

CHOCOLATE, FLOWERS, AND § 363(B): THE OPPORTUNITY FOR SWEETHEART DEALS WITHOUT CHAPTER 11 PROTECTIONS

INTRODUCTION

Testifying before the Subcommittee on Commercial and Administrative Law in 2004, Lynn M. LoPucki stated that Bankruptcy Code § 363 sales are “fraught with potential for abuse.”¹ Others have described § 363 preplan business sales as “hijacking chapter 11”² or “side-stepping creditor protections.”³ While some criticize the use of the provision to sell all or substantially all of the debtor’s assets, troubled companies are increasingly using § 363⁴ as an alternative exit from bankruptcy to minimize the expense and duration of the process.⁵

Bankruptcy Code § 363(b) allows for the debtor in possession (“DIP”) to use, sell, or lease property of the estate outside the ordinary course of business after notice and a hearing.⁶ The strategic use of this provision allows the debtor to not only “cherry pick” advantageous protections from chapter 11 but also to achieve a quick approval for the sale of all or substantially all of its assets without complying with chapter 11 requirements for plan confirmation.⁷ The stark contrast between chapter 11’s numerous and intricate requirements

¹ *Admin. of Large Bus. Bankr. Reorganizations: Has Competition for Big Cases Corrupted The Bankruptcy System?: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary*, 108th Cong. 15 (2004).

² George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 25 (2004) (citation omitted) (among insider retention deals, secured credit DIP financing, liability releases for insiders).

³ Craig A. Sloane, *The Sub Rosa Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 EMORY BANKR. DEV. J. 37, 45 (1999).

⁴ Rachael M. Jackson, Comment, *Responding to Threats of Bankruptcy Abuse in a Post-Enron World: Trusting the Bankruptcy Judge as the Guardian of Debtor Estates*, 2005 COLUM. BUS. L. REV. 451, 452 (2005); Lynn M. LoPucki, Bankruptcy Research Database, <http://lopucki.law.ucla.edu> (last visited Jan. 12, 2007).

⁵ Ronald L. Leibow et al., *Distressed Asset Sales: Selling and Acquiring Assets from the Debtor Estate*, 877 PRACTISING L. INST. 71, 81 (2005); Judith Greenstone Miller & Michael P. Di Laura, *The Ultimate Garage Sale: Disposing of a Troubled Company*, 14-Oct BUS. L. TODAY 11, 12 (2004).

⁶ 11 U.S.C. § 363(b) (2000). “The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate” *Id.*

⁷ *Id.* § 1123 (allowing liquidation but also requiring compliance with §§ 1125 and 1129).

for plan confirmation⁸ and the nominal requirements for § 363 sales naturally causes tension. The preplan business sale is attractive to debtors because of its ease,⁹ speed,¹⁰ and finality.¹¹ The lack of transparency,¹² the pace of the process,¹³ and the inconsistent treatment by the courts,¹⁴ however, leave the bankruptcy courts and parties in interest vulnerable to unfair dealing, abuse, and sweetheart deals.

The susceptibility of abuse with § 363 preplan business sales requires increased scrutiny. Recent memory of flagrant corporate corruption in Enron,¹⁵ WorldCom,¹⁶ and Adelphia¹⁷ should arouse concern and encourage reform. The waning bias against preplan business sales,¹⁸ vague good faith standards,¹⁹ and the ability of the debtor or inside creditor to manufacture a sound business justification for preplan sale approval²⁰ illustrate the need for reform. Courts requiring debtors to merely provide a business justification for

⁸ See *id.* § 1129.

⁹ Compare § 1125 requirements for the disclosure statement, including “adequate information,” with § 363(b)’s generic notice.

¹⁰ FED. R. BANKR. P. 2002(a)(2) (2000). The notice requirement is twenty days. *Id.*

¹¹ Section 363(b) sales are final if made in good faith. 11 U.S.C. § 363(m) (2000).

¹² *Id.* § 363(b) (requiring minimal information compared to § 1125(b)’s disclosure statement and plan summary). Additionally, the chapter 11 disclosure statement must be distributed to claim holders and approved by the court prior to soliciting any votes for confirmation. *Id.* § 1125(b).

¹³ James Patrick Shea et al., *Pushing the Limits of § 363—Is Confirmation Obsolete in the Asset Sale Case?*, 14 J. BANKR. L. & PRAC. 2 Art. 2 (2005). Section 363(b) sales are “[u]ndeniably faster and less costly,” while sales pursuant to a reorganization plan are a “[s]lower, more cumbersome process.” *Id.* at Appendix A.

¹⁴ See Sloane, *supra* note 3, at 51.

¹⁵ See John R. Emshwiller & Rebecca Smith, *Corporate Veil: Behind Enron’s Fall, a Culture of Operating Outside Public’s View—Hidden Deals with Officers and Minimal Disclosure Finally Cost It Its Trust—Chewco and JEDI Warriors*, WALL ST. J., Dec. 5, 2001, at A1 (filing bankruptcy after its accounting scheme was discovered to keep debt off the books and to misstate earnings).

¹⁶ Jared Sandberg, Shawn Young & Deborah Solomon, *WorldCom to File Chapter 11, As Cash Reserves Dwindle Fast*, WALL ST. J., July 19, 2002, at A1 (attempting to hide losses by improperly accounting for \$3.9 billion in operating expenses led to its financial demise).

¹⁷ *Adelphia Commc’ns Corp. v. Rigas (In re Adelphia Commc’ns Corp.)*, 285 B.R. 848, 851 (Bankr. S.D.N.Y. 2002) (filing bankruptcy after the Rigas family grossly misappropriated corporate funds via self-dealing).

¹⁸ See Sloane, *supra* note 3, at 51 (courts are generally permitting sales over sub rosa objections).

¹⁹ George W. Kunej, *Misinterpreting Bankruptcy Code § 363(f) and Undermining the Chapter 11 Process*, 76 AM. BANKR. L.J. 235, 272 (2002) (“vague ‘you know it when you see it’ standards for good faith”).

²⁰ LYNN M. LOPUCKI, *COURTING FAILURE: HOW COMPETITION FOR BIG BANKRUPTCY CASES IS CORRUPTING THE BANKRUPTCY COURTS* 169 (The University of Michigan Press 2005) [hereinafter *COURTING FAILURE*].

§ 363 sales²¹ without any additional disclosure requirements is grossly insufficient to expose unfair dealing.

To address the need for increased scrutiny of § 363 preplan business sales, this Comment will first identify the differences between chapter 11 confirmation requirements and procedural requirements for § 363(b) sales. Part I will provide the mechanics, application, and policy for chapter 11 reorganizations and § 363(b) sales. Part II will present a brief history of case law and the evolving restrictions on § 363(b) sales. Part III of this Comment will analyze the application of case law from Part II and provide case examples where courts chose to increase scrutiny with preplan business sales. Part IV will survey recent bankruptcy decisions that demonstrate § 363(b)'s vulnerabilities and highlight areas of abuse in preplan sales. Part V contains recommendations for intensified scrutiny and modifications to the current treatment of § 363 preplan business sales.

I. COMPARING CHAPTER 11 AND § 363(B)

A reorganization through chapter 11 bankruptcy allows the business to continue operations by relieving a portion of its unsecured debt and supporting its return to economic stability and prosperity.²² The Bankruptcy Code provisions balance creditor protections and debtor tools to facilitate continued business operations and negotiations during the confirmation process.

Traditionally, business reorganizations were seen as superior to liquidation because assets used in a particular industry for which they were designed were more valuable than the liquidation value of those same assets.²³ Congress explained the underlying rationale of reorganization as:

The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. . . . It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.²⁴

²¹ See *infra* notes 158–62 and accompanying text.

²² CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY*, § 1.2, at 6–8 (1997) (providing the goals of reorganization and evaluating the success of reorganization practice).

²³ H.R. REP. NO. 95-595 at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179.

²⁴ *Id.*

Today, the theory that assets are worth more within their existing industry does not have the same strength with twenty-first century, service-oriented industries,²⁵ and debtors have increasingly altered their use of chapter 11 protections.²⁶ A § 363 preplan business sale is an alternative use of chapter 11 protections because all of the debtor's assets can be sold outside the ordinary course of business after a simple notice and a hearing.²⁷ For some, § 363 sales have become the preferred method of disposing of an entire business,²⁸ but preplan business sales have been and continue to be controversial.

Permitting the use or sale of the debtor's assets outside of a reorganization plan has been debated since 1938 when chapter X was enacted.²⁹ One of the principle purposes of chapter X was to offer businesses a means to reorganize and continue operations³⁰ as a distinct option from straight liquidation.³¹ However, section 116(3) permitted the debtor to sell estate property outside a plan of reorganization.³²

Courts struggled with the inherent contradiction of the provision. The intricate requirements of reorganization plans created a structured, fair bargaining process and plan. Yet a plain reading of the statute³³ permitted a sale of all or substantially all of a debtor's assets outside the plan.³⁴ *Collier* described the use of section 116(3) as follows:

[U]nder § 116(3) . . . if the facts impel a decision that the debtor's property be sold prior to the working out of a reorganization plan, the

²⁵ See Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 78 (2004) [hereinafter Baird, *New Face of Chapter 11*].

²⁶ See Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 674 (2003) (stating that "in 84% of all large Chapter 11s from 2002, the investors entered bankruptcy with a deal in hand or used it to sell the assets of the business"); see also Elizabeth Warren & Jay Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. 12 (Sept. 2003).

²⁷ 11 U.S.C. § 363(b) (2000).

²⁸ Miller & Di Laura, *supra* note 5, at 13.

²⁹ In August of 1937, section (c)(3-1/2) of section 77B was enacted. This section granted the judge authority for the "lease or sale of property owned by the debtor upon such terms as he might approve." John J. Hurley, *Chapter 11 Alternative: § 363 Sale of All of the Debtor's Assets Outside a Plan of Reorganization*, 58 AM. BANKR. L.J. 233, 236 (1984).

³⁰ Chapter X's predecessor, § 77B of the Bankruptcy Act, attempted to create a mechanism for reorganization, but if no plan were presented within a reasonable period of time the judge was authorized to order a liquidation. *Id.*

³¹ *Id.*

³² *Id.*

³³ See, e.g., *In re V. Loewer's Gambrinus Brewery Co.*, 141 F.2d 747, 749 (2d Cir. 1944) (reasoning that "any," the statutory language, can include all of the debtor's assets).

³⁴ Hurley, *supra* note 29, at 238-40.

court may authorize the sale to be made. And even if such disposition involves *all* the income-producing property of the debtor, the order may be justified. Section 116(3) says ‘any property of the debtor, whether real or personal’ and even though the sale may practically prevent the adoption of a reorganization plan and thus defeat the purpose of the case, it may be permitted where conditions warrant. There is no inconsistency in this result. True, as we have said, the goal of Chapter X is rehabilitation not liquidation. But some play must be allowed for the joints of the machine. A rigid denial of the right to sell or lease to the fullest extent necessary would prove ruinous to creditors and stockholders where the situation called for that action.³⁵

Despite the provision’s plain language, courts did not freely allow outside-of-plan sales. Over time, courts have used a variety of standards and doctrines to limit the use of preplan sales.³⁶

Courts are accommodating the debtors’ demands for alternative exits from bankruptcy, and the historical bias against preplan business sales is dwindling.³⁷ Chapter 11 no longer serves as a “substitute for a market sale, chapter 11 now serves as the forum where such sales are conducted.”³⁸ The surge in chapter 11 mega-cases in the late 1990s revealed that debtors adapted their use of chapter 11 protections beyond mere reorganization plans.³⁹ With § 363 preplan business sales, debtors sped up the process and essentially cemented their nonbankruptcy deals with bankruptcy provisions.⁴⁰ Section 363 sales circumvent the time-consuming and expensive process of plan confirmation and offer an attractive streamlined process for business sales. However, diminished court oversight also increases vulnerability to unfair dealing and sweetheart deals.

³⁵ COLLIER ON BANKRUPTCY ¶ 3.27 (14th ed. 1978) (emphasis added).

³⁶ See *infra* Part II.

³⁷ Kuney, *supra* note 19, at 272.

³⁸ Baird, *New Face of Chapter 11*, *supra* note 25, at 71.

³⁹ Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002) (asserting that chapter 11 is now primarily used by companies to dispose of their assets). *But see* Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen’s The End of Bankruptcy*, 56 STAN. L. REV. 645, 666 (2003) (countering that reorganizations remain more prevalent than strict asset sales).

⁴⁰ See Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1374–76 (2000). Approximately ten percent of the chapter 11 cases filed by publicly-traded firms are prepackaged bankruptcies. See THE 2001 BANKRUPTCY YEARBOOK & ALMANAC 134 (2001).

A. Chapter 11 Provisions

Despite these well-known and increasingly popular nontraditional practices, the goals and purposes for chapter 11 were stated by the 1997 National Bankruptcy Reporting Commission in its Final Report as follows:

- Maximize enterprise value;
- Preserve jobs;
- Rehabilitate viable businesses;
- Encourage out of court restructuring;
- Resolve distributive decisions;
- Promote efficiency; and
- Benefit other parties affected by business failure.⁴¹

Traditionally, the above reorganization goals were achieved in chapter 11 by providing a balanced set of tools for both the debtor and the creditor that compelled negotiations and provided the necessary transparency for true multiparty bargaining. The Bankruptcy Code provides each party with tools via its provisions.

1. The Debtor's Tools

The Bankruptcy Code generally defers to the debtor's expertise and control of its own business within a reorganization plan. There are four key chapter 11 provisions, for purposes of a § 363 comparison, that facilitate debtor control in plan formulation and confirmation. The role of the DIP, the exclusivity period for the debtor,⁴² claims classification,⁴³ and cramdown⁴⁴ provide the debtor leveraging power in reorganization.

First, chapter 11 generally allows the DIP, typically the original management,⁴⁵ to continue running the business. The retention of management is believed to increase the value of the estate while preserving industry expertise for plan confirmation negotiations and successful emergence from

⁴¹ NAT'L BANKR. REV. COMM'N BANKR.: THE NEXT TWENTY-FIVE YEARS (1997), available at <http://govinfo.library.unt.edu/nbrcreporttitlepg.html> (last visited Aug. 27, 2006).

⁴² 11 U.S.C. § 1121(b) (2000).

⁴³ *Id.* § 1122(a).

⁴⁴ *Id.* § 1129(b)(1).

⁴⁵ Section 1107(a) allows for the appointment of a trustee in chapter 11 cases, but absent fraud or gross mismanagement this is a rare occurrence, especially in cases with large publicly-traded companies. Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 693 (1993).

bankruptcy.⁴⁶ Although management typically remains in place,⁴⁷ their roles and duties dramatically shift with entry into bankruptcy. Prebankruptcy directors and officers owe fiduciary duties to shareholders and the corporate entity, but upon entry into bankruptcy the DIP's charge is to maximize the value of the estate with additional fiduciary duties attaching to its creditors.⁴⁸

Second, the DIP benefits from the 120-day exclusivity period⁴⁹ where only it can propose a reorganization plan.⁵⁰ The automatic stay⁵¹ provides breathing room and time for regrouping, so that the DIP can negotiate and work towards a viable confirmation plan. Although the DIP has exclusive rights to propose a plan, the plan is a product of multiparty bargaining where leveraging tactics and negotiations create a product that has a chance for confirmation.⁵² Without an approved confirmation plan, there is no reorganization.

Third, the debtor may strategically classify claims.⁵³ Debtors can use claim classification as a tool to better ensure plan confirmation. The debtor's only instruction in structuring the claims is that "substantially similar" claims can be placed in the same class.⁵⁴ However, substantially similar claims are not required to be placed in the same class.⁵⁵ Section 1123(a)(4) requires that all claims within a class are treated the same, so the debtor may group seemingly similar claims into different classes to allow for different treatment.⁵⁶ The debtor garners control over the proposed reorganization plan with the exclusivity period and classification of claims.

⁴⁶ *But see* Lynn M. LoPucki, *Chapter 11: An Agenda for Basic Reform*, 69 AM. BANKR. L.J. 573, 576–78 (1995) (chapter 11 gives debtors too much control).

⁴⁷ Absent the appointment of a trustee for cause. 11 U.S.C. § 1104(a)(1). There is a strong presumption for retaining the DIP, but when conflicts between debtors and creditors "extend beyond the healthy conflicts that always exist between debtor and creditor" or when parties "work for cross-purposes," a trustee can be appointed. RICHARD F. BROUDE, *REORGANIZATIONS UNDER CHAPTER 11 OF THE BANKRUPTCY CODE*, § 3.03, at 3-38 to 3-39 (Law Journals Seminars-Press 1986) (2005) (internal quotations and citations omitted).

⁴⁸ *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355 (1985) (holding the fiduciary duty of the DIP runs to the equity holders and the creditors). The Court clarified its holding by stating, "One of the painful facts of bankruptcy is that the interests of shareholders become subordinated to the interests of creditors." *Id.*

⁴⁹ § 1121(b).

⁵⁰ *Id.* Section 1121(d)(1) provides for a party in interest to reduce or increase the 120-day period after notice and a hearing.

⁵¹ *Id.* § 362.

⁵² *See* Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1691–93 (1996).

⁵³ *Id.* at 1695–96.

⁵⁴ § 1122(a).

⁵⁵ Debtors can classify claims so that creditors that may be inclined to vote against the plan are paired with cooperative creditors, thus diluting their disapproving vote. Tung, *supra* note 52, at 1684, 1695–96.

⁵⁶ BROUDE, *supra* note 47, at § 9.02[1], at 9-6.

Fourth, the debtor can override a nonconsenting voting class through cramdown.⁵⁷ Cramdown does not grant the debtor unrestrained veto power, but instead the debtor's control over the plan is counterbalanced by the voting requirements for plan confirmation.⁵⁸ In practice, the cramdown requirements make it difficult for the debtor to approve any reorganization plan over creditor objections. The order and priorities of payments created by entering bankruptcy are maintained according to the "absolute priority rule."⁵⁹ For example, a debtor must pay any dissenting class in full prior to any subordinated class receiving any property.⁶⁰ The Bankruptcy Code provides guidelines for both priorities and fairness. The "absolute priority rule" and the requirement that the plan must be "fair and equitable"⁶¹ compel the debtor to negotiate with all of its creditors to formulate a plan of reorganization that is acceptable to all interested parties, while still providing negotiating tools for each side.⁶² Despite its restricted use, the cramdown option gives the debtor leverage with control and plan confirmation.

2. *The Creditor's Protections*

The policy and purpose of reorganization are premised on the additional value that a debtor and the accompanying specialized expertise bring to an estate,⁶³ therefore many chapter 11 provisions give the debtor control over confirmation.⁶⁴ However, the Bankruptcy Code also privileges the creditor with valuable checks on the debtor's control of confirmation. Especially when comparing the minimal procedural requirements of § 363(b) sales, there are three sources of creditor protection within the reorganization process that grant leverage to creditors and foster negotiations.⁶⁵ The disclosure statement,⁶⁶

⁵⁷ § 1129(b)(1) (requiring all other § 1129(a) plan requirements be met except (a)(8) for cramdown to even be an option for the debtor).

⁵⁸ See generally, BROUDE, *supra* note 47, at § 13.03, at 13-12.

⁵⁹ § 1129(b)(2).

⁶⁰ *Id.* The "absolute priority rule" requires that if the class of secured creditors dissents, claims from the secured creditors must be paid in full prior to any unsecured creditor class receiving payment.

⁶¹ *Id.* This requirement goes beyond mere compliance with the "absolute priority rule." See Fed. Sav. & Loan Ins. Corp. v. D & F Constr., Inc. (*In re D & F Constr., Inc.*), 865 F.2d 673, 675 (5th Cir. 1989).

⁶² See generally Sloane, *supra* note 3, at 40.

⁶³ See *supra* notes 23-24 and accompanying text.

⁶⁴ See LoPucki, *supra* note 46.

⁶⁵ Section 1129(a) is a laundry list of sixteen requirements that the debtor must satisfy before the court can confirm its plan. The cramdown option for debtors, see *supra* notes 57-62 and accompanying text, can only substitute one of those requirements.

⁶⁶ § 1125(b).

creditor approval,⁶⁷ and good faith⁶⁸ provide the creditor with adequate information, a vote, and an assurance of fair dealing.⁶⁹

First, prior to voting on plan confirmation, § 1125 requires that the debtor provide voting parties with a disclosure statement and plan summary.⁷⁰ The disclosure requirement in § 1125(b) was a product of reform⁷¹ and was intended to allow creditors to make informed decisions.⁷² The contents of the disclosure statement must provide adequate information, a term defined as:

[I]nformation of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor . . . that would enable such a hypothetical investor of the relevant class to make an informed judgment about the plan . . . whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties at interest, and the cost of providing additional information.⁷³

The standard for adequate information is subjective, not objective, and acknowledges the often chaotic conditions in which failing businesses enter chapter 11.⁷⁴ However, there are some essential items that every disclosure statement should contain to offer adequate information: a balance sheet, an income statement, a cash flow statement, a list of factors contributing to bankruptcy, liquidation analysis, disclosure of insiders, and a prior operating history.⁷⁵

⁶⁷ *Id.* § 1126(c).

⁶⁸ *Id.* § 1129(a)(3).

⁶⁹ Section 1129(b)(2)'s absolute priority rule also gives the creditors leverage. Additionally, postpetition financing options often provide new ways for creditors to have a greater stake in the reorganization process. *Id.* § 364(b), (c), (d)(1).

⁷⁰ *Id.* § 1125(b).

⁷¹ H.R. REP. NO. 95-595 at 408 (1977) (“This section is new. It is the heart of the consolidation of the various reorganization chapters found in current law. It requires disclosure before solicitation of acceptance of a plan.”).

⁷² BROUDE, *supra* note 47, at § 11.01[2], at 11-4.

⁷³ § 1125(a)(1).

⁷⁴ BROUDE, *supra* note 47, at § 11.01[3], at 11-7 (emphasizing “reasonably practicable” wording from § 1125(a)(1)) (internal quotations omitted).

⁷⁵ See *In re Dakota Rail, Inc.*, 104 B.R. 138, 142 (Bankr. D. Minn. 1989). The 2005 Amendments also require a discussion of federal tax consequences resulting from the proposed plan. BROUDE, *supra* note 47, at § 11.01[4], at 11-9.

Because creditors would have comprehensive information regarding the debtor prior to the vote, the confirmation process now had an internal safeguard ensuring that informed negotiations would predicate confirmation.

Second, although the debtor creates classes with claims classification,⁷⁶ plan acceptance is contingent on creditor approval by class.⁷⁷ There are two percentages that serve as threshold requirements for acceptance by each class. First, creditors holding claims for “at least two-thirds in amount”⁷⁸ must accept the plan. Second, creditors holding claims of “more than one-half in number” must also accept the plan.⁷⁹ The voting requirements give creditors leverage to negotiate because absent their vote, the debtor is in control of formulating the plan.⁸⁰ Leverage is limited to “impaired creditors” because only they have a voting right in plan confirmation.⁸¹

Third, creditors are protected by a good faith requirement.⁸² Good faith is not defined within the Code and courts have routinely expanded the good faith inquiry beyond plan proposal.⁸³ Abuse of either the judicial process or the purposes of reorganization violates the good faith standard.⁸⁴ Other examples of good faith violations include a debtor’s intent to frustrate the efforts of secured creditors to enforce their rights⁸⁵ or acts of self-dealing where plans would benefit the prepetition committee.⁸⁶ Courts have generally exercised judicial discretion and assessed good faith by the totality of the circumstances involved in plan confirmation.⁸⁷ One court’s good faith analysis identified that “the most important feature . . . [was an] inquiry into the fundamental fairness of the plan.”⁸⁸

⁷⁶ See *supra* notes 53–56 and accompanying text.

⁷⁷ § 1126(c).

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ See *supra* notes 49–52 and accompanying text.

⁸¹ § 1126.

⁸² *Id.* § 1129(a)(3) (“The plan has been proposed in good faith and not by any means forbidden by law.”).

⁸³ See, e.g., *In re Cajun Elec. Power Coop., Inc.*, 230 B.R. 715, 737 (Bankr. M.D. La. 1999) (holding there was no “legitimate and honest purpose to reorganize” when a plan was intended to hold dissenting suppliers to twenty-five year contracts).

⁸⁴ BROUDE, *supra* note 47, at § 12.06, at 12-12.

⁸⁵ *Travelers Ins. Co. v. Pikes Peak Water Co. (In re Pikes Peak Water Co.)*, 779 F.2d 1456, 1460 (10th Cir. 1985).

⁸⁶ *In re ACandS, Inc.*, 313 B.R. 36, 43 (Bankr. D. Del. 2004).

⁸⁷ See *In re Coram Healthcare Corp.*, 271 B.R. 228, 234 (Bankr. D. Del. 2001).

⁸⁸ *Id.* (internal quotations and citation omitted).

B. *The Mechanics of § 363(b) Sales*

Section 363(b) preplan sales of all or substantially all of the debtor's assets have evolved into an alternative strategy for the debtor to accomplish liquidation.⁸⁹ While sales of the debtor's assets have long been an accepted and common part of structuring a reorganization plan, a sale of the entire business is suspect. Opponents believe that § 363(b)'s legislative history does not support the sale of an entire business via this provision.⁹⁰ The majority of § 363(b)'s legislative history focuses on protecting the creditors' collateral.⁹¹ Therefore, the sale of an entire business was neither contemplated nor intended.⁹²

As evidenced from the chapter 11 requirements discussed above, the traditional protections afforded to creditors are absent with § 363(b)'s sole requirements of notice and hearing. Coupled with the lack of protections, much of the controversy surrounding § 363 preplan business sales focuses on the finality of the sale under § 363(m). Section 363 provisions also balance debtor tools and creditor protections, similar to chapter 11 provisions, yet within the context of preplan business sales, creditors are not satisfactorily protected by the procedural requirement of notice and a hearing.⁹³ The debtor almost exclusively controls § 363 sales and § 363(m)'s finality strengthens the debtor's influence. These provisions are discussed in turn.

1. *Notice and a Hearing*

There are minimal requirements for a § 363(b) sale. First, only transactions outside the ordinary course of business require notice and a hearing.⁹⁴ The sale of all or substantially all of the debtor's assets easily qualifies as a nonordinary course action.⁹⁵ Prior to court approval, the unsecured creditors'

⁸⁹ Traditionally, chapter 11 is seen as the reorganization plan and chapter 7 as the liquidating plan. Section 363 controversially allows liquidation in chapter 11. Case conversion, § 1112(a), is not required.

⁹⁰ See, e.g., George W. Kuney, *Let's Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy*, 40 Hous. L. Rev. 1265, 1269 (2004).

⁹¹ H.R. REP. NO. 95-595, at 181-84 (1977); COURTING FAILURE, *supra* note 20, at 168 n. 89.

⁹² H.R. REP. NO. 95-595, at 181-84.

⁹³ "After notice and a hearing" is an accommodating standard that takes into account the particular circumstances of the case. 11 U.S.C. § 102(1)(A) (2000) (internal citations omitted); *see infra* note 103.

⁹⁴ §§ 363(b), (c)(1).

⁹⁵ See, e.g., Burlington N. R.R. Co. v. Dant & Russell, Inc. (*In re Dant & Russell, Inc.*), 853 F.2d 700, 704 (9th Cir. 1988) (defining ordinary course of business transactions). To discern whether a transaction is outside the ordinary course, courts typically make a two-step inquiry. First, commonly referred to as the horizontal test, the court determines whether the proposed transaction would comply with objective industry

committee receives notification, and there is a hearing for any objections to the proposed sale.⁹⁶ The disclosure requirement for chapter 11 voting parties is significantly different from notice with a § 363(b) sale.⁹⁷ With a § 363 sale, fewer people receive less information, and the lack of a disclosure requirement weakens creditor leverage when compared with what leverage they may have had with chapter 11 plan confirmation.

The hearing requirement allows for creditor objections. However, the onus for objecting to a § 363(b) transaction is borne by the objecting party.⁹⁸ The lack of a full disclosure requirement, as compared to § 1125(b), contributes to the difficulty for a party in interest to prepare a well-reasoned objection within the twenty days⁹⁹ prior to the hearing. The § 363(b) notice requirement on its face¹⁰⁰ does not include a comparable level of detail with chapter 11's plan summary and disclosure.¹⁰¹

In *In re Naron & Wager, Chartered*,¹⁰² the court addressed the vague definition of notice and a hearing in § 363(b) and § 102(1)(A).¹⁰³ The court required more from the debtor than mere formalistic compliance with the statutes. In reviewing the policy underlying different bankruptcy chapters, the court applied a stricter minimum standard for the contents of notice. The court stated:

The Court has a responsibility to review this proposed sale carefully because of the circumstances of the sale. The sale is private; it is to a corporation controlled by insiders of the seller, which is Debtor's subsidiary; the sale will liquidate a substantial asset of Debtor; and the sale is a preconfirmation sale controlled by the Debtor in Chapter

standards or practices. Second, the court assesses the dynamics between the particular debtor and creditor to make a subjective determination of ordinary course. See *In re Roth Am., Inc.*, 975 F.2d 949, 952 (3d Cir. 1992).

⁹⁶ § 363(b). If a debtor proceeds with a sale that is later deemed to be outside the ordinary course of business and requiring more procedural protection for the creditor, the trustee or DIP may avoid the transfer. *Id.* § 549(a).

⁹⁷ See *infra* notes 103–11 and accompanying text for additional disclosure-like requirements as discussed in *In re Naron & Wagner, Chartered*, 88 B.R. 85, 88 (Bankr. D. Md. 1988).

⁹⁸ See *Instit'l. Creditors of Continental Air Lines, Inc. v. Continental Air Lines, Inc. (In re Continental Air Lines, Inc.)*, 780 F.2d 1223, 1227 (5th Cir. 1986).

⁹⁹ FED. R. BANKR. P. 2002(a)(2) (2000) (amended 2005).

¹⁰⁰ 11 U.S.C. § 102(1)(A) (2000) (“[S]uch notice as is appropriate in the particular circumstances . . .”).

¹⁰¹ Compare § 102(1)(A) with § 1125(b).

¹⁰² *In re Naron & Wagner, Chartered*, 88 B.R. 85 (Bankr. D. Md. 1988).

¹⁰³ “[A]fter notice and hearing,” or similar phrase—means after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as appropriate in the particular circumstances . . .” § 102(1)(A).

11, rather than a sale within a Chapter 7 case where a disinterested trustee controls the proposed liquidation of assets. The Chapter 11 Debtor is here liquidating all or substantially all its assets without providing creditors and equity holders with adequate information through a written disclosure statement approved by the court after notice and a hearing pursuant to 11 U.S.C. § 1125. Creditors are not offered an opportunity to protect their interests through the Chapter 11 voting and confirmation process.¹⁰⁴

The court went on to conclude that appropriate notice would be the functional equivalent of information that would be included in a disclosure statement.¹⁰⁵ It even asserted that a lack of objection can serve as evidence that notice itself was insufficient.¹⁰⁶ The original notice failed for several reasons. First, the notice did not disclose that the sale included the last operating assets of the debtor.¹⁰⁷ Second, the notice did not state that the debtor was liquidating all its assets.¹⁰⁸ Third, the notice failed to include that the consideration paid by the purchaser would pay off a claim and not pass through the debtor.¹⁰⁹ With amended notice and sufficient evidence to support good business reasons¹¹⁰ for a § 363(b) sale, the court approved the sale.¹¹¹ Unfortunately, even blatant triggers, such as insider deals, only occasionally result in vigilant scrutiny by the court. The court's level of inquiry should maintain flexibility and relate to the fact-specific context of the case.¹¹² However, in traditional areas of increased scrutiny—good faith objections and insider dealing—notice should minimally include what chapter 11 requires.¹¹³ The fairness and legitimacy of the transaction and the larger bankruptcy process are at stake.

2. *Finality of the Sale: § 363(m) Mootness*

An increased level of scrutiny to ward off abuse is even further justified with § 363 preplan business sales because the opportunity to appeal the

¹⁰⁴ *In re Naron & Wagner, Chartered*, 88 B.R. at 88.

¹⁰⁵ *Id.* at 89.

¹⁰⁶ *Id.* at 88–89 (“Assuming adequate notice, the process is likely to be more self-policing . . .”).

¹⁰⁷ *Id.* at 89.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ See *infra* notes 160–66 and accompanying text.

¹¹¹ *In re Naron & Wagner, Chartered*, 88 B.R. at 89–90.

¹¹² See Jackson, *supra* note 4, at 455.

¹¹³ See *supra* notes 70–75 and accompanying text.

transaction is limited.¹¹⁴ Section 363(m) is a powerful tool for the debtor since an appeal from a § 363 sale is moot, unless the objector has obtained a stay pending appeal or the purchaser has not acted in good faith.¹¹⁵ Beyond this mention of good faith, the remaining provisions of § 363 do not have the explicit good faith requirement, as does chapter 11.¹¹⁶

The key differences between confirmation and § 363 preplan sales center on timing, information exchange, and voting rights for creditors. Parties in interest have only twenty days to assess the § 363 proposed sale. The expedited timeline exaggerates the loss of extensive DIP information that would be shared in a disclosure statement. Plan confirmation requires court approval of the disclosure statement prior to the creditor vote, but with a § 363 preplan sale creditors must invest intensified research time to even formulate an objection to the sale within twenty days. Further, the objecting party in a preplan sale hearing bears the burden of proving harm.¹¹⁷ This burden is in stark contrast to the multiparty negotiation facilitated in plan formulation where creditor voting required parties to work together for confirmation. Plan confirmation depends on creditor approval but § 363 sale approval depends on the creditors' failure.

The absence of creditor approval in § 363 sales may not drastically affect all parties in interest, but it may have a profound effect on others. Generally, the less bargaining power a creditor class in chapter 11 has, the greater the effect of losing their vote and corresponding leveraging points in § 363 sales.¹¹⁸ The loss of veto power with a § 363 preplan sale is significant to groups such as priority creditors because if they do not reach the level of administrative priority,¹¹⁹ their weak negotiating leverage is diminished even

¹¹⁴ 11 U.S.C. § 363(m) (2000) ("The reversal or modification on appeal of an authorization under subsection (b) or (c) of the section of a sale or lease of property does not affect the validity of a sale or lease . . . to an entity that purchased or leased such property in good faith . . .").

¹¹⁵ *Id.* (knowing the pendency of appeal does not affect the purchasers good faith assessment); *see also* Karbo Assocs. v. Colony Hill Assocs. (*In re* Colony Hill Assoc.), 111 F.3d 269, 272–74 (2d Cir. 1997) (inquiring whether a sale transaction was in good faith for purposes of § 363(m) is not subject to mootness and is reviewable on appeal). However, there is a prohibition on collusive bidding. § 363(n).

¹¹⁶ *Id.* § 1129(a)(3); *see supra* notes 82–88 and accompanying text; *see also In re* SGL Carbon Corp., 200 F.3d 154, 165 (3d Cir. 1999) (noting that several other courts consider the absence of good faith or a finding of bad faith grounds for dismissal under § 1112).

¹¹⁷ *See infra* note 170 and accompanying text.

¹¹⁸ Kuney, *supra* note 19, at 278.

¹¹⁹ Section 507 provides for claim priorities and dictates the order of payout upon confirmation.

further.¹²⁰ General unsecured creditors lose more than negotiating leverage in a preplan sale;¹²¹ they lose § 1129 protections of the “absolute priority rule”¹²² and the “best interest test.”¹²³ Section 363 sales give the debtor an advantage by circumventing the time-consuming and expensive process of confirmation, but that may not be all that is gained by the debtor. Disproportionate leverage in an accelerated sale also gives the debtor the opportunity for unfair dealing. Within the context of preplan business sales, the imbalance of control and power granted to the debtor may contribute to the courts’ reluctance to freely allow outside-of-plan sales.

II. SECTION 363(B) CASE LAW DEVELOPMENT

Historically, courts have resisted an unbridled use of nonreorganization sales. To contain the use of preplan sales, courts developed the emergency doctrine, the sub rosa doctrine, and the business justification test. The following case examples track the major decisions that restricted the debtor’s use of a preplan sale of all or substantially all of the debtor’s assets.

A. *The Emergency Doctrine*

In *In re Solar Manufacturing Corp.*,¹²⁴ the court denied the sale of the debtor’s assets because the sale did not comply with the provisions of chapter X.¹²⁵ The court stated that a debtor’s sale of assets outside a reorganization plan ought to be “confined to emergencies where there is imminent danger that the assets of the ailing business will be lost if prompt action is not taken.”¹²⁶ The court held there was no such emergency;¹²⁷ therefore, the sale was not approved.¹²⁸ The court further expressed its concern over the unrestricted use of outside-of-plan asset sales since they are “not surrounded by the rather

¹²⁰ Kuney, *supra* note 19, at 278 (hypothesizing that the impact on classes lower than priority creditors is negative).

¹²¹ *Id.* at 279.

¹²² § 1129(b)(2).

¹²³ *Id.* § 1129(a)(7) (requiring that an impaired class receive at least what they would have in liquidation); *see supra* notes 70–75 and accompanying text (contents of disclosure statement include a liquidation analysis).

¹²⁴ *In re Solar Mfg. Corp.*, 176 F.2d 493 (3d Cir. 1949).

¹²⁵ *Id.* (denying the sale assets to a competitor well below the going concern appraisal value because the court deemed no emergency existed, just a slow market).

¹²⁶ *Id.* at 494.

¹²⁷ *Id.*

¹²⁸ *Id.*

elaborate safeguards which the Congress has provided to protect the interests of those whose money is tied up in the tottering enterprise.”¹²⁹

A number of circuit courts later disapproved of *Solar's* broad restriction on the debtor's sale of assets and rejected or modified the emergency doctrine.¹³⁰ The Fifth Circuit's 1968 decision in *In re Dania Corp.*¹³¹ rejected the emergency test and implemented a “cause shown” standard by primarily relying on statutory language.¹³² The proposed sale would “realize substantial equity to the Debtor and, in turn, be of substantial benefit to the Debtor's creditors”¹³³ The benefit to the debtor's estate was enough cause to approve the sale under the statute because “[e]ven if no ‘emergency’ situation existed here, as that word is normally used, there was certainly just cause shown to warrant the sale”¹³⁴

Both *In re Dania Corp.* and *In re Solar Manufacturing Corp.* illustrate the tension between reorganization provisions and the separate provision allowing for the sale of assets outside the reorganization plan. The court's choice in *In re Dania Corp.* to reject *Solar's* emergency restriction and to rely instead upon the broader plain meaning of the statutory text mirrors the more liberal practice of courts approving § 363(b) transactions today.¹³⁵ However, courts still impose restrictions¹³⁶ reminiscent of the judicial legislation that the *In re Dania Corp.* court criticized.

¹²⁹ *Id.*

¹³⁰ *In re Equity Funding Corp. of Am.*, 492 F.2d 793 (9th Cir. 1974) (per curiam); *In re Wonderbowl, Inc.*, 424 F.2d 178 (9th Cir. 1970); *In re Air & Space Mfg., Inc.*, 394 F.2d 900 (7th Cir. 1968); Hurley, *supra* note 29, at 238 (describing *In re Marathon Foundry and Machine Co.*, 228 F.2d 594 (7th Cir. 1955)).

¹³¹ *Int'l. Bank of Miami v. Brock (In re Dania Corp.)*, 400 F.2d 833 (5th Cir. 1968).

¹³² *Id.* at 836 (stating that language of the statute makes no mention of impending emergency or necessity).

¹³³ *Id.* at 837 n. 2.

¹³⁴ *Id.* at 837.

¹³⁵ See Sloane, *supra* note 3, at 51 (granting preplan business sales unless there is an overt reason not to).

¹³⁶ There are two notable cases that imposed more rigid limits on the use of § 363(b) in a sale of assets outside of a reorganization plan. First, in *In re White Motor Credit Corp.*, the court concluded that a sale of all the estate's assets was reserved only for emergencies. *In re White Motor Credit Corp.*, 14 B.R. 584, 589 (Bankr. N.D. Ohio 1981). But see Hurley, *supra* note 29, at 242–43 (asserting that *In re White Motor's* reasoning was flawed). Second, in *In re D.M. Christian Co.*, the bankruptcy judge refused to enter an order approving a sale because the sale did not conform to the confirmation requirements set out in chapter 11. See *In re D.M. Christian Co.*, 7 B.R. 561, 562–63 (Bankr. N.D. W.Va. 1980.) But see *In re WHET, Inc.*, 12 B.R. 743, 750–51 (Bankr. D. Mass. 1981) (noting that *Christian* “has not been followed by any other courts and completely ignores the existence of § 363(b). Courts before and after the enactment of the Bankruptcy Reform Act of 1978 . . . have rejected the *Christian* approach.”).

B. *The Sub Rosa Objection*

The emergence of the sub rosa doctrine in the 1983 Fifth Circuit case *In re Braniff Airways, Inc.*¹³⁷ and the business justification test asserted in *In re Lionel Corp.*¹³⁸ shape § 363(b) analysis for courts today. *In re Braniff Airways, Inc.* provided the first mention of a sub rosa plan¹³⁹ in the context of a debtor's sale of assets. Essentially, a § 363(b) sale of assets is sub rosa if the remaining plan is predetermined based on the sale.¹⁴⁰ Other courts developed synonyms. A "creeping plan[] of reorganization"¹⁴¹ or a "de facto plan"¹⁴² is also a valid objection to § 363(b) sales because the possibilities of a reorganization are altered enough to serve as a reorganization by itself.

The court in *In re Braniff Airways, Inc.* examined the terms of the § 363 "PSA transaction."¹⁴³ The court skirted the issue of whether all assets could be sold via § 363(b) sale because it held that the PSA transaction¹⁴⁴ should not even be classified as a § 363(b) sale.¹⁴⁵ Instead, the court held that the terms of the transaction far exceeded the scope of a § 363(b) sale and reversed the district court's approval of the sale.¹⁴⁶ In exchange for Braniff's cash, aircraft, equipment, terminal leases, and landing slots, Braniff would receive \$7.5 million in travel scrip,¹⁴⁷ unsecured notes, and participation in PSA's proposed operation.¹⁴⁸ The court avoided assessing technicalities of the sale and exchange. Instead, it pinpointed the underlying substantive issue with the transaction. "The PSA transaction would also require significant restructuring of the rights of Braniff creditors"¹⁴⁹ and would "ha[ve] the practical effect of dictating some of the terms of any future reorganization plan."¹⁵⁰ The court predicated its reversal on the assertion that terms of the sale were sub rosa and

¹³⁷ Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (*In re Braniff Airways, Inc.*), 700 F.2d 935 (5th Cir. 1983).

¹³⁸ Comm. of Equity S'holders v. Lionel Corp. (*In re Lionel Corp.*), 722 F.2d 1063 (2d Cir. 1983).

¹³⁹ *In re Braniff Airways, Inc.*, 700 F.2d at 940. Sub rosa is defined as "confidential, secret, not for publication." BLACK'S LAW DICTIONARY 1468 (8th ed. 2004).

¹⁴⁰ Sloane, *supra* note 3, at 45.

¹⁴¹ *E.g.*, *In re Dow Corning Corp.*, 192 B.R. 415, 420 (Bankr. E.D. Mich. 1996).

¹⁴² *E.g.*, *In re Lion Capital Group*, 49 B.R. 163, 175 (Bankr. S.D.N.Y. 1985).

¹⁴³ *In re Braniff Airways, Inc.*, 700 F.2d at 939.

¹⁴⁴ An agreement and memorandum of understanding between debtor airline and its creditors were referred to jointly as the PSA transaction. *Id.* at 936.

¹⁴⁵ *Id.* at 939.

¹⁴⁶ *Id.*

¹⁴⁷ Comparable to a certificate, therefore, its use and value are limited by the terms of the issuer.

¹⁴⁸ *In re Braniff Airways, Inc.*, 700 F.2d at 939-40.

¹⁴⁹ *Id.* at 939.

¹⁵⁰ *Id.* at 940.

beyond the scope of permissible § 363(b) uses. Specifically, the terms of the use for the scrip¹⁵¹ greatly influenced the reorganization plan because Braniff's only options were to comply with the terms or forfeit a valuable asset.¹⁵²

For an already-insolvent business, a transaction that offers the debtor's cash in exchange for an asset with little liquidity should automatically trigger intensified judicial scrutiny. The court noted that this transaction would affect creditors' rights of Braniff, but it did not mention the possibility that the transaction might be an insider sale or product of unfair dealing.¹⁵³ The court's ruling, however, presumably improved the eventual payout for Braniff's unsecured creditors compared to the distribution that would have been available with the proposed PSA transaction. While the court's holding did not expound on the appropriate use of a *sub rosa* objection or specify a limitation on the use of § 363(b) sales, it did produce the oft-quoted language that provides valuable substantive guidance: "[T]he Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets."¹⁵⁴

C. *The Business Justification Test*

The Second Circuit established the business justification test with its *In re Lionel Corp.*¹⁵⁵ decision shortly following *Braniff*. After filing chapter 11 but prior to confirming a reorganization plan, the Lionel Corporation proposed a sale of its most important asset, eighty-two percent ownership of common stock in a manufacturing company, in exchange for forty-three million dollars in cash.¹⁵⁶ Both the bankruptcy court and district court approved the sale over objections from the Committee of Equity Security Holders.¹⁵⁷ In approving the sale, the district court's reasoning was largely based on the Creditors' Committee's insistence on the sale.¹⁵⁸

¹⁵¹ *Id.* at 939 (requiring that it only be used in "future Braniff reorganization and that it be issued only to former Braniff employees or shareholders or, in a limited amount, to unsecured creditors").

¹⁵² *Id.* at 940.

¹⁵³ These potential forms of abuse with § 363(b) sales are discussed *infra* in Part IV.

¹⁵⁴ *In re Braniff Airways, Inc.*, 700 F.2d at 940.

¹⁵⁵ *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2d Cir. 1983).

¹⁵⁶ *Id.* at 1065.

¹⁵⁷ *Id.* at 1065-66.

¹⁵⁸ *Id.*

The Committee of Equity Security Holders argued that this type of sale “deprives the equity holders of the Bankruptcy Code’s safeguards of disclosure, solicitation and acceptance and divests the debtor of a dominant and profitable asset which could serve as a cornerstone for a sound plan.”¹⁵⁹ The court concluded that court approval of the sale, lease, or use of property outside the ordinary course of business under § 363(b) required a business justification.¹⁶⁰ The court regarded its business justification requirement as a limit on unbridled judicial discretion with § 363 motions.¹⁶¹ At the same time, a business justification assessment permitted debtors to break from the rigid chapter 11 requirements and procedural safeguards.¹⁶²

The court considered the following factors to assess Lionel’s business justification for the sale of its most important asset:¹⁶³

- Proportionate value of the asset to the whole;
- Amount of elapsed time since 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 dispositions vis-à-vis any appraisals;
- Which of the § 363 alternatives, use, sale, or lease, the proposal envisions; and
- Whether the asset is increasing or decreasing in value.¹⁶⁴

In denying the sale, the Second Circuit stated that the appeasement of a major creditor was not a sufficient business justification.¹⁶⁵ The Lionel’s CEO admitted that the *sole* reason for the application to sell was the Creditors’

¹⁵⁹ *Id.* at 1066 (urging also that only emergencies can warrant the use of § 363(b)).

¹⁶⁰ *Id.* at 1070.

¹⁶¹ William T. Bodoh, John W. Kennedy & Joseph P. Mulligan, *The Parameters of the Non-Plan Liquidating Chapter Eleven: Refining the Lionel Standard*, 9 BANKR. DEV. J. 1, 5 (1992) (“§ 363(b) does not grant a judge carte blanche”) (citing *In re Lionel Corp.*, 722 F.2d at 1069).

¹⁶² *In re Lionel Corp.*, 722 F.2d at 1065–68. The court does not suggest that § 363(b)’s application requires a literal reading of the provision. *Id.* (“Yet, analysis of the statute’s history and over seven decades of case law convinces us that such a literal reading of § 363(b) would unnecessarily violate the congressional scheme for corporate reorganizations”).

¹⁶³ Its most important asset was ownership of eighty-two percent of Dale Corporation’s common stock. Dale’s balance sheet reflects a healthy company with \$28 million in shareholder’s equity and a reported \$18 million dollar profit in the period ending December 1982. *Id.* at 1065.

¹⁶⁴ *Id.* at 1071 (stating that the last factor was the most important in assessing the proposed sale, use, or lease).

¹⁶⁵ *Id.* at 1070–72.

Committee's insistence on it.¹⁶⁶ The business justification test remains to be the dominant standard for assessing asset sales outside the ordinary course of business pursuant to § 363(b).

In *In re Continental Airlines, Inc.*,¹⁶⁷ the Fifth Circuit refined the method of approaching a sub rosa allegation by considering the *Lionel* factors.¹⁶⁸ In denying the § 363 motion, the court established several key standards.¹⁶⁹ First, the objector bears the responsibility for identifying which chapter 11 protection is denied.¹⁷⁰ Additionally, the Fifth Circuit granted authorization for lower courts to “fashion[] appropriate protective measures modeled on those which would attend a reorganization plan.”¹⁷¹ The court created a conditional approval option for a sale instead of limiting the court's role to a simple ruling of approval or denial. Essentially the court gave itself authority to approve the transaction with modifications that could reinstate any necessary protections circumvented by a § 363(b) sale.¹⁷²

Craig Sloane asserts in his article, *The Sub Rosa Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, that the *Continental* decision encourages judges to scrutinize § 363 preplan sales more carefully.¹⁷³ The additional burden on the objector “should be rewarded with closer scrutiny of the transaction to which it objects and, theoretically, greater sensitivity to its concerns.”¹⁷⁴ Unfortunately, courts have continued to evaluate plans inconsistently and often only rely on *Braniff*, *Lionel*, and *Continental* as a basis for mere factual comparison.¹⁷⁵ Inconsistencies and vulnerabilities of § 363 preplan business sales invite and tolerate unfair dealing at the expense of the parties in interest, our bankruptcy system, and the larger business economy.¹⁷⁶

¹⁶⁶ *Id.* at 1065 (referring to CEO's statement that there was no reason why the sale could not be accomplished through its reorganization plan).

¹⁶⁷ *Inst. Creditors of Continental Air Lines, Inc. v. Continental Air Lines, Inc. (In re Continental Air Lines, Inc.)*, 780 F.2d 1223 (5th Cir. 1986).

¹⁶⁸ *Id.* at 1228.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² Sloane, *supra* note 3, at 51 (generating flexibility for judges).

¹⁷³ *Id.*

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*; e.g., *In re Rausch Mfg. Co.*, 59 B.R. 501, 503 (Bankr. D. Minn. 1985).

¹⁷⁶ While beyond the scope of this Comment, Lynn M. LoPucki deconstructs the factors contributing to corruption in the bankruptcy system as a whole in his book, *Courting Failure*. He asserts that court competition for large bankruptcy cases and businesses with assets in excess of \$220 million induces judges to create policies that make their courts more attractive. The reputation for infrequent trustee appointment,

III. SECTION 363(B) APPLICATION

Today, § 363 sales offer a drastically accelerated approval process when compared to chapter 11 plan confirmation and attract debtors seeking to complete quicker and less expensive transactions. Fewer requirements reduce the duration and expense, but without restrictions opportunities for abuse also arise. Empirically, the number of § 363 preplan sale motions for all or substantially all of the debtor's assets dramatically increased in the 1990s and preplan sales enjoy even more use since 2000.¹⁷⁷ The benefits that § 363(b) preplan sales offer to debtors are so pronounced that one commentator suggests it may even be malpractice to not advise clients of its potential benefits when planning for bankruptcy today.¹⁷⁸

Since *Lionel*, courts have considered an array of articulated business justifications for § 363(b) preplan sales and simple assets sales. The DIP typically asserts that savings of time and/or money via § 363 sales maximize value for the estate.¹⁷⁹ In fact, some courts have simply used a best interest test, instead of the *Lionel* business justification test, but this standard has been used sparingly.¹⁸⁰

A. *Sound Business Justifications*

Courts regularly apply the business justification standard for approval of § 363 preplan business sales.¹⁸¹ Yet the basis for court approval varies.¹⁸² There are reoccurring business justifications that typically result in approval of the debtor's sale of all or substantially all of its assets. Sales that allow the debtor to avoid unnecessary administrative costs, sales where time is of the essence, and sales that preserve the going concern value of the business are generally found to be sound business justifications.

deference to the debtor's management, and "rubber stamping" are alluring traits for businesses that are filing bankruptcy. COURTING FAILURE, *supra* note 20, at 12–14, 104, 176.

¹⁷⁷ COURTING FAILURE, *supra* note 20, at 168 (increasing use of § 363 business sales is also linked to increased use of these sales in mega-bankruptcies); Lynn M. LoPucki, Bankruptcy Research Database, available at <http://lopucki.law.ucla.edu> (last visited Jan. 12, 2007).

¹⁷⁸ Kuney, *supra* note 19, at 273.

¹⁷⁹ Bodoh, Kennedy & Mulligan, *supra* note 161, at 7.

¹⁸⁰ See, e.g., *Fin. Assocs. v. Loeffler (In re Equity Funding Corp.)*, 492 F.2d 793, 794 (9th Cir. 1974) (holding that the sale was in the best interest of the estate because the asset was deteriorating).

¹⁸¹ See Shea et al., *supra* note 13.

¹⁸² 7 COLLIER ON BANKRUPTCY ¶ 1129.01 (Lawrence P. King, et al eds., 15th ed. rev. 2006) (stating that courts differ as to the extent that they permit the sale of substantially all assets outside a bankruptcy plan).

1. Avoiding Administrative Cost

The administrative costs of case conversion are sufficient for approval of a § 363 sale motion.¹⁸³ In *In re Alves Photo Service, Inc.*, the court approved a § 363 sale of substantially all of the debtor's assets based on the reasoning that upon conversion¹⁸⁴ to chapter 7, the role of the DIP terminates and additional administrative expenses will attach to the estate.¹⁸⁵ Similarly, in *In re WHET, Inc.*,¹⁸⁶ no conversion to chapter 7 was required with a cash sale of substantially all of the debtor's assets.¹⁸⁷

2. Time Is of the Essence

Justifying a § 363 preplan business sale is perhaps more obvious when time is of the essence for the transaction. Many courts¹⁸⁸ follow the analysis in *In re Oneida Lake Development, Inc.*¹⁸⁹ which mimics the emergency doctrine reasoning in *In re Solar Manufacturing Corp.*¹⁹⁰ In *In re Oneida Lake Development, Inc.*, the debtor pled for an "immediate"¹⁹¹ sale only within sixty days¹⁹² of its chapter 11 filing. After evaluating the sale of the debtor's business and property with the *Lionel* factors,¹⁹³ the bankruptcy court approved the sale because the proposal brought the best price and the assets were declining in value.¹⁹⁴ Despite only having limited information, with neither a plan nor a disclosure statement, the court succumbed to the pressure of the DIP. The court is generally persuaded by maximizing value to the estate. Especially when there are no creditor objections, the court is reluctant to

¹⁸³ E.g., *In re Alves Photo Serv., Inc.*, 6 B.R. 690, 695 (Bankr. D. Mass. 1980) (approving the sale of substantially all of the debtor's assets).

¹⁸⁴ See 11 U.S.C. § 1112(a) (2000).

¹⁸⁵ *In re Alves Photo Servs, Inc.*, 6 B.R. 690, 694 (Bankr. D. Mass. 1980) (contemplating the added expenses of trustee, delay and expense associated with replacing and educating replacement fiduciaries, and the possibility of duplication with discovery efforts).

¹⁸⁶ *In re WHET, Inc.*, 12 B.R. 743 (Bankr. D. Mass. 1981).

¹⁸⁷ *Id.* at 750–51 (rejecting the argument that the debtor must state why a plan will not be filed or the case will be converted).

¹⁸⁸ E.g., *Criimi Mae Servs. Ltd. P'ship v. WDH Howell L.L.C. (In re WDH Howell, L.L.C.)*, 298 B.R. 527 (Bankr. D. N.J. 2003).

¹⁸⁹ *In re Oneida Lake Dev., Inc.*, 114 B.R. 352 (Bankr. N.D.N.Y. 1990).

¹⁹⁰ See *supra* notes 124–29 and accompanying text.

¹⁹¹ *In re Oneida Lake Dev., Inc.*, 114 B.R. at 355.

¹⁹² *Id.* at 354.

¹⁹³ See *supra* note 163 and accompanying text.

¹⁹⁴ *In re Oneida Lake Dev., Inc.*, 114 B.R. at 356–57.

scrutinize quick transactions since a denial would risk irreparable¹⁹⁵ diminished payouts to creditors.

3. *Preserving the Going Concern*

Since rehabilitation is one of the fundamentals in chapter 11 bankruptcy,¹⁹⁶ bankruptcy judges place tremendous value on preserving the going concern value of the business. The added value of an operating business is a strong justification for § 363(b) sales.¹⁹⁷ For example, in *In re Naron & Wagner, Chartered*,¹⁹⁸ the bankruptcy court approved the computer supply company sale while commenting, “[F]ailure to close the sale quickly will likely result in a halt of [its] continuous operations. If [it] cannot be sold as a going concern, there will be a substantial decrease in its value to the Debtor’s estate.”¹⁹⁹ Even societal benefits and job retention from an industry presence in the community have served as a business justification for approving preplan business sales.²⁰⁰

A consistent theme in the courts’ assessment of business justification is the debtor’s superior position in liquidation efforts.²⁰¹ This is a fundamental difference between chapter 7 and chapter 11 bankruptcies. Upon filing bankruptcy in chapter 7, a trustee is appointed with the sole purpose of liquidating the debtor’s assets and maximizing value for the estate.²⁰² With a chapter 11 filing the debtor’s management typically remains in the DIP role.²⁰³ Pre-existing business relationships and industry expertise are generally seen as tools to maximize the estate value, especially when compared to the options of distressed sales or public auctions by a trustee in chapter 7.²⁰⁴ Deference to the debtor’s expertise and connections is especially common with complex business structures and specialized industries.²⁰⁵

¹⁹⁵ Section 363(b) sales are final. *See supra* notes 113–15 and accompanying text.

¹⁹⁶ *See supra* note 41 and accompanying text.

¹⁹⁷ Kuney, *supra* note 90; *see also* Bodoh, *supra* note 179, at 10.

¹⁹⁸ *In re Naron & Wagner, Chartered*, 88 B.R. 85 (Bankr. D. Md. 1988); *see supra* notes 102–11 and accompanying text.

¹⁹⁹ *In re Naron & Wagner, Chartered*, 88 B.R. at 90.

²⁰⁰ *See, e.g., In re Rausch Mfg. Co.*, 59 B.R. 501, 503 (Bankr. D. Minn. 1985).

²⁰¹ *Id.*

²⁰² In chapter 7 the debtor has no control over any assets. All of the debtor’s property becomes property of the estate, save exemptions, which is managed by the trustee.

²⁰³ *See supra* notes 45–48 and accompanying text.

²⁰⁴ Bodoh, *supra* note 179, at 12.

²⁰⁵ Jackson, *supra* note 4, at 496 (using failing dot-com businesses as examples).

Without comprehensive information available to the court and the committee the sale is vulnerable to sweetheart deals or unfair dealing. As applied, the business justification test falls short of a prudent inquiry. The lax standards used to evaluate these sales have contributed to some of the most corrupt and egregious acts by mega-companies in our country's history.²⁰⁶

B. Beyond Business Justification: An Increased Level of Scrutiny

Courts occasionally intensify the scrutiny of the debtor's business justification when a § 363 sale is disputed.²⁰⁷ In *In re Enron Corp.*, the bankruptcy order approved the debtor's proposed sale because it fell within the scope of its business judgment.²⁰⁸ An appeal followed and the district court considered the merits of the debtor's business judgment.²⁰⁹ The court stated that an objection to a sale of substantially all of the debtor's assets requires "more than cursory scrutiny" because the debtor did not go through confirmation requirements.²¹⁰ In addition to evaluating whether the proposed sale price was fair and reasonable,²¹¹ this court demanded that the lower court conduct an analysis of the proposed sale itself.²¹² The court based the need for an increased level of scrutiny on context and the fact-specific nature of the case.²¹³ The court explicitly stated that "meaningful scrutiny of the allocation here in issue is needed, among other reasons, to address the possibility that the allocation may have been infected by self-dealing on the part of Enron Corp."²¹⁴ The order was vacated and remanded.²¹⁵ On remand, the court was ordered not to "defer in conclusory fashion to the debtors' business judgment but to consider on the merits whether the price . . . was a fair reflection of those assets' relative value"²¹⁶

²⁰⁶ COURTING FAILURE, *supra* note 20, at 9.

²⁰⁷ *E.g.*, *Mission Iowa Wind Co. v. Enron Corp.* (*In re Enron Corp.*), 291 B.R. 39 (S.D.N.Y. 2003).

²⁰⁸ *Id.* at 41 (filing chapter 11 simultaneously with a § 363 motion for a prenegotiated sales agreement).

²⁰⁹ *Id.* at 43 (also determining that the appeal was not moot).

²¹⁰ *Id.* (citing to *Comm. of Equity Sec. Holders v. Lionel Corp.* (*In re Lionel Corp.*), 722 F.2d 1063, 1070 (2d Cir. 1983)).

²¹¹ *Id.* at 43; *see also* 3 COLLIER ON BANKRUPTCY ¶ 363.02 (Lawrence P. King, et al eds., 15th ed. Rev. 2006).

²¹² *In re Enron Corp.*, 291 B.R. at 43 (stating that the bankruptcy court avoided any of its own analysis and solely deferred to the parties' business judgment).

²¹³ *Id.*

²¹⁴ *Id.* (recognizing that Enron Corp. and not Enron Wind of its U.S. subsidiaries negotiated the deal with General Electric).

²¹⁵ *Id.*

²¹⁶ *Id.* (also requiring a finding of fact).

The issues in the *In re Enron Corp.* appeal revealed the danger in having a low threshold for the business justification test. Yet, even the notorious reputation of the debtor, Enron, did not initially trigger any intensified scrutiny with the bankruptcy court.²¹⁷ Instead, the bankruptcy court merely accepted an infamous company's valuation and sale proposal at face value.²¹⁸ While, here, court oversight caught the lack of scrutiny, it only had the opportunity because of a party in interest's appeal.²¹⁹ The bankruptcy court's casual approval of the sale demonstrates the vulnerability of § 363 preplan business sales when its assessment is based on the manipulable business justification test.

1. A Good Faith Rule: The Intent to Reorganize

To augment the low business justification standard in *Lionel*, several courts condition the filing of a bankruptcy petition upon a finding of good faith.²²⁰ Based on the court's analysis of § 1112,²²¹ it concluded that SGL, the debtor, did not file in good faith because there was not an intent to reorganize.²²² The court was not evaluating the good faith of the plan²²³ but instead the debtor's intended use of chapter 11 protections.²²⁴ SGL's financial disclosures indicated that its assets far exceeded its liabilities.²²⁵ The court found only a "mere possibility of a future need to file"²²⁶ and concluded that filing as a litigation tactic did not comport with the good faith standard.²²⁷

2. A Broader Interpretation of Good Faith Assessments

The more persisting view of good faith in § 363 preplan sales is a more flexible standard.²²⁸ In *In re PPI Enterprises, Inc.*, the court applied the *In re*

²¹⁷ *Id.* at 41 (finding appropriate business justification without deciding the merits of the controversy).

²¹⁸ *Id.*

²¹⁹ *Id.* Enron argues that the sale should be final. See *supra* notes 114–16 and accompanying text.

²²⁰ *E.g., In re SGL Carbon Corp.*, 200 F.3d 154 (3d Cir. 1999).

²²¹ Section 1112 provides grounds for a chapter 11 dismissal. Although § 1112 good faith does not appear in the enumerated reasons for dismissal, the statute uses the word "including" among the factors. "Including" suggests that the explicitly mentioned reasons are not exhaustive. *In re SGL Carbon Corp.*, 200 F.3d at 160.

²²² *Id.* at 166 (using the chapter 11 filing as a litigation tactic also concerned the court).

²²³ *Id.* at 167 n.17.

²²⁴ *Id.* at 166.

²²⁵ *Id.*

²²⁶ *Id.* at 164.

²²⁷ *Id.* The Third Circuit later relied on *In re SGL's* reasoning that filing as a litigation tactic was inconsistent with good faith requirements. *In re Integrated Telecom Express, Inc.*, 384 F.3d 108, 120 (3d Cir. 2004).

²²⁸ Jackson, *supra* note 4, at 495, 498 (emphasizing the bankruptcy courts' reluctance to constrain equitable powers of bankruptcy judges).

SGL good faith principle, but also concluded that good faith determinations require a case-specific inquiry.²²⁹ This court rejected *In re SGL*'s stricter standard. Instead, it adopted a more lax standard.²³⁰ The court prohibited the "abuse [of] bankruptcy law by employing it for a purpose for which it was not intended."²³¹ Therefore, a strategic petition that allows the debtor to avail itself of a certain Code provision is not necessarily bad faith.²³²

In addition to a more prevalent and flexible good faith standard, courts have also limited the scope of a bad faith inquiry. In *In re Condere Corp.*,²³³ the court stated, "The integrity of the sale is the issue to be addressed – not any general past conduct of a bidder in relation to other matters."²³⁴ Over the objections of the union and another corporation, the court affirmed the sale of all of the debtor's assets.²³⁵ The objectors asserted several reasons for its bad faith allegation. First, the objecting party used the committee's motion for a trustee as evidence of purchaser's lack of good faith.²³⁶ Also, they argued that good faith was destroyed since the purchaser was a shareholder of the debtor and the purchaser.²³⁷ The court stated that there was no precedent suggesting an automatic bar of purchases of the bankruptcy estate by insiders or fiduciaries.²³⁸

The court relied on a formalistic analysis of precedent to distinguish the facts of this case from those provided by the objecting party. For example, the objectors argued that heightened scrutiny was required when insiders serve as purchasers in § 363 sales because they are "rife with the possibility of abuse."²³⁹ The court distinguishes the role of the insider, here, with that in *In re Bidermann Industries, Inc.*²⁴⁰ In *In re Bidermann Industries, Inc.*, a CEO was hired for his expertise in running troubled companies, and the court denied the § 363 sale of the debtor's major asset when that same CEO was slated as

²²⁹ *Solow v. PPI Enters. (U.S.), Inc. (In re PPI Enters. (U.S.), Inc.)*, 324 F.3d 197, 210–11 (3d Cir. 2003) ("[C]ourts have not identified with any consistency which circumstances of the debtor's filing are indicia of good faith . . .").

²³⁰ *Id.*

²³¹ *Id.* (quoting *In re PPI Enters. (U.S.), Inc.*, 228 B.R. 339, 345 (Bankr. D. Del. 1998)).

²³² *Id.*

²³³ *In re Condere Corp.*, 228 B.R. 615 (Bankr. D. Miss. 1998).

²³⁴ *Id.* at 631 (citing *Gross v. Russo (In re Russo)*, 762 F.2d 239, 243 (2d Cir. 1985)).

²³⁵ *Id.* at 637.

²³⁶ *Id.* at 631.

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ *Id.* at 632 (citing *In re Bidermann Indus., U.S.A., Inc.*, 203 B.R. 547, 551 (Bankr. S.D.N.Y. 1997)).

²⁴⁰ *Id.*

the purchaser.²⁴¹ The *In re Condere Corp.* court summarized the reasoning in *In re Bidermann Industries, Inc.*:

[T]he court went on to state that it was concerned not so much with the purchaser's position as chief executive officer, but more importantly, with the fact that he was hired by the debtor for his professional expertise in running troubled companies. . . . In the case at bar, the Purchaser is not the chief executive officer of the Debtor.²⁴²

The court did examine the relationship between the purchaser and the debtor. However, it also restricted its scrutiny to a rigid definition of good faith.²⁴³ In large part, the court simply fell back on the sound business justification asserted by the debtor to affirm the sale.²⁴⁴

IV. SWEETHEART DEALS AND CORRUPTION WITH § 363(B) PREPLAN BUSINESS SALES

Whether it is the inconsistent scrutiny afforded § 363 sales or the more aggressive use by debtors, the current standards are not sufficient to shield the bankruptcy system from unfair dealing and abuse. Within the context of minimal disclosure requirements,²⁴⁵ a fast-paced approval process,²⁴⁶ and negligible checks against insider dealing,²⁴⁷ debtors have manipulated the protections of bankruptcy.

A. *Business Justification Manipulation*

The business justification test for § 363 sale approval is sweepingly broad.²⁴⁸ Many of the approved justifications for a sale are also themes of chapter 11 protections. For example, the automatic stay²⁴⁹ and tools for

²⁴¹ *In re Bidermann Indus., U.S.A., Inc.*, 203 B.R. at 551.

²⁴² *In re Condere Corp.*, 228 B.R. at 632.

²⁴³ *Id.* (citing *Rock Indus. Mach. Corp.*, 572 F.2d 1195, 1198 (7th Cir. 1978)) (“Typically, the misconduct that would destroy a purchaser’s good faith status at a judicial sale involves fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders.”).

²⁴⁴ *Id.* at 631, 636 (subject to slight modifications).

²⁴⁵ See *supra* notes 94–101 and accompanying text.

²⁴⁶ *COURTING FAILURE*, *supra* note 20, at 168 (comparing the average time it takes to close on a house with the time it takes to sell an entire business).

²⁴⁷ See, e.g., *Mission Iowa Wind Co. v. Enron Corp. (In re Enron Corp.)*, 291 B.R. 39 (S.D.N.Y. 2003).

²⁴⁸ See *supra* notes 181–82 and accompanying text.

²⁴⁹ 11 U.S.C. § 362 (2000); see *supra* note 51 and accompanying text.

obtaining postpetition financing²⁵⁰ are based on the presumption of illiquidity by the debtor. Chapter 11 allows the company to stabilize, continue operations, and make efforts to reorganize or wait for the right buyer who offers a fair price.²⁵¹ Therefore, the credence courts give to dwindling liquidity as a sound business justification is flawed.

The debtor's management, in the role of DIP, also has the ability to manipulate the asserted immediate need for a § 363 sale approval. In Lynn M. LoPucki's book, *Courting Failure*, he uses the Derby Cycle Corporation as a case study on sweetheart deals and corruption with § 363 preplan sales.²⁵² The debtor, Derby Cycle Corporation, brings in the corporation's founder to serve as turnaround management when it experiences financial difficulty. Following five months of research by the turnaround management group, Derby Cycle Corporation decided to sell its European subsidiary.²⁵³ Upon announcing the subsidiary sale, Derby's urgency rhetoric began.²⁵⁴ Without the revenues from the European subsidiary, Derby insisted that "the Debtor's business is not viable on a stand-alone basis."²⁵⁵ The debtor urged for sale approval prior to a critical revenue-generating event, a bike trade show one month away, for any chance of future viability. The court approved the business sale only forty-three days after Derby Cycle Corporation filed chapter 11.²⁵⁶ Despite not meeting the bike show deadline,²⁵⁷ the sale was completed very quickly. In objecting to the sale, the trustee pointed out that the debtor essentially manufactured his own emergency by delaying the chapter 11 filing.²⁵⁸ The trustee explained:

[T]he rushed nature of this sale appears to be a creation of the Buyer's own doing, who, it can be assumed, as Chief Executive Officer of the Debtor, played some role in the decision to delay the filing of Chapter 11 until shortly before these events. Indeed, it is

²⁵⁰ *Id.* § 364; see David A. Skeel, *Threats to Secured Lending and Asset Securitization*, 25 CARDOZO L. REV. 1905 (2004).

²⁵¹ COURTING FAILURE, *supra* note 20, at 177.

²⁵² *Id.* at 169, 172.

²⁵³ *Id.*

²⁵⁴ *Id.* at 172.

²⁵⁵ *Id.* at 172 (quoting Motion for Orders Under 11 U.S.C. §§ 105, 363, 365, and 1146(c), dated Aug. 21, 2001, Docket No. 14, *In re Derby Cycle Corp.*, Case No. 01-10200 (Bankr. D. Del.) at 6–7).

²⁵⁶ *Id.* at 170 tbl. 11.

²⁵⁷ *Id.* at 172. The court approved the sale three days after the bike show and the sale was completed one month after the show. *Id.*

²⁵⁸ *Id.* at 173.

arguable that the Buyer's actions caused the quickly deteriorating conditions that Debtor now alleges require a quick sale.²⁵⁹

The court's stilted business justification assessment coupled with the debtor's ability to manufacture a sufficient reason for sale approval foster potential and actual abuse with § 363 business sales.

The court can even play into the debtor's manipulation of its asserted business justification with prior rulings. In *In re Medical Software Solutions*, the court approved the preplan business sale primarily because of the debtor's immediate need.²⁶⁰ Its going concern was at risk of substantially decreasing in value. One reason for a quick sale was the threat of the debtor losing its licensing agreement.²⁶¹ However, as a condition of its financing deal, Medical Software Solutions agreed to relinquish its licensing agreement to OfficeRX if its operations ceased.²⁶²

B. Sweetheart Deals: Insider and Unfair Dealing

Compared to chapter 11 disclosure requirements, the information provided to the unsecured creditors' committee in a § 363(b) sale is sparse.²⁶³ The diminution in information and time creates the potential for unfair dealing with § 363 sales. While these characteristics only suggest the potential for abuse, preliminary results from a LoPucki empirical study suggest that § 363 insider dealing occurs with disproportionate frequency when compared to chapter 11 confirmed plans.²⁶⁴ Another trend is that purchasers in § 363 sales commonly hire the debtor's management and "reward them with stock totaling in value as much as 5 percent to 10 percent of the entire company."²⁶⁵ This type of arrangement serves as "a standing bribe offer for managers to arrange sweetheart deals on the sales of their companies."²⁶⁶

²⁵⁹ *Id.* (quoting Objection of the United States Trustee to Motion for Orders, dated Aug. 31, 2001, Docket No. 47, *In re Derby Cycle Corp.*, Case No. 01-10200 (Bankr. D. Del.) (at paragraph 13)).

²⁶⁰ *In re Med. Software Solutions, Inc.*, 286 B.R. 431 (Bankr. D. Utah 2002).

²⁶¹ *Id.* at 437.

²⁶² *Id.* at 436. Incidentally, an OfficeRX consultant sits on both the debtor's and purchaser's board. *Id.*; see *infra* notes 274–81 and accompanying text.

²⁶³ A disclosure requirement would provide a detailed depiction of debtor's financial condition, the reason for the proposed sale, alternatives to the sale, and ulterior motives for the sale. See *supra* notes 70–75 and accompanying text.

²⁶⁴ COURTING FAILURE, *supra* note 20, at 175.

²⁶⁵ *Id.* (citing Deposition of William L. Flaherty, July 1, 2003, at 162, Exhibit 107 to the Examiner's Report, Docket No. 2954, *In re Polaroid Corp.*, Case No. 01-10864 (Bankr. D. Del.)).

²⁶⁶ *Id.* at 174.

Management rewards played a significant role in Polaroid's bankruptcy § 363 preplan business sale. Polaroid offered up OEP Imaging, a new venture capitalist sponsored corporation, as its purchaser,²⁶⁷ and no other bids were made.²⁶⁸ Despite the \$1.8 billion assets value asserted with Polaroid's chapter 11 filing, the § 363 sale was approved over objections from the creditors' committee for \$465 million.²⁶⁹ The sale included taking on \$200 million in secured debt, but that debt was already covered by Polaroid's cash assets that totaled at least \$200 million at the time of the sale.²⁷⁰ Later investigations into the deal revealed that many individuals profited from the deal.²⁷¹ The public was unsettled²⁷² with the outcome of the Polaroid sale, and as recently as September 2004 a pro se litigant continued to challenge the sale.²⁷³

In *In re Medical Software Solutions*, the bankruptcy court approved a preplan sale for all of the debtor's assets to an inside creditor, the debtor's start-up lender.²⁷⁴ The debtor experienced changes in its board members within two years of filing bankruptcy, and the creditor-purchaser, DF Lenders, shared four board members with Medical Software Solutions at the time of the § 363 sale motion and approval.²⁷⁵ Less than ten days after filing chapter 11, the debtor sought the appointment of an examiner "to preempt²⁷⁶ the anticipated allegations of bias against the current board."²⁷⁷ The examiner's report relied upon prebankruptcy sale attempts by the investment banking firm Thomas Weisel Partners.²⁷⁸ The purchase agreement was also subject to better

²⁶⁷ *Id.* at 175. The members of OEP have never been disclosed. *Id.*

²⁶⁸ *Id.*

²⁶⁹ *Id.* at 176.

²⁷⁰ *Id.* at 175.

²⁷¹ Jeffrey Krasner, *Once-Ailing Polaroid Pays Off for New Owners*, BOSTON GLOBE, Sept. 18, 2003. Former Polaroid executive was hired on by new company, paid a bonus of sixty-two percent of his annual salary, given between five to ten percent in equity, and an increase in his annual salary. Additionally, a member of the creditor's committee ended up owning over forty-two thousand shares of OEP. *Id.*

²⁷² See, e.g., Tom Becker & Lingling Wei, *Questions Mount in Chapter 11 of Former Polaroid*, WALL STREET JOURNAL ONLINE, Jan. 28, 2003.

²⁷³ *In re Polaroid Corp.*, No. BKR. 01-10864-PJW, 2004 WL 2223301 (D. Del. Sept. 30, 2004).

²⁷⁴ *In re Med. Software Solutions, Inc.*, 286 B.R. 431, 437 (Bankr. D. Utah 2002).

²⁷⁵ *Id.*

²⁷⁶ The CEO was fired and shortly thereafter there were significant changes to the board's structure and its members. New members included creditors and people with inside connections to the purchaser. *Id.* at 436.

²⁷⁷ *Id.* at 437.

²⁷⁸ *Id.* at 438. The court also acknowledged the debtors' prebankruptcy selection process in choosing TWP to aid in their marketing efforts. *Id.* at 436-37.

and higher offers, yet the only offer made was by OfficeRX.²⁷⁹ Incidentally, one of the board members of DF Lenders was a consultant for OfficeRX.²⁸⁰

In re Medical Software Solutions illustrates two common areas of abuse in § 363 preplan business sales. First, the debtor probably can avoid trustee appointment if it acts proactively. Debtors prefer the appointment of an examiner over that of a trustee. Courts also want to avoid trustee appointment since debtor-management is most qualified to run its business and because trustee appointment reduces the value of the estate.²⁸¹ In *In re Medical Software Solutions*, the preemptive motion by the debtor impressed the court.²⁸² Similarly, Enron's appointment of turnaround management gave the judge the opportunity to not appoint a trustee.²⁸³ The court reasoned that the hiring of a well-known turnaround manager would be sufficiently independent from the corrupt debtor. However, the same board that managed Enron prescandal was still in charge of the company through bankruptcy. Managers remained in control of the corporation and chose their own successor.²⁸⁴ Further, recommendations of the examiner did not bind the debtor.²⁸⁵

Second, the courts' deference to investment banking firms' "fully marketed" sales reveals the other area vulnerable to abuse. The investment banking groups are hired by, paid by, and controlled by the debtor.²⁸⁶ They have no incentive to indicate there is a higher bidder than the proposed purchaser.²⁸⁷ LoPucki reviewed the investment banking firms' bills in connection with the Derby Cycle sale.²⁸⁸ Although two firms attested to their unsuccessful attempts at finding a higher bidder, the final fee application did not reference any such services.²⁸⁹ Deference to the efforts of debtor-hired and debtor-controlled investment banking firms to justify the valuation of the proposed sale is a meaningless check against the debtor's proposal.

²⁷⁹ *Id.* at 438.

²⁸⁰ *Id.* at 436.

²⁸¹ See *supra* notes 45–48 and accompanying text.

²⁸² See *supra* note 276 and accompanying text.

²⁸³ COURTING FAILURE, *supra* note 20, at 14.

²⁸⁴ *Id.* at 173. The examiner recommended voiding Kenneth Lay's stock sale back to Enron worth ninety-five million dollars but the buyback was only voidable at Enron's election. LoPucki asserts, "A trustee would have elected to avoid those transactions, but Enron's management did not." *Id.* at 148.

²⁸⁵ *Id.* at 148.

²⁸⁶ *Id.* at 173.

²⁸⁷ *Id.* at 173–74.

²⁸⁸ *Id.* at 173.

²⁸⁹ *Id.*

Polaroid's § 363 sale may also demonstrate unfair tactics used by investment banking firms to discourage other potential buyers from bidding. Polaroid's investment banking firm initially presented to the court that \$32 million was the maximum value it could obtain for its sale of the division.²⁹⁰ However, persistent prospective bidders convinced the court to reopen the bidding.²⁹¹ Ultimately the division was sold for \$60 million as a result of open bidding.²⁹² Bidders later stated that the investment banking firm approached them with an overvalued claim for the division. In fact, the investment banking firm was routinely representing the division's worth as \$75 to \$125 million to discourage alternative bidding.²⁹³

The precarious decision for the courts with trustee appointment and deference to investment banking firms is also present in traditional reorganizations, but confirmation provides transparency to both the court and the impaired creditors with adequate information in disclosure requirements and creditor voting.²⁹⁴ Confirmation also almost always requires negotiations with its prescribed voting requirements.²⁹⁵ The internal procedural safeguards of information dispersal, transparency, and creditor voting are absent in § 363(b) sales. When the debtor's entire business is for sale, the integrity of the ongoing business operations and management are critical in ensuring that the business is sold for its maximum value. The debtor's ability to manipulate the value of the business is more of a vulnerability in § 363(b) sales because of the lack of transparency and the accelerated speed of the process. These same reasons also reinforce § 363(b)'s vulnerability because the lack of transparency and oversight can also lure debtors into sacrificing the value of the business in return for personal benefits with insider dealing schemes.²⁹⁶

²⁹⁰ Jeffrey Krasner, *Insiders Landed Out of the Running at Polaroid*, BOSTON GLOBE, Dec. 9, 2001, at E1 (reporting on the sale of Polaroid's Identification Systems Division unit); *see also* COURTING FAILURE, *supra* note 20, at 173.

²⁹¹ Jeffrey Krasner, *Suitors Say Polaroid Unit Sale Rules Unfair; Management Bid Favored, They Say*, BOSTON GLOBE, Nov. 2, 2001, at E3.

²⁹² *Id.*

²⁹³ *Id.*

²⁹⁴ *See supra* notes 70–75, 77–81, and accompanying text.

²⁹⁵ *See supra* notes 77–81.

²⁹⁶ The relationships between the debtor and investment banking firms mentioned in this Part may not meet the Code's definition of insider, yet the effect is the same. *See* 11 U.S.C. § 101(31) (2000).

C. Manipulation in Valuation

Information regarding the debtor's assets, its history, and its operating systems is critical in determining its valuation. Informed participation by outsiders, however, is difficult with § 363 preplan business sales because only limited information is offered to a small group of parties in interest.²⁹⁷ A purchaser outside of the proposed buyer is at a severe disadvantage for several reasons. Credit bidding,²⁹⁸ inadequate financial information on the debtor,²⁹⁹ short evaluative timeframes,³⁰⁰ and deal protection fees³⁰¹ are some of the tools that a debtor can employ to ensure its proposed § 363 business sale is successfully approved. Credit bidding and deal protection fees are not unique issues to § 363(b) sales, but again the lack of transparency and the lack of procedural safeguards³⁰² intensify the impact of these issues in § 363(b) preplan business sales.

Frequently the buyer is an existing creditor, so a noncreditor interested buyer will most likely suffer a loss to a credit bidder. The introduction of deal protection fees³⁰³ only strengthens the slated purchaser's likelihood of success. In LoPucki's Polaroid case study, he indicates that the purchaser, OEP, was in a no-lose situation.³⁰⁴ If their bid was successful they received more value than they paid.³⁰⁵ If they were outbid, they were guaranteed a \$5 million termination fee.³⁰⁶ Essentially, the fee gave them a \$5 million advantage if a bidding war resulted.³⁰⁷ Again, credit bidding and deal protection are not precluded in the confirmation process, but their use is more legitimized because of the increased scrutiny and transparency fostered in confirmation. Alternatively, these same tools can too easily pervert § 363(b) sales because of

²⁹⁷ Compare H.R. REP. NO. 95-595 at 226 (1977) (explaining purpose for requiring adequate information with the disclosure statement), with *supra* notes 94–101 and accompanying text.

²⁹⁸ See *infra* text accompanying note 309.

²⁹⁹ See *supra* notes 94–101 and accompanying text.

³⁰⁰ See *supra* note 99 and accompanying text.

³⁰¹ See *infra* notes 304–09 and accompanying text.

³⁰² See *supra* text accompanying notes 294–97.

³⁰³ Breakup fees are fees paid to the potential purchaser if the sale is not consummated for reasons outlined in the purchase agreement. *In re APP Plus Inc.*, 223 B.R. 870, 874 (Bankr. E.D.N.Y. 1998). Topping fees are paid to the lead bidder when a subsequent bidder becomes the eventual purchaser. Marc L. Barreca, David C. Neu & Kimberly W. Osenbaugh, *Technology Business Asset Sales in Bankruptcy*, Preston Gates Ellis LLP (2004), available at <http://www.prestongates.com/images/pubs/TechnologyBusinessAsset.pdf> (last visited October 7, 2006).

³⁰⁴ COURTING FAILURE, *supra* note 20, at 179.

³⁰⁵ *Id.*

³⁰⁶ *Id.*

³⁰⁷ *Id.*

diminished oversight, negotiation and participation by industry creditors, and the courts' reliance on the manipulable business justification test³⁰⁸ and uninformed creditor objections.

The speed of a § 363(b) sale also supports opportunities for abuse. An interested buyer only has a short time to make an alternative offer. For example, in *Derby Cycle's* § 363 sale³⁰⁹ the debtor debated for over eight months, while experiencing financial difficulty, before deciding to file bankruptcy.³¹⁰ It took the former owner over five months to prepare a bid.³¹¹ Obviously both of these parties had industry-specific knowledge and access to records. In contrast, the court opened the sale to better offers by uninformed parties for only five weeks.³¹² Liquidation under chapter 11 protections would have minimally required that the debtor distribute court-approved disclosure statements that met the adequate information standard prior to confirmation. Information-dispersal to creditors and claims holders is critical to informed participation and debtor oversight. Also, equal access to information greatly encourages parties in interest negotiations that more sufficiently legitimize purchase price and valuation.

Another flawed attempt at justifying the debtor's sale proposal is the courts' deference to bidding practices that expose assets to the market. The market cannot correct deal protection fees, credit bidding, and disparity in bidders' information. Additionally, the debtor's ability to limit participants even with open auctions makes the courts' use of market exposure as an objective standard insufficient as well. In *In re Torch Offshore, Inc.*, the court was explicitly satisfied with the value of the debtor's assets after an auction produced more than one hundred bids over a twelve-hour period.³¹³ The disparity between the appraisal value³¹⁴ and the sale value was of no significant concern to the court.³¹⁵ An overreliance on solutions that courts perceive as "generated by the marketplace"³¹⁶ only continues to mask potential

³⁰⁸ See *supra* text accompanying note 206.

³⁰⁹ See *supra* notes 252–59 and accompanying text.

³¹⁰ COURTING FAILURE, *supra* note 20, at 172.

³¹¹ *Id.*

³¹² *Id.*

³¹³ *In re Torch Offshore, Inc.*, 327 B.R. 254, 258 (E.D. La. 2005).

³¹⁴ *Id.* at 257. The basis for the Committee's objection to the sale was valuation.

³¹⁵ *Id.*

³¹⁶ COURTING FAILURE, *supra* note 20, at 181, 258 ("The lesson is that markets do not automatically serve the public interest. Markets are structured by law, culture, and technology.").

and actual debtor manipulation of the terms and process of § 363 preplan business sales.

Chapter 11 protections certainly do not end or mitigate the valuation debate between debtors and creditors. However, the debate in chapter 11 is regulated by shared information³¹⁷ and compelled negotiations with the impaired claim holders as part of confirmation.³¹⁸ The complexities of a § 363 sale require intensified scrutiny because of the dangers of debtor manipulation of market forces.

CONCLUSION

This Comment does not critique or limit the appropriate, productive, and efficient use of § 363 sales. Instead, it seeks to identify the vulnerable areas of an increasingly popular and precarious alternative to the traditional chapter 11 process. The benefits offered to debtors through § 363 sales are too alluring to expect a decrease in its abuse without action. Further, the debtor's ability to manipulate the circumstances to produce a sound business justification³¹⁹ makes that standard alone an ineffective, formalistic limitation on sales of entire businesses.

The following are some practical recommendations to create a more transparent, more supervised, and less vulnerable § 363 preplan sale process. While expanded good faith and a more involved business justification test would safeguard § 363 sales from abuse, additional requirements and more rigid standards would also effectively eliminate the advantages of § 363 sales. Instead, these recommendations focus on options for the parties in interest to gain more information so that their participation is more informed.

Negotiations between debtor and creditor in bankruptcy have been valuable in the traditional chapter 11 confirmation process. With some adjustments to § 363 practices, a fairer negotiating structure can be successful as well. First, objectors to the sale should have the option to extend the notice period for cause shown. There should be a low standard for that cause because the objector is operating at such a time³²⁰ and informational disadvantage.³²¹

³¹⁷ See *supra* notes 70–75 and accompanying text.

³¹⁸ See *supra* notes 77–81 and accompanying text.

³¹⁹ See *supra* note 206 and accompanying text.

³²⁰ See *COURTING FAILURE*, *supra* note 20, at 170–71 tbl. 11 (charting the jurisdiction and time from chapter 11 filing to § 363 sale for large bankruptcy cases between 1982–2003).

Second, there should be a tiered system for debtor disclosure requirements. Nonsuspect sales only need to conform with the current generic notice and a hearing requirement in § 102(1)(A). Upon creditor objections made in good faith, courts should consider heightened disclosure requirements. Objectors' requests for additional disclosure would be at the discretion of the court. A request for disclosure would not require a preliminary finding of harm,³²² but the court would have discretion to assess the reasonableness of the request by balancing the inconvenience to the debtor with the benefit to the objecting party. Formal disclosure statements would be required for sales benefiting an insider or involving management retention kickbacks. These disclosure statements should fulfill the adequate information definition of § 1125(a)(1), and court approval of the disclosure statement should be required.³²³ Court approval will still allow a flexible, subjective standard to be used in accord with plan confirmation practices,³²⁴ but equal and adequate information dispersal will increase the transparency of the sale and curb debtor temptation to abuse the system and personally profit from sweetheart deals.

While the increased use of nontraditional reorganization may suggest that twenty-first century businesses need a reformed bankruptcy scheme, the solution is not to erode the very pillars of the existing system in the name of practicality. Fraudulent § 363 preplan business sales undermine the principles and policies that govern our bankruptcy system. In evaluating the impact of these § 363 preplan business sales, we must recognize what is at stake. The finality of the sales, the integrity of the bankruptcy system, and the people that are harmed by sweetheart deals and management's greed justify a substantial limitation on the process and opportunity of § 363 preplan business sales.

ELIZABETH B. ROSE*

³²¹ See *supra* notes 70–75, 94–101, and accompanying text.

³²² See *supra* note 170 and accompanying text.

³²³ See *supra* notes 70–75 and accompanying text.

³²⁴ See *supra* notes 74–75 and accompanying text.

* J.D. Candidate, Emory University School of Law (2007); B.A., University of Notre Dame (2000). My sincere thanks to Professor Frederick Tung for his thoughtful guidance and feedback and to Matthew Rose for his patience, encouragement, love, and support. Thanks also to Michaela Kendall, Dana Yankowitz, and the members of the Emory Bankruptcy Developments Journal for their careful edits.