 2013, the bankruptcy court entered an order approving procedures for the sale or auction of substantially all property of the debtor. Pursuant to the court-approved bidding procedures, the debtor's financial consultant and liquidator, Great American Group, LLC, would market the debtor's assets to potential buyers on both a going concern and a piecemeal basis for three weeks. If qualified bids were received during such marketing efforts, the debtor, with the input of its principal secured lender and the official committee of unsecured creditors, could designate a winning bidder and proceed to close. If no going concern or piecemeal bid was accepted (or if some property remained unsold after acceptance of any piecemeal bid(s)), the debtor's assets would be sold through an on-line auction to the highest bidder. Among other things, the bankruptcy court's bidding procedures order provided that "[t]he Assets shall be sold free and clear of all claims and interests of any kind or nature whatsoever" and "[v]alid liens shall attach to the proceeds." Although bidding procedures and notice of the sale often use such language to describe the effect of a 363 sale, the decretal language used by the bankruptcy court typically would be contained in the order approving the 363 sale, not necessarily in the bidding procedures order.

Because no going concern or piecemeal bid was accepted during the initial marketing period, Great American conducted an on-line auction for two days in June 2013. At the conclusion of that auction, GeoSynFuels, LLC, was deemed the winning bidder, offering to purchase the debtor's assets for $525,000. As the winning bidder, GeoSyn transferred its purchase price to Great American in accordance with the bidding procedures.

About 10 days later, the secured lender filed with the bankruptcy court an objection to approval of the GeoSyn sale and, in the alternative, a motion to set aside the sale, arguing that the purchase price was grossly inadequate and that there were irregularities in the auction process. In support of its argument that the purchase price was grossly inadequate, the secured lender cited a year-old appraisal that provided that the scrap value for the debtor's assets was $1,865,570, as well as a letter in which GeoSyn expressed interest in the assets during the initial marketing period, in which GeoSyn stated that it believed "a return closer to $1 to $1.5 million could be achieved through an entirety bid." Additionally, the secured lender disclosed that it recently had learned of another

offer to purchase all of the assets for approximately $1.14 million, which, the secured lender argued, indicated that the value of the assets was significantly higher than GeoSyn's bid. The objection did not explain why the secured lender, if it believed the assets to be undervalued, did not exercise its right to credit bid under Section 363(k) of the Bankruptcy Code.

The following day, the bankruptcy court entered an order staying the sale to GeoSyn pending resolution of the secured lender's objection.

GeoSyn filed a response to the objection in which it argued, among other things, that the secured lender's objection was procedurally improper because the bidding procedures order not only approved the bidding procedures, but also approved the actual sale of the debtor's assets. Therefore, GeoSyn asserted, no further bankruptcy court action or approval was required to proceed with GeoSyn's winning bid. GeoSyn further argued that its purchase price was not grossly inadequate because the winning bid at "a fair and open auction" represented a superior measure of market value than "a grossly inflated appraisal." Moreover, GeoSyn argued that its written expression of interest constituted an "uncommitted offer" that was expressly rejected by the debtor and the secured lender in favor of an auction, which was conducted in accordance with the bidding procedures order, and that the "half-hearted suggestion of a cash offer of $1.14 [million] is illusory at best."

API SALE — THE AUCTION CONTINUES

Two weeks later, before the bankruptcy court ruled on the secured lender's objection, the debtor filed a motion to sell substantially all of its assets to American Process, Inc. for a purchase price of $1,218,750. In that motion, the debtor stated that the sale to GeoSyn "would be grossly inadequate and extremely detrimental if allowed to proceed." The debtor also filed a contemporaneous motion to approve its settlement agreement with the secured lender, pursuant to which the secured lender agreed to carve out $368,750 from any purchase price equal to or greater than the amount offered by American Process. The proposed carve-out would be used to satisfy administrative expenses, after which the remaining balance would fund distributions to unsecured creditors. The settlement agreement, however, would automatically terminate if the bankruptcy court approved the GeoSyn sale.

The debtor also filed a response in support of the secured lender's objection to the GeoSyn sale in which the debtor requested that the bankruptcy court disapprove or set aside the GeoSyn sale in favor of the sale to American Process. The unsecured creditors' committee also weighed in against GeoSyn, filing a response and joinder in support of the secured lender's objection that emphasized how a sale to American Process, or another party that bids in excess of the amount offered by American Process, would be "unequivocally" in the best interest of the estate as "it is the only potential source for distribution to unsecured creditors in this case."

In a supplemental response, GeoSyn reiterated its earlier arguments and questioned the genesis of American Process's competing offer. Specifically, GeoSyn noted that American Process was a prepetition unsecured creditor of the debtor. GeoSyn also suggested that the secured lender had solicited the offer from American Process to circumvent the bankruptcy court's bidding procedures order, inappropriately using GeoSyn's successful bid as an after-the-fact stalking horse bid. American Process explained that it had attempted to participate in the auction, but "experienced difficulties in seeking to increase its bid on certain auction items when it received notices from the auctioneer that its bid(s) had been outbid…." After American Process learned that it had not won the auction, it submitted the $1,218,750 offer for which the debtor sought approval. The secured lender and the debtor added that neither knew of American Process's offer until after the conclusion of the auction, and the debtor referenced certain events during the auction that it believed were "highly questionable and call into doubt the integrity of the auction process." Indeed, repeated references to irregularities in the auction process made by the secured lender and debtor even led Great American to file limited responsive papers in which it objected to any allegation or finding that it had not conducted the auction according to the terms of the bidding procedures order or industry standards.

GeoSyn further objected and urged the bankruptcy court to deny the motions to approve the American Process sale and the settlement agreement between the debtor and the secured lender because the proposed transaction implemented a *sub rosa* plan. The debtor countered by arguing that the settlement agreement did not prejudice other creditors because American Process's purchase price was expected to be less than the secured lender's claim,

and, therefore, the settlement agreement was the only means by which other creditors would receive any distribution.

BANKRUPTCY COURT OPINION

After holding an evidentiary hearing on the matters, the bankruptcy court issued a judgment and opinion sustaining the secured lender's objection to the GeoSyn sale. In its opinion, the bankruptcy court characterized its bidding procedures order as an "Auction Order" and noted that a debtor typically moves for court approval of a sale after an auction is completed. Although the debtor had not filed such a motion, the secured lender's objection presented the bankruptcy court with the issue of whether to confirm the outcome of the on-line auction.

Considering the evidence presented, the bankruptcy court found that the assets were worth more than twice the purchase price offered by GeoSyn at auction, and, therefore, that the purchase price offered by GeoSyn was grossly inadequate. Additionally, the bankruptcy court found that confirmation of the GeoSyn sale would provide only partial payment to the secured lender and leave all unsecured creditors without any recovery. Moreover, because the debtor and the creditors' committee had a viable alternative that provided a distribution to unsecured creditors, the bankruptcy court found "an additional circumstance indicating unfairness as grounds to deny confirmation of a sale [to GeoSyn]…." With respect to irregularities in the auction process, however, the bankruptcy court determined that it could not find that Great American failed to comply with the procedures established by the bidding procedures order and refused to deny the GeoSyn sale on those grounds.

Having issued its judgment and opinion with respect to the GeoSyn sale, the bankruptcy court entered orders denying, without prejudice, the American Process sale and the settlement agreement between the debtor and the secured lender. Rather, the bankruptcy court stated that "it is in the best interests of the estate and its creditors to allow interested parties to bid" and directed the Chapter 7 trustee (an order converting the case had been entered five days earlier) to "evaluate and determine whether a telephone auction between interested parties is in the estate's best interest and proceed accordingly in the immediate future…."

APPEAL

On August 14, 2013, GeoSyn appealed from the bankruptcy court's decision. By order of the U.S. Bankruptcy Appellate Panel of the Tenth Circuit, GeoSyn's appeal has been held in abeyance until January 15, 2014, to facilitate a settlement between the Bank and GeoSyn that would render the appeal moot.

FUNDAMENTAL TENSION IN 363 AUCTIONS

A fundamental tension underlies bankruptcy auctions: The estate's primary interest in any bankruptcy auction is to obtain the highest and/or best offer for the assets being sold, yet the estate must preserve the integrity of the auction process in order to maximize value effectively. For example, if bidders knew they could submit the winning offer after an auction had finished, they would lack the proper incentive to participate in the auction, thereby undermining the estate's pursuit of the highest and/or best offer.

In this case, the debtor and the secured lender argued that the post-auction American Process bid should be approved, at least in part because the GeoSyn sale was the result of an auction process that had been compromised. If the bankruptcy court had ordered a "redo" of the auction because of irregularities, then its decision could be viewed as a narrow one based upon very specific facts and circumstances. The bankruptcy court, however, rejected that argument, and instead denied the GeoSyn sale and directed the Chapter 7 trustee to consider re-opening the auction because the American Process offer was significantly higher. The bankruptcy court's decision creates potentially troubling precedent that the winning bidder at a full and fair auction can still be out-bid prior to bankruptcy court approval of the sale so long as the new bid is significantly higher. Such outcomes clearly favor the estate's interest in obtaining the highest offer over the estate's interest in preserving the integrity of the auction.

COUNTERPOINT

It is worth noting that the U.S. Bankruptcy Court for the District of Delaware recently approved a motion to reopen the auction in *Allied Systems Holdings, Inc.*[2]

In *Allied Systems*, the debtors, a vehicle transportation company, sought to sell substantially all of their assets through an auction under Section 363 of the Bankruptcy Code. After conducting a two-day auction in August 2013, the debtors determined that the winning bidder was an acquisition entity established by their first lien lenders, which offered a purchase price of $105 million ($40.5 million in cash and a $64.5 million credit bid). Shortly thereafter, the official committee of unsecured creditors, among others, objected to approval of the winning bid because it was "a complex, distressed M&A multi-purchaser transaction that is fraught with transaction risk…and was the product of an auction process that can be described as less than fair and open." Two days later, the committee moved to reopen the auction to address "issues related to whether the Auction was conducted in a fair, open and transparent manner and whether the Debtors exercised sound business judgment in determining that the…Winning Bid was the highest and best bid." The committee also presented a higher and allegedly better bid from a bidder that lost at the auction: $135 million ($125 million in cash and $10 million in notes or cash), as well as fewer execution risks than the winning bid. The debtors soon joined in the committee's motion to reopen, stating that they believed it would eliminate the numerous "procedural objections" to approval of the winning bid and would allow the court "to focus its time and attention determining the real issue before the Court — which bidder has submitted the highest and best bid for the Debtors' assets in accordance with section 363 of the Bankruptcy Code." The bankruptcy court authorized the debtors to reopen the auction.

Allied Systems is an excellent counterpoint to *Western Biomass* insofar as the parties seeking to reopen the auction framed the issue of accepting the post-auction bid(s) as the means to obtain the highest and best offer by preserving the integrity of the auction process. Unlike the parties objecting to approval of the winning bid in *Western Biomass* that asked the court to find irregularities in the auction process, the parties in favor of reopening the auction in *Allied Systems* presented the court with a seemingly simple solution for alleged irregularities. Nevertheless, the outcome in both cases was objectively the same: The winning bidder at auction was topped by a post-auction bid.

NOTES

[1] *In re Western Biomass Energy LLC*, Case No. 12-21085 (Bankr. D. Wyo. Aug. 6, 2013).
[2] Case No. 12-11564 (Bankr. D. Del. Sept. 9, 2013).