HOW TO SURVIVE A FAILING CHAPTER 11 – A CREDITOR'S PERSPECTIVE

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Introduction

The primary goal of Chapter 11 of Title 11 ("Chapter 11") of the United States Code (the "Bankruptcy Code") is the financial rehabilitation, rather than liquidation, of a debtor's business. Under Chapter 11, the debtor will continue to operate its business as a debtor in possession unless a trustee is appointed to restructure the debtor's liabilities. A successful reorganization entails the continuation of the debtor's business as a result of the confirmation of a plan of reorganization (the "plan"). A plan may take many forms and, if successful, results in the creation or continuation of a viable entity. Unfortunately, however, the vast majority of Chapter 11 proceedings do not culminate in a successful reorganization. In fact, it is becoming more and more common for Chapter 11 cases to involve the confirmation of plans that provide for the liquidation, instead of the reorganization, of the debtor. A liquidating Chapter 11 enables the debtor in possession to liquidate its business for the benefit of its creditors without the additional expense of a Chapter 7 trustee.

Creditors dealing with a "DIP" should not assume that all administrative claims will be satisfied upon confirmation because confirmation may not occur. In addition, some Bankruptcy Courts have fashioned orders to bifurcate the bankruptcy proceeding to insure that the estate has resources available to conduct an orderly liquidation to maximize the value of the debtor's remaining assets. This burgeoning area of law presents new problems for creditors' committees and trade creditors dealing with Chapter 11 debtors. In a failing Chapter 11, the creditors' committee appointed to represent the interests of creditors may become complacent and accept whatever is offered by the debtor. A creditors' committee should be proactive in all aspects of the Chapter 11 process in order to maximize the value of the debtors' assets for its constituency. A creditors' committee should restrict extensions of exclusivity and monitor any sale process to prevent the debtor and/or its management from repressing the sale price of the debtor's assets. Trade creditors must carefully monitor the Chapter 11 proceeding to enable them to make realistic credit decisions about the debtor's prospects for reorganization.

The following outline addresses some of the issues creditors should be aware of in the event they find themselves involved in a failing Chapter 11 bankruptcy case.

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I. Termination of Debtor's Exclusivity – May be Necessary to Conduct Sale of Assets

A. Bankruptcy Code Section 1121(b) provides that "only the debtor may file a plan until after 120 days after the date of the order for relief under this chapter." 11 U.S.C. § 1121(b). In addition, the debtor has an exclusive period of 180 days after the date of the order for relief to solicit acceptances of its proposed plan of reorganization. *See* 11 U.S.C. § 1121(c)(3). Upon notice and a hearing, the court may increase the debtor's exclusive periods for cause. *See* 11 U.S.C. § 1121(d).

B. In the event of a failing Chapter 11 case, a creditors' committee or individual creditor(s) may wish to sell the assets of the debtor in the context of a plan of reorganization or pursuant to § 363 of the Bankruptcy Code. In order to file and circulate a plan, such creditors must first seek to terminate exclusivity to the extent it has not already expired or been terminated. The court may reduce the debtor's exclusive periods for cause following notice and a hearing. *See* 11 U.S.C. § 1121(d).

(i) A party seeking to modify the statutory periods of exclusivity "bears the burden of establishing that the requisite cause exists." *In re Gibson & Cushman Dredging Corp.*, 101 B.R. 405, 409 (E.D.N.Y. 1989). It has been observed that "the Debtor's burden gets heavier with each extension it seeks as well as the longer the period of exclusivity lasts; and a creditor's burden to terminate gets lighter with the passage of time." *In re Dow Corning Corp.*, 208 B.R. 661, 664 (Bankr. E.D. Mich. 1997). However, as a practical matter, many courts routinely extend the debtor's exclusive periods, particularly in large, complex Chapter 11 cases, on a relatively minimal showing of cause. A motion to shorten or terminate exclusivity is usually heavily litigated because the debtor is not only fighting to retain the right to control its own destiny, but also, in may instances, to retain the jobs of senior management.

(ii) The Bankruptcy Court has discretion and "maximum flexibility" in determining whether or not to grant a motion seeking to extend or shorten the debtor's exclusive period. *See Gibson & Cushman*, 101 B.R. at 409.

(iii) The factors a court will consider in determining whether to extend or terminate exclusivity include the following: (a) the size and complexity of the case; (b) whether the debtor has had sufficient, or needs more time to negotiate a plan of reorganization; (c) whether the debtor is making good faith progress toward reorganization; (d) whether the debtor is paying its bills as they become due; (e) whether the debtor has a reasonable chance of filing a viable plan; (f) whether the debtor has made progress in negotiating the terms of a plan with its creditors; (g) the amount of time that has elapsed; (h) whether the debtor is seeking to extend exclusivity to pressure its creditors to submit to its reorganization demands; and (i) whether an unresolved contingency exists. *See, e.g., Dow Corning*, 208 B.R. at 665. "When [a] Court is determining whether to terminate a debtor's exclusivity, the primary consideration should be whether or not doing so would facilitate moving the case forward. And that is a practical call that can override a mere toting up of the factors." *Id.* at 670.

(iv) "In … cases where the exclusivity periods [have been] reduced, factors such as gross mismanagement of the debtor's operations … or acrimonious feuding between the debtor's principals … were major obstacles to a successful reorganization." *In re Texaco, Inc.*, 76 B.R. 322, 327 (Bankr. S.D.N.Y. 1987).

(v) In *In re Express One Int'l, Inc.*, 194 B.R. 98 (Bankr. E.D. Tex. 1996), the Court was faced with the debtor's motion to extend exclusivity and a creditor's motion to terminate exclusivity. The creditor argued that its proposed plan would provide a better recovery for creditors than the debtor's plan, but the Court recognized that the creditor's "involvement in this case [was] motivated solely by its desire to purchase [the debtor's] business." *Id.* at 99. The Court went on to state that "[t]he issue to be determined … is not whether some other plan may exist which provides greater recovery; the issue is whether [the] debtor has been diligent in its attempts to reorganize." *Id.* at 101. Finding that the debtor had been making a diligent attempt to reorganize, the Court extended the debtor's exclusivity period. The *Express One* case demonstrates that a court will not necessarily terminate a debtor's exclusive periods in which to file and solicit acceptances to a plan of reorganization just because a proposed sale of the debtor's assets will provide a greater recovery for creditors than the debtor's proposed plan.

C. In a failing Chapter 11, the debtor's management may attempt to use exclusivity as a shield to protect themselves from ouster by outside forces, such as the creditors' committee or a third party interested in purchasing the debtor's business. Such a potential purchaser may wish to replace the debtor's management with a new team or integrate the debtor's business into its own operations. The debtor, in order to preserve the control of existing management, may reject the offers of third parties to either purchase the debtor's assets or fund a plan of reorganization although such offers may be in the best interest of the debtor's estate and creditors. An active creditors' committee can play a pivotal role in eliminating or curtailing this type of conduct by a debtor. The creditors' committee should insist on short extensions of the exclusive periods to insure that the debtor will not have a stranglehold on the reorganization process. The creditors' committee might also insist on co-exclusivity with the debtor, which would enable only the debtor and/or the creditors' committee to file a plan of reorganization and solicit acceptances thereto. Many debtors will oppose this arrangement because it neutralizes the debtor's bargaining leverage and gives the committee the ability to discuss plan alternatives with third parties. The interests of the committee and the debtor, in certain instances, will be diametrically opposed in the plan negotiation process. While the creditors' committee will want to maximize the value of the debtor's assets, the debtor may wish to preserve existing management or equity to serve the interests of management. If a debtor is permitted to obtain unfettered extensions of exclusivity, it will be able to use exclusivity as a sword to compel its creditors to accept whatever is offered by its proposed plan. This may also prolong the Chapter 11 proceeding, thereby increasing the likelihood of the estate becoming administratively insolvent.

II. Sale of Assets Pursuant to Section 363

A. One of the primary benefits provided by Chapter 11 is the debtor's ability to sell its assets pursuant to Section 363 of the Bankruptcy Code. The Bankruptcy Code authorizes the trustee or DIP to sell assets in several ways: in the ordinary course of business pursuant to Section 363(c) without notice or a hearing; other than in the regular course of business under Section 363(b) following notice and a hearing; or as part of a plan of reorganization under Sections 363 and 1123(a)(5)(B) and (D). Section 363 provides both the debtor and any potential purchaser of its assets protections otherwise unavailable outside of bankruptcy.

B. Standing to Sell Assets: Bankruptcy law provides one major obstacle in that only a debtor in possession or a trustee may sell a debtor's assets pursuant to Section 363. Although a creditors' committee has the power to act in place of the debtor in adversary proceedings involving lien avoidance, preference actions, and fraudulent transfers, such authority does not extend to the sale of property of the estate free and clear of liens. *See In re Calvary Temple Evangelistic Ass'n*, 47 B.R. 520, 522 (Bankr. D. Minn. 1984) ("[n]o cases have allowed a creditors committee to proceed with a sale of property free and clear of liens under 11 U.S.C. § 363"); *see also In re Dow Corning Corp.*, 199 B.R. 896, 900 (Bankr. E.D. Mich. 1996) ("Although it might be in the best interest of the estate to sell an asset, an official committee cannot usurp the power of management (Trustee or debtor-possession) to make that choice") (citing *Calvary*, 47 B.R. at 522-23 (denying motion of creditor's committee for authority to effectuate a 363(b) sale)). This leverage gives the debtor the ability to negotiate more favorable plan terms with its creditors' committee. In order to take control away from the debtor, creditors may seek the appointment of a trustee under either Chapter 7 or Chapter 11 of the Bankruptcy Code. Generally, creditors would prefer to have the debtor's assets liquidated under Chapter 11 by existing management rather than in the context of a Chapter 7 case or under the supervision of a Chapter 11 trustee. This is because the conversion of a case to Chapter 7 or the appointment of a Chapter 11 trustee may have a devastating impact on the value of the assets in a failing Chapter 11. The debtor may experience even greater losses in the time it takes the trustee to familiarize himself with all aspects of the debtor's business.

(i) The creditors' committee can neutralize the debtor's leverage by maintaining short periods of exclusivity and attempting, at the appropriate time, to get the debtor's consent, with the Bankruptcy Court's blessing, to market the debtor's assets to third parties or, at the very least, be an integral part of the debtor's efforts to liquidate its assets.

(ii) In many instances, the debtor's management will no longer have any incentive to maximize the value of the debtor's assets and may assign responsibility for the liquidation to less senior officers who lack the knowledge and experience to maximize the value of the assets.

C. The debtor's management owes a fiduciary duty to creditors and, therefore, must attempt to maximize the value of the debtor's assets for the benefit and creditors.

(i) In order to keep management motivated to maximize the value of the estate, the committee must remind these individuals that they are fiduciaries. *See generally*, *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 354-56 (1985) (noting obligations of a DIP as trustees); *Gumport v. China & Inv. Corp.* (*In re Intermagnetics Am.*, *Inc.*), 926 F.2d 912, 917 (9th Cir. 1991) (stating that officers of a DIP are officers of the court and have fiduciary duties as such); *Slater v. Smith* (*In re Albion Disposal*, *Inc*.), 152 B.R. 794, 813 (Bankr. W.D.N.Y. 1993) (noting debtor's management takes on heightened fiduciary obligations in bankruptcy). The debtor's management and board of directors are required to act in the best interest of the bankruptcy estate, including the debtor's creditors, equity holders, and other parties in interest. *See Intermagnetics*, 926 F.2d at 917 (noting that chapter 11 debtors occupy fiduciary role with respect to the contents of the estate); *Continental Ill. Nat'l Bank & Trust Co. v. Wooten, Ltd.* (*In re Evangeline Refining Co.*), 890 F.2d 1312, 1323 (5th Cir. 1989) (stating that those performing duties in the administration of the bankruptcy estate are officers of the court). Although prior to insolvency, officers and directors of a corporation owe no duty to creditors, an entity's insolvency creates a fiduciary duty in favor of the debtor's creditors. *See In re Biderman Indus. U.S.A.*, Inc., 203 B.R. 547, 551 (Bankr. S.D.N.Y. 1997) ("The fiduciary obligations of directors pervade bankruptcy administration") (citation omitted); *see also In re Freedom Solar Ctr.*, *Inc.*, 776 F.2d 14, 18 (1st Cir. 1985); *In re Office Prod. of America*, *Inc.*, 136 B.R. 983, 986 (Bankr. W.D. Tex. 1992) (finding that debtor and its management occupy a fiduciary role vis-à-vis the estate and its constituents). As fiduciaries, the officers and directors of a debtor in possession must refrain from activities designed to benefit themselves rather than the debtor's estate. *See In re Wilde Horse Enterprises*, *Inc.*, 136 B.R. 830, 840 (Bankr. C.D. Cal. 1991). Having a debtor's management market and sell the debtor's assets creates a fundamental conflict, as the debtor's management may be motivated to enter into a deal that benefits management, but is obligated to act for the benefit of the debtor's estate and creditors.

(ii) A diligent committee must be fully familiar with the debtor's operating and financial procedures to enable it to effectively compel a debtor and its management to sell the debtor's assets, even if doing so would be against management's self interest, when it is apparent that such a sale is necessary to maximize value.

(iii) In a failing Chapter 11, a debtor may attempt to use Section 363 to liquidate appreciated assets to mask continuing losses. Thus, the committee must carefully scrutinize all asset sales. The debtor may gamble what little value exists for unsecured creditors in the hopes of rehabilitating its failing business.

D. <u>Sale of Property of the Estate in the Ordinary Course of Business:</u> Pursuant to Section 363(c)(1),[1] unless a court rules otherwise, the trustee may sell estate property in the ordinary course without notice or hearing. However, neither the Bankruptcy Code nor the legislative history of Section 363 defines what constitutes a transaction within the ordinary course of a debtor's business. *See Burlington Northern Railroad Co. v. Dant & Russell*, *Inc.* (*In re Dant & Russell*, *Inc.*), 853 F.2d 700, 704 (9th Cir. 1988). The courts, therefore, have delineated the following two part inquiry to determine whether a transaction is within the ordinary course of business: (1) under the horizontal test, courts ask whether the transaction is the type that comparable businesses in the industry would undertake; and (2) under the vertical test, courts ask whether the transaction is similar to those entered into by the debtor prepetition, such that, from the vantage point of hypothetical creditors, the proposed transaction does not undermine the creditors' reasonable expectations as to what type of transactions the DIP is likely to be engaged in. *See*, *e.g.*, *In re Roth American*, *Inc.*, 975 F.2d 949, 953 (3d Cir. 1992); *Committee of Asbestos-Related Litigants v. Johns-Manville Corp.* (*In re Johns-Manville Corp.*), 60 B.R. 612, 616-618 (Bankr. S.D.N.Y. 1986).

(i) The court in *In re Waterfront Co., Inc*., 56 B.R. 31, 34-35 (Bankr. D. Minn. 1985) noted that some postpetition transactions, either by their quantity (*e.g.*, all or substantially all of the debtor's assets) or nature (*e.g.*, inconsistent with transactions typical to others in the industry), are not ordinarily conducted in the daily operation of the debtor's business, and are, therefore, extraordinary. *See*, *e.g.*, *In re Thompson McKinnon Sec*., *Inc.*, 120 B.R. 301 (Bankr. S.D.N.Y. 1990) (sale of 64% of the debtor's interest plainly outside the debtor's ordinary course); *In re Fountain Bay Mining Co.*, 46 B.R. 122, 124 (Bankr. W.D. Va. 1985) (transaction transferring debtor's most valuable asset not in ordinary course); *In re Frank*, 27 B.R. 748, 750 (Bankr. S.D. Ohio 1983) (transaction involving more than "typical business risk" was not in ordinary course).

(ii) Normally, a transaction is deemed to be within the ordinary course of business if it is in accord with the debtor's prepetition practices and typically consists of those daily operating expenses which are relatively insignificant. Requiring court approval for every minor transaction would frustrate the purpose of Section 363[2] and the debtor's ability to reorganize and would overburden the court. *See*, *e.g.*, *In re D'Lites of America*, *Inc*., 108 B.R. 352 (Bankr. N.D. Ga. 1989); *In re Metropolitan Cosmetic & Reconstructive Surgical Clinic*, *P.A.*, 115 B.R. 185 (Bankr. D. Minn. 1990), *remanded for ordinary course of business determination*, 124 B.R. 784 (D. Minn. 1990).

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[1] Section 363 states in pertinent part: "(1) If the business of the Debtor is authorized under Section … 1108 … and unless the court orders otherwise, the trustee [or the debtor in possession] may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or hearing…" 11 U.S.C. § 363 (c)(1).

[2] The purpose of Section 363 is to allow a business to continue its daily operations without the burden of obtaining court approval or notifying creditors of minor transactions, while protecting secured creditors and others from dissipation of estate assets. *See Dant & Russell*, 853 F.2d at 704; *see also In re Selgar Realty Corp.*, 85 B.R. 235 (Bankr. E.D.N.Y. 1988).

E. <u>Sale of Property of the Estate Other than in the Ordinary Course:</u> Section 363(b)(1) allows the Bankruptcy Court, after proper notice and a hearing, to authorize the sale of the debtor's assets outside the ordinary course of business. *See In re Coastal Cable T.V., Inc.*, 24 B.R. 609, 611 (Bankr. 1st Cir. 1982), *vacated on other grounds*, 709 F.2d 762 (1st Cir. 1983).[3]

(i) Despite the literal text of Section 363(b), no hearing is required where all parties are given proper notice and there is no objection to the proposed sale. *See In re Northern Star Ind., Inc.*, 38 B.R. 1019 (E.D.N.Y. 1984). The trustee need only give notice affording an opportunity for objection; a court order approving the sale is not required in the absence of objection.[4]

(ii) Bankruptcy Rule 6004 requires that notice of a proposed sale outside the ordinary course be given pursuant to Rule 2002 and, if appropriate, Section 363(b)(2). Rule 2002 mandates 20 days notice to parties in interest[5] of "a proposed use, sale, or lease of property of the estate other than in the ordinary course of business, unless the court for cause shown shortens the time or directs another method of giving notice."[6] Notice is sufficient if it provides parties in interest with: (1) the time and place of public sale or terms and conditions of private sale; (2) the deadline for filing objections; and (3) an adequate description the property to be sold, used or leased.[7]

(iii) Where an objection is made to a proposed sale, courts employ a variety of approaches in deciding whether to approve the proposed disposition of assets. *See*, *e.g.*, *In re Schipper*, 933 F.2d 513, 515 (7th Cir. 1991) (363 sale involves exercise of fiduciary duty and requires an "articulated business justification"); *Committee of Equity Security Holders v. Lionel Corp.* (*In re Lionel Corp.*), 722 F.2d 1063, 1071 (2d Cir. 1983) (judge passing on contested motion to sell should "act to further the diverse interests of the debtor, creditors and equity holders, alike"); *In re Apex Oil Co.*, 92 B.R. 847, 866 (Bankr. E.D. Mo. 1988) ("Section 363(b)(1) mandates that the best interest of the estate be met by requiring any sale not in the ordinary course of business be: (1) for fair and reasonable price, and (2) in good faith"); *In re Planned Sys., Inc.*, 82 B.R. 919,

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[3] The Bankruptcy Appellate Panel stated that: "[t]his power falls within the sound discretion of the trial court." *Id.*; *see also In re Ancor Exploration Co.*, 30 B.R. 802, 808 (Bankr. Okla. 1983) ("the bankruptcy court should have wide latitude in approving even a private sale of all or substantially all of the estate assets not in the ordinary course of business under § 363(b)").

[4] The notice and hearing requirement of Section 363(b) requires court review of a proposed disposition of estate property only where there is an objection. Accordingly, where there is no objection after proper notice, a proposed disposition of assets may be achieved without judicial review. *In re Winston Inn & Restaurant Corp. v. DeMichiel* (*In re Winston Inn & Restaurant Corp*), 104 B.R. 589, 595 (Bankr. E.D.N.Y. 1989); *In re Snyder*, 74 B.R. 872, 877 (Bankr. E.D. Pa. 1987), *rev'd on other grounds*, 120 B.R. 631 (E.D.N.Y. 1990).

[5] In addition to those entities that have claims against the debtor, parties in interest include any entity whose pecuniary interest might be negatively affected by the proposed sale. *See Western Auto Supply Co. v. Savage Arms* (*In re Savage Indus.*), 43 F.3d 714 (1st Cir. 1994).

[6] Fed. R. Bankr. P. 2002 (a)(2).

[7] Fed. R. Bankr. P. 2002 (c)(1); (c)(2).

923 n. 2 (Bankr. S.D. Ohio 1988) ("The proper standard for determining in the first instance if a proposed sale should be ordered is whether such sale is in the best interest of the estate").

F. Sales Free and Clear of Interests of Entities Other than the Estate: Section 363(f) permits a debtor or trustee, under specified conditions, to sell assets of the estate free and clear of any interest. Particularly, Section 363(f) permits a sale free and clear of interests of an entity other than the estate if (1) applicable non-bankruptcy law authorizes such sale free and clear, s*ee, e.g., Citicorp Homeowners Serv. v. Elliot* (*In re Elliot*), 94 B.R. 343 (E.D. Pa. 1988); (2) such entity consents, *see, e.g., In re Cleary Bros. Constr.*, 9 B.R. 40, 41 (Bankr. S.D. Fla. 1980); (3) such interest is a lien and the property's sale price is greater than the aggregate value of all liens, *see, e.g.*, *Scherer v. Fed. Nat'l Mortgage Ass'n* (*In re Terrace Chalet Apts.*, *Ltd.*), 159 B.R. 821 (Bankr. N.D. Ill. 1993); *Richardson v. Pitt County* (*In re Stroud Wholesale, Inc.*), 47 B.R. 999, 1001-02 (E.D.N.C. 1985), *aff'd mem.*, 983 F.2d 1057 (4th Cir. 1986); (4) such interest is a bona fide dispute, *see, e.g., Lindsey v. Cryts* (*In re Cox Cotton Co.*), 24 B.R. 930, 938 (E.D. Ark. 1982), *vacated on other grounds sub nom*., *Lyndsey v. Ipok*, 732 F.2d 619 (8th Cir.), *cert. denied*, 469 U.S. 881 (1984); or (5) such entity could be lawfully be compelled to accept a money satisfaction of such interest, *see, e.g.*, *Bank of Wheaton v. Red Oak Farms*, *Inc.* (*In re Red Oak Farms.*, *Inc.*,) 36 B.R. 856, 858 (Bankr. W.D. Mo. 1984). Section 363(f) allows a debtor to sell assets free and clear of liens with any such liens to attach to the proceeds of sale. This will enable a debtor to accelerate the sale process with respect to assets encumbered by disputed liens. Upon proper notification to affected parties, Section 363(f) may also protect a purchaser from claims of third parties to the sold assets.

G. Sale of All or Substantially All Assets of the Estate: In certain instances, the highest value for a debtor's assets can be achieved by selling substantially all of the debtor's assets pursuant to Section 363 of the Bankruptcy Code. Since such a sale will result in the liquidation of substantially all the debtor's assets without many of the safeguards provided in the plan process, courts require an additional showing of cause to justify such a sale. In *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983), the Second Circuit enunciated the circumstances under which a bankruptcy court can authorize, prior to the acceptance of and outside of any Chapter 11 plan of reorganization, the sale of an important asset of the debtor's estate outside of the ordinary course of business. The Court held "that there must be some articulated business justification . . . for using, selling, or leasing property out of the ordinary course of business before the bankruptcy judge may order such disposition under Section 363(b)." *Id.* at 1070. Accordingly, the Court adopted a rule requiring that the bankruptcy judge "expressly find from the evidence presented before him at the hearing a good business reason to grant such an application." *Id. at 1071.* Lastly, the Second Circuit furnished some direction for bankruptcy courts:[8]

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[8] The majority of courts have adopted the *Lionel* standard, see, *e.g., Stephens Indus., Inc. v. McClung,* 789 F.2d 386, 390 (6th Cir. 1986); *In re Walsh Chevrolet, Inc.,* 118 B.R. 99, 101-02 (Bankr. E.D. Mo. 1990); *In re Channel One Communications, Inc.,* 117 B.R. 493, 496 (Bankr. E.D. Mo. 1990); *In re Burke Mountain Recreation, Inc.,* 56 B.R. 72, 73 (Bankr. D. Vt. 1985).

> In fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike. He might, for example, look to such relevant factors as the proportionate value of the asset to the estate as a whole, the amount of the elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-à-vis any appraisals of the property, which of the alternatives of use, sale or lease of the proposal envisions, and, most importantly perhaps, whether the asset is increasing or decreasing in value. This list is not intended to be exclusive, but merely to provide guidance to the bankruptcy judge.

H. Courts disagree on whether and under what circumstances a Chapter 11 debtor may sell substantially all of its assets under Section 363. However, the majority of courts permit the sale of all or substantially all the assets of a Chapter 11 debtor outside a plan of reorganization pursuant to Section 363(b) where the facts and circumstances warrant such a sale.

(i) Some courts have adopted the "emergency" rule. These courts have refused to authorize the sale of all or substantially all of the debtor's assets except in emergency situations. *See, e.g., In re White Motor Credit Corp.*, 14 B.R. 584 (Bankr. N.D. Ohio 1981). However, this rule has been relaxed, if not abandoned, in favor of a "sound business purpose" test or "best interest standard."

(ii) Other courts have articulated a "best interest" test. *See*, *e.g.*, *Stephens Ind.*, *Inc. v. McClung*, 789 F.2d 386, 390 (6th Cir. 1986); *Financial Assoc. v. Loeffler* (*In re Equity Funding Corp. of America*), 492 F.2d 793, 794 (9th Cir. 1974), *cert. denied*, 419 U.S. 964 (1974).

(iii) Other courts adhere to the "good business reason" standard. *See, e.g., In re Lionel Corp.*, 722 F.2d at 1071 ("The rule we adopt requires that a judge determining a § 363(b) application expressly find from the evidence presented before him at the hearing a good business reason to grant such application"); *In re Chateaugay Corp.*, 973 F.2d 141 (2d Cir. 1992) (following the good business reason test).

I. Advantages of a Sale Under a Plan of Reorganization: A sale under a plan of reorganization is substantially more flexible than a sale pursuant to Section 363, as it allows a purchaser more latitude to negotiate and to avail itself of protections and safeguards unavailable outside of a plan. For example, a purchaser under a plan is entitled to exemptions from certain securities laws and recording taxes that may be unavailable to a Section 363 purchaser. *See, e.g., In re Jacoby-Bender*, *Inc.*, 40 B.R. 10 (E.D.N.Y. 1984), *aff'd*, 758 F.2d 840 (2d Cir. 1985) (finding building sold pursuant to confirmed plan exempt from state and city recordation tax). Furthermore, because

of the comprehensive notice required for a plan and the broad discharge provisions taking effect upon confirmation, a purchaser under a plan may be better protected from successor liability than a purchaser in the context of a Section 363 sale.[9]

J. Advantages of a Sale Outside of a Plan of Reorganization: A sale under Section 363 may be consummated more expeditiously than a sale under a plan. Under Section 363, the approval of the sale may be accomplished at one hearing, whereas the plan process involves extensive negotiations, court approval of a disclosure statement, solicitation of votes and a confirmation hearing. Since Section 363 avoids the formalities of the plan process, a Section 363 sale is considerably less expensive than a sale under a plan. Lastly, a Section 363 sale may be approved over any objections without the need to procure the acceptance of creditors, whereas approval of a sale under a plan is generally dependent upon creditor acceptance[10] or confirmation over the objection of creditors pursuant to the cramdown provisions[11] of the Bankruptcy Code.

K. Break-up Fees: A creditors' committee must monitor the sale process not only to insure that the transaction is in the best interests of the estate, but also to make sure it is not structured in such a way as to discourage competitive bidding. A break-up fee is "a fee paid to the potential purchaser of business assets when the transaction is not consummated, most commonly when the seller accepts a later bid." *In re Tiara Motorcoach Corp.,* 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997) (quoting *In re Twenver, Inc., 149 B.R. 954, 955* (Bankr. D. Colo. 1992) (citation omitted)). Break-up fees have arisen, both in the bankruptcy and non-bankruptcy context, in an effort to lure potential purchasers to make an offer to purchase assets. A break-up fee is designed to compensate a proposed purchaser for its time incurred in structuring and negotiating the purchase. Two tests have been developed to determine whether such economic incentives are appropriate: (1) the "business judgment" test; and (2) the "best interest of the estate" test.

(i) A three part business judgment test has been established to evaluate the appropriateness of break-up fees in bankruptcy cases: "(1) is the relationship between the parties who negotiated the break-up fee tainted by self-dealing or manipulation; (2) does the fee hamper rather than encourage, bidding, (3) is the amount of the fee unreasonable relative to the proposed sale price?" *The Official Committee of Subordinated Bondholders v. Integrated Resources*, *Inc*. (*In re Integrated Resources*, *Inc.*), 147 B.R. 650, 657 (S.D.N.Y. 1992), *appeal*

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[9] *See*, *e.g.*, *American Living Sys. v. Bonapfel* (*In re All American of Ashburn*, *Inc.*), 56 B.R. 186, 190 (N.D. Ga. 1986) (authorizing bankruptcy sale free and clear of successor liability), *aff'd sub nom Griffin v. Bonapfel* (*In re All American of Ashburn, Inc.*), 805 F.2d 1515 (11th Cir. 1986); *Rubinstein v. Alaska Pacific Constr.* (*In re New England Fish Co.*), 19 B.R. 323, 328 (Bankr. W.D. Wash. 1982) (disallowing the application of successor liability where debtor's asset sale was approved by the bankruptcy court); *Forde v. Kee-Lox Mfg. Co*., 437 F. Supp. 631, 633-34 (W.D.N.Y. 1977) (stating that permitting a claim against a purchaser in bankruptcy would inhibit the ability of the of the trustee to liquidate the estate and contravene the priority scheme of the Bankruptcy Code), *aff'd on other grounds*, 584 F.2d 4 (2d Cir. 1978); *but see Chicago Truck Drivers, Helpers and Warehouse Workers Union v. Tasemkin*, 59 F.3d 48, 51 (7th Cir. 1995) (finding a bankruptcy sale did not have a per se preclusive effect on the applicability of successor liability).

[10] *See* 11 U.S.C. § 1129(a).

[11] *See* 11 U.S.C. § 1129(b)(2)(A).

dismissed, 3 F.3d 49 (2d Cir. 1993). The District Court unequivocally agreed with the Bankruptcy Court that the break-up fee was economically appropriate because it (1) attracted and retained a successful bid, (2) established a bidding standard for other bidders, and (3) served to attract additional bidders. *Id.* at 662.

(ii) The Court in *In re Hupp Indus.*, *Inc*., 140 B.R. 191 (Bankr. N.D. Ohio 1992) developed a more restrictive approach and listed a seven factor test for determining the appropriateness of a break up fee:

(1) Whether the fee requested correlates with the maximization of value to the debtor's estate;
(2) Whether the underlying negotiated agreement is an arms-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) 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 will be a substantial adverse impact upon unsecured creditors, if such creditors oppose the break-up fee.

Id. at 194; *see also In re S.N.A. Nut Co.*, 186 B.R. 98, 104 (Bankr. N.D. Ill. 1995) (analyzing "whether the interests of all concerned parties are best served by such fee"); *In re America West Airlines*, *Inc*., 166 B.R. 908, 912 (Bankr. D. Ariz. 1994) (repudiating the business judgment rule as the appropriate test and stating that the appropriate question is whether the transaction was in the best interests of the debtor and its creditors and equity holders).

L. Reimbursement of Bidder's Actual Expenses Under § 503(b): Another form of economic incentive gaining favor in bankruptcy cases is the reimbursement of a bidder's actual expenses under Section 503(b).[12] In order to recover an administrative expense pursuant to 503(b)(3)(D), [13] the applicant must demonstrate that it made a "substantial contribution" to the estate. *See, e.g., In re Jack Winter Apparel*, *Inc.*, 119 B.R. 629, 632 (E.D. Wis. 1990). Although "substantial contribution" is not defined in the Bankruptcy Code or in the legislative history of Section 503, case law has established that, for an entity to recover under Section 503(b), it must demonstrate that

[12] *See*, *e.g.*, *Hall Fin. Group*, *Inc.* v. *DP Partners Ltd. Partnership* (*In re DP Partners Ltd. Partnership*), 106 F.3d 667, 672-73 (5th Cir. 1997); *In re 995 Fifth Ave. Assoc.*, *L.P.*, 96 B.R. 24 (Bankr. S.D.N.Y. 1989); *but see In re S.N.A. Nut Co*., 186 B.R. at 105-106 (applying "best interests of the estate" test in the context of administrative expense analysis and declaring that unsuccessful bidders not entitled to bring claim for administrative expense under Section 503(b)).

[13] Bankruptcy Code Section 503(b)(3)(D) states that compensable administrative expenses include "the actual, necessary expenses . . . incurred by . . . a creditor . . . in making a substantial contribution in a case under chapter . . . 11." 11 U.S.C. § 503(B)(3)(D).

(1) services were rendered to benefit all parties in the case and not just the applicant; (2) the services rendered a direct, significant, and demonstrable benefit to the estate and the unsecured creditors; and (3) the services were not duplicative. *See In re Envirodyne Indus.*, *Inc.*, 176 B.R. 815, 819 (Bankr. N.D. Ill. 1995).[14]

(i) In *Hall Fin. Group*, *Inc.*, v. *DP Partners*, *Ltd. Partnership* (*In re DP Partners Ltd. Partnership*), 106 F.3d 667, 672-73 (5th Cir. 1997), the Fifth Circuit expressly approved the right of an unsuccessful bidder to seek compensation under Section 503(b). The Court, after noting the absence of a clear definition of "substantial contribution", adhered to the ordinary, everyday meaning of the phrase, thus stating that the term "substantial contribution" within the meaning of Section 503(b) means a contribution that is "considerable in amount, value or worth." *Id.* at 673. The court noted that, despite the need for a more complete standard for substantial contribution:

> At a minimum . . . the court should weigh the cost of the claimed fees and expenses against the benefits conferred upon the estate which flow directly from those actions. Benefits flowing to only a portion of the estate or to limited classes of creditors are necessarily diminished in weight. Finally, to aid the district and appellate courts in the review process, bankruptcy judges should make specific and detailed findings on the substantial contribution issue.

Id. In addition, claimants are required to show the expenses to have been actual and necessary and any fees incurred to have been reasonable.[15]

III. Bifurcation of Chapter 11 Case

A. In *In re Caldor, Inc.-NY, et al.,* currently pending in the United States Bankruptcy Court for the Southern District of New York, the debtor's management decided, as a result of the debtor's continuing losses, that the debtor could no longer continue to operate. These losses had caused the estate to become administratively insolvent. The debtor, as part of its plan to wind down its business operations and liquidate its assets, requested the Court to grant a motion which, among other things, would authorize the bifurcation of its Chapter 11 case into two distinct phases: the "operating period" and the "wind-down period." The debtor asserted that, as a result of the public disclosure of the possibility of administrative insolvency of its estate, no suppliers would continue to provide goods and services to the estate, which were necessary to complete the liquidation, for fear of not being paid unless its Chapter 11 case was so bifurcated. Caldor had hundreds of millions of dollars of assets that needed to be liquidated in an orderly fashion and the debtor asserted that a conversion to Chapter 7 would result in

[14] "Compensation under § 503(b) must be reserved for those rare occasions when the creditor's involvement truly fosters and enhances the administration of the estate." *Envirodyne*, 176 B.R. at 819.

[15] Bankruptcy Code Section 503(b)(3)(D) states that compensable administrative expenses include "the actual, necessary expenses . . . incurred by . . . a creditor . . . in making a substantial contribution in a case under chapter . . . 11." 11 U.S.C. § 503(B)(3)(D).

substantial dilution of the value of the assets. The Court granted the motion over the objections of several creditors. The possibility of such a bifurcation being granted in a failing Chapter 11 case in the future has serious implications for administrative creditors.

(i) The order granted by the Court bestowed super-priority status upon claims arising during the wind-down period. While these claims would likely be paid in full, administrative claims that arose during the Chapter 11 operating period would not be paid in full. Thus, administrative creditors would not be treated equally.

(ii) The order also imposed an administrative stay of collection efforts with respect to all operating period claims. Thus, administrative creditors could not seek payment of their administrative claims. Certain creditors objected to being deprived of their reclamation rights.[16] Suppliers that shipped goods to the debtor immediately prior to the announcement of administrative insolvency believe that they were entitled to reclaim those goods as a result of the administrative "insolvency" of the debtor.

B. Bifurcation of a Chapter 11 case into an operating period and a wind-down period so that the claims of wind-down creditors are preferred over the claims of other administrative creditors would appear to violate the notion that all Chapter 11 administrative claimants should be paid on a *pro rata* basis. There is arguably no statutory or other authority for bestowing super-priority status upon administrative claims that accrue during a debtor's wind-down period.

(i) The Bankruptcy Code contemplates that “burial expenses” may be paid ahead of other administrative expenses by converting a Chapter 11 case to a case under Chapter 7. *See* 11 U.S.C. § 726.[17] The priority scheme established by the Bankruptcy Code does not contemplate a comparable bifurcation of claims within a Chapter 11 case.

(ii) Such relief was summarily denied by the Honorable Arthur J. Gonzalez of the Bankruptcy Court for the Southern District of New York in ARLCO, Inc. and HFO, Inc. f/k/a Arley Corp. and Home Fashions Outlet, Inc., Case Nos. 97-B-43789 and 97-B-43790 (*see* Order Denying Debtors’ Application in Support of Order Pursuant to 11 U.S.C. §§ 105 and 364(c) Granting Super-Priority Administrative Claim Status For Goods and Services Provided from and After October 1, 1997 and Granting Related Relief dated February 27, 1998).

[16] See discussion of reclamation, *infra.*

[17] The conversion of a Chapter 11 case to a Chapter 7 case, unlike the bifurcation of a Chapter 11 case, involves the appointment of an impartial trustee who can investigate the debtor's financial affairs and determine whether the debtor's management and/or professionals have contributed to the failure of the debtor's efforts to reorganize. Although Chapter 7 administrative expenses get paid ahead of Chapter 11 administrative claims, creditors at least have the comfort of knowing that there is a neutral third party conducting an investigation of the debtor's affairs and overseeing the liquidation of its assets.

C. The imposition of an administrative stay deprives creditors of, among other things, their right to (a) reclaim goods pursuant to Section 546(c) of the Bankruptcy Code; and (b) seek payment of their administrative expense claims pursuant to Bankruptcy Code Section 503(a).

D. In order to protect itself from the possibility of the bifurcation of a Chapter 11 proceeding and/or the imposition of an administrative stay, a creditor should monitor the debtor's operations and financial situation as closely as practicable so as to be able to detect any early warning signs of the failure of the debtor's reorganization attempts. If any such warning signs exist, a creditor may wish to stop extending credit, or curtail its extension of credit, to the debtor.

IV. Reclamation

A. Section 2-702 of the Uniform Commercial Code ("UCC")[18] provides a seller with the ability to recover goods sold on credit to an insolvent purchaser. Section 2-702 is incorporated and modified by Bankruptcy Code Section 546(c).[19] Section 546(c)

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[18] Section 2-702 of the UCC provides as follows:

2-702. Seller's Remedies on Discovery of Buyer's Insolvency.

(1) Where the seller discovers the buyer to be insolvent he may refuse delivery except for cash including payment for all goods theretofore delivered under contract, and stop delivery under this Article (Section 2-705).

(2) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has made to the particular seller in writing within three months before delivery the ten day limitations does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

(3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser under this Article (Section 2-403). Successful reclamation of goods excludes all other remedies with respect to them.

[19] Section 546(c) of the Bankruptcy Code provides as follows:

Except as provided in subsection (d) of this section, the rights and powers of a trustee under sections 544(a), 545, 547, and 549 of this title are subject to any statutory or common-law right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, but—

(1) such a seller may not reclaim any such goods unless such seller demands in writing reclamation of such goods—

(A) before 10 days after receipt of such goods by the debtor; or

(B) if such 10-day period expires after the commencement of the case, before 20 days after receipt of such goods by the debtor; and

(2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court—

(A) grants the claim of such a seller priority as a claim of a kind specified in section 503(b) of this title; or

recognizes and modifies a seller's state law reclamation rights; it does not create an independent right of reclamation. *See, e.g., In Re Victory Markets, Inc.,* 212 B.R. 738, 741 (Bankr. N.D.N.Y. 1997).

B. Often, the filing of a bankruptcy petition will result in many reclamation claims being filed against the debtor. Where the requirements of Bankruptcy Code Section 546(c) are satisfied, the rights of a trustee or debtor in possession will be subject to the rights of a seller with a reclamation claim against the debtor. If a seller does not satisfy all of the requirements of Section 546(c), its only remedy will be its ability to file an unsecured claim against the estate.

C. The requirements for establishing a reclamation claim pursuant to Section 546(c) of the Bankruptcy Code are as follows:[20]

(i) The seller must satisfy the requirements for establishing a reclamation claim under state law.

(ii) The sale of goods must have been made in the ordinary course of business.

(iii) The seller must make a written reclamation demand. The demand must clearly indicate the seller's intent to reclaim the goods and must specifically identify the goods to be returned.

(iv) The goods sought to be reclaimed must be in the debtor's possession and must be identifiable. *See, e.g. In re Adventist Living Centers, Inc.,* 52 F.3d 159, 162 (7th Cir. 1998); *Archer Daniels Midland Co. v. Charter Int'l Oil Co.*, 60 B.R. 854, 856 (M.D. Fla. 1986). Reclamation may not be permitted where the goods have been incorporated into another product or have been otherwise altered.

(v) The debtor/buyer must have been "insolvent" at the time the goods were received.

(a) Under the Bankruptcy Code, "insolvent" means a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation …" 11 U.S.C. § 101(32).

(b) Under the UCC, a person is "insolvent" if he "either has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due or is insolvent within the meaning of the federal bankruptcy law." UCC § 1-201(23).

(B) secures such claim by a lien.

[20] *See, e.g. Victory Markets*, 212 B.R. at 741*; Graphic Prod. Corp. v. WWF Paper Corp. (In re Graphic Prod. Corp.),* 176 B.R. 65, 73 (Bankr. S.D. Fla. 1994).

(c) "The overwhelming weight of authority holds … that the word insolvent as used in U.S.C. § 546(c) refers to the Bankruptcy Code definition of insolvent … rather than the definition of insolvent in the state statutes and the Uniform Commercial Code." *Lawrence Pharmaceuticals, Inc. v. Best Buy Drugs, Inc. (In re Best Buy Drugs, Inc.),* 89 B.R. 997, 998 (Bankr. S.D. Fla. 1988).

(vi) The demand must be made within ten days of the debtor's receipt of the goods, or within twenty days after receipt if the ten day period expires after the commencement of the debtor's bankruptcy case.

D. Bankruptcy Code Section 546(c)(2) provides alternative remedies for creditors with reclamation claims. Instead of allowing a seller to reclaim goods, a bankruptcy court may allow the creditor an administrative priority claim under Section 503(b) or a lien on property of the estate. *See, e.g., Griffin Retreading Co. v. Oliver Rubber Co. (In re Griffin Retreading Co.)*, 795 F.2d 676, 679 (8th Cir. 1986).

E. A seller's reclamation rights are subject and subordinate to any pre-existing "floating" liens on the debtor's inventory. *See, e.g.*, *Victory Markets,* 212 B.R. at 742; *In re Child World, Inc.,* 145 B.R. 5, 7 (Bankr. S.D.N.Y. 1992). Where goods sought to be reclaimed are subject to a third party's lien, the seller's administrative claim pursuant to Bankruptcy Code § 546(c) is limited to the residual value of the goods after payment of any secured claims collateralized by the goods. *See, e.g., Victory Markets,* 212 B.R. at 743. Thus, to the extent a secured creditor takes the value of the goods subject to the seller's reclamation claim, the seller's administrative claim is worthless and may not be satisfied from other estate assets. *See, e.g., Child World,* 145 B.R. at 8.

F. It is unclear whether, in the event of a failing Chapter 11 case, creditors selling to a debtor in possession on credit possess the right to reclaim goods in accordance with state law and Section 546(c)(2) of the Bankruptcy Code. Arguably, the administrative insolvency of the debtor creates another period of insolvency such that a creditor should be entitled to reclaim the goods shipped to the debtor in possession within ten days of the administrative insolvency.