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Articles

RETHINKING 363 SALES

Jacob A. Kling

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Jacob A. Kling is a law clerk to the Honorable Dennis Jacobs, Chief Judge, United States Court of Appeals for the Second Circuit. Yale Law School, J.D. 2010; Brown University, A.B. 2007. ***I thank the staff of the Stanford Journal of Law, Business & Finance for its excellent editorial assistance. I am also grateful to Alan Schwartz, Ben Klein, and Alexandra Briggs for their feedback and support.***

Rather than go through the traditional Chapter 11 reorganization process, insolvent companies increasingly seek to sell all or substantially all of their assets under the authority of section 363 of the Bankruptcy Code. Such 363 sales offer certain advantages over reorganizations; they can be accomplished more quickly and at less cost, and often preserve the firm's going concern value just as effectively. They also present certain concerns, including the possibility that, perhaps at the behest of senior creditors who stand to benefit from an immediate disposition, the sale may be conducted at a time or in a manner that is not revenue maximizing. This Article argues that although the basic judicial approach to 363 sales reflects these advantages and concerns as well as the incentives of senior and junior claimants, three specific aspects of 363 sales are problematic. These are (1) the right of secured creditors to credit bid their claim at a sale of the underlying collateral, (2) the Code's limitations on the ability of the debtor to sell assets free and clear of liens, and (3) courts' acceptance of sales that violate the absolute priority principle. Credit bidding represents an unnecessary protection for secured creditors (frequently the proponents of 363 sales), may chill outside bids, and, if not properly limited, can allow a creditor to circumvent absolute priority. The restrictions on sales free and clear of liens, at least as interpreted by some courts, allow junior lienholders to veto even value maximizing 363 sales. And permitting 363 sales that violate the absolute priority principle encourages strategic and inefficient behavior among senior and junior claimants, and may enable a purchaser to effectively redistribute sales proceeds from senior creditors to a preferred junior claimant. The Article suggests that each of these three features of 363 sales be reconsidered.

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*260 Introduction

Rather than go through the traditional protracted process of proposing a plan of reorganization to be voted on by its various claimants, bankrupt companies increasingly seek to sell all or substantially all of their assets under the authority of 11 U.S.C. § 363(b), which permits the bankruptcy court alone to approve a sale after notice and a hearing. [1] From an efficiency perspective, such 363 sales offer a number of advantages over a traditional reorganization. Because they can be accomplished quickly and without complying with Chapter 11's disclosure and voting requirements, [2] 363 sales reduce considerably the costs of administering the debtor's estate [3] while minimizing the period of time during which the debtor must operate under the cloud of bankruptcy. [4] In many cases, the sale of an entire division or of all of a firm's assets will preserve the firm's going concern value, [5] thereby displacing the need for a full-blown reorganization process. [6]

The use of section 363 to effectuate substantial asset sales also presents potential concerns, however. The first is that senior creditors, who tend to dislike the duration and uncertainty of the reorganization process, may successfully advocate a quick sale even if the deal does not represent the best available price. [7] The second is that a particular transaction may undermine the absolute priority principle, which requires that senior creditors be paid in full before junior claimants receive any value on account of their claims (or equity) and that creditors of equal priority be paid ratably. [8] Although the absolute priority rule governs the later distribution of the proceeds from a 363 sale, several courts have declined to apply it to invalidate payments made to junior claimants [9] in connection with the sale itself.

This Article draws on the economics of 363 sales to argue that three specific aspects of the law governing such sales should be reconsidered. The first two involve provisions in section 363 that are designed to protect secured creditors against the possibility that the collateral underlying their claims may be sold at an inadequate ***261** price--specifically, the right of secured creditors to credit bid [10] and the restrictions that the Code imposes on the ability of the debtor in possession (DIP) to sell collateral free and clear of liens and other interests. [11] These protections are largely unnecessary insofar as secured creditors are the group most likely to advocate a quick sale even at a discount. Moreover, the operation of these two provisions can, in certain circumstances, create inefficiencies. Credit bidding has the potential to chill outside bids and reduce the expected revenue from an auction. In some cases, if not properly restricted, it can also allow a credit bidder to circumvent the absolute priority principle. As to the limitations that the Code imposes on the sale of assets free and clear of liens, because senior secured creditors are likely to support 363 sales, the principal effect of these limitations (at least as they have been interpreted by some courts) is to give junior lienholders significant power to hold up even efficient 363 sales.

The third aspect of 363 sales this Article addresses is the permissive approach that courts have taken towards sales that circumvent the absolute priority principle by delivering value to junior claimants ahead of other claimants of equal or greater priority. Such transactions can enable a purchaser to favor a preferred junior claimant by effectively reallocating a portion of the price from senior creditors to that claimant. Permitting 363 sales that violate absolute priority also encourages spurious objections by junior claimants to efficient transactions, while at the same time allowing a purchaser or secured creditor to silence the principal source of opposition to an inefficient transaction.

The Article proceeds in four parts. Part I provides a general overview of the potential benefits and costs of 363 sales and of the incentives of senior and junior claimants as they relate to such sales. Part II examines the basic law governing 363 sales and suggests that, in broad strokes at least, it reflects these economics. Part III considers two specific aspects of 363 sales--credit bidding and the Code's restrictions on sales free and clear of liens--and questions their efficacy in light of the incentives of senior and junior claimants. Part IV discusses the potential for 363 sales to violate the absolute priority principle and argues for strict adherence to the absolute priority rule in 363 sales.

I. A Theoretical Framework for 363 Sales

A. The Benefits of 363 Sales

Section 363 of the Bankruptcy Code allows a debtor to sell assets outside the ordinary course of business, subject only to approval of the bankruptcy court following ***262** notice and a hearing. [12] 363 sales are often pursued shortly after the filing of a bankruptcy petition, and negotiations with a potential purchaser may be underway even before the debtor files. [13] Asset sales under section 363 have become an increasingly popular alternative to traditional Chapter 11 reorganizations. [14] There are two distinct but closely related explanations for this trend. The first is that a 363 sale can be accomplished more quickly and at less cost than a full blown reorganization. The second explanation for the growing frequency of 363 sales is that assets have become less firm specific; as a result, a firm's going concern surplus can generally be preserved as effectively through a 363 sale as through a reorganization.

Perhaps the most obvious benefit of 363 sales is that they are fast. A plan of reorganization must be submitted to a vote of creditors and equity holders after furnishing them with a disclosure statement, [15] a process that can take years. [16] Substantial asset sales, by comparison, require only notice and a hearing, and are often completed in a matter of months. [17] To illustrate, the sale of BearingPoint Inc. to Deloitte was approved less than one month after BearingPoint filed its bidding procedures with the bankruptcy court, [18] and Lehman Brothers sold its assets to Barclays five days after filing for bankruptcy. [19] The speed with which 363 sales can be carried out may benefit the debtor's estate in a number of ways. It can dramatically reduce the administrative expenses that would otherwise be incurred in managing the estate during the reorganization process, [20] which are generally proportionate to the length ***263** of the reorganization. [21] These include fees paid to lawyers, bankers, and DIP lenders, all of which are entitled to administrative expense priority under the Code. [22] Although the proceeds from a 363 sale are distributed pursuant to either a plan of liquidation or a plan of reorganization, the cost of managing this fund is likely to be comparatively low. [23] By reducing these administrative expenses, a 363 sale can increase the recovery to the company's creditors, which in turn reduces the firm's ex ante cost of capital. [24]

In addition to reducing administrative costs, the speed of 363 sales can produce several indirect benefits. It enables a company to take advantage of business opportunities or plush capital markets that might not be available if the company were to sell its assets pursuant to a plan at some later date. Perhaps more importantly, operating a company that is in financial distress can

be a difficult task. Suppliers may be unwilling or reluctant to do business with an insolvent debtor and may insist on cash on delivery or advance deposits; customers may be hesitant to purchase an insolvent debtor's goods for fear the debtor will fail to provide service in the future. [25] In extreme cases, if DIP financing is unavailable, or available only on very onerous terms (notwithstanding the administrative priority that the Code gives DIP lenders), [26] the debtor's assets might be sitting idly or even depreciating in value during the reorganization period. [27] In such cases, 363 sales offer an important and efficient mechanism to maximize the value of the estate.

The use of a 363 sale in lieu of a plan of reorganization may also reduce judicial error costs. In order for a bankruptcy court to confirm a plan of reorganization over the objection of an impaired class, it must conduct a valuation analysis to ensure that the plan complies with the absolute priority rule--including the requirement that the present value of the payments to be made to secured creditors equal the value of their collateral. [28] It must also determine that the plan is feasible, and not likely to be followed by liquidation or the need for further reorganization. [29] A number of scholars have argued that bankruptcy courts lack the institutional competence, or incentive, ***264** to accurately make such valuation and business judgments. [30] If properly conducted, 363 sales can reduce these error costs by replacing judicial valuation with market valuation. [31]

As a corollary to the cost savings generated by 363 sales, the opportunity costs of a 363 sale--i.e., the unique benefits of a reorganization--are relatively low because a firm's going concern value can usually be preserved as effectively through a sale of the firm as through a reorganization. [32] From an economic perspective, the central goal of a bankruptcy process is to preserve firms with positive going concern value (and liquidate firms without positive going concern value). [33] Because section 363 can be used to sell all of a firm's assets, it can preserve any synergies generated by bundling those assets together just as a traditional reorganization can. [34] The only reason a reorganization might be a more effective means of preserving a firm's going concern value is if the firm depends on assets that are more valuable if they remain in that particular firm. [35] The most likely source of such firm specific value is human capital. But in practice, acquirers can and often do retain key employees and even teams of employees of the debtor. [36] Moreover, a sale of the corporation's assets can be a particularly efficient way to preserve going concern value because, as Professors Roe and Skeel observe, "[b]ankrupt companies come disproportionately from declining industries that should shrink" and "[a]n excellent way for a declining industry to consolidate capacity is via merger." [37] Thus, asset sales will often generate the same benefits as a reorganization--the preservation of going concern surplus--more quickly and at less cost.

*265 B. Concerns with 363 Sales

Notwithstanding these advantages of 363 sales, they also present several countervailing concerns. As an initial matter, it is conceivable that in certain circumstances a reorganization might better preserve going concern value than an asset sale because the debtor does indeed have valuable firm specific assets, such as an effective team of employees, that cannot easily be transplanted to a purchaser in a 363 sale. The inability of a purchaser to retain these employees would most likely be a product of transaction costs, informational asymmetries, or both. The purchaser simply may not know which employees of the debtor are particularly important, and it could have difficulty ascertaining that information since the advice of incumbent management may be tainted by self-interest. Alternatively, even if the purchaser is able to identify the team of key employees, it may be costly to contract with each of them. Such contracting presents a sequentiality problem if the value of any given team member is largely dependent on the retention of the rest of the team, since the purchaser may be reluctant to sign the debtor's employees one at a time but may have difficulty signing them all at once. [38] The debtor, by contrast, has already contracted with these employees and can assume their contracts under Bankruptcy law, [39] at least if they have not left the company during the pendency of

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the reorganization process.[40] It is also possible that the terms of existing employment contracts may impede a purchaser's ability to retain employees if, for example, employees hired by the purchaser are not entitled to severance payments[41] or their contracts contain non-compete clauses that would be triggered if they accepted employment with the purchaser.[42] Of course, these concerns are somewhat overstated. Distressed firms are often distressed because of their management, not in spite of it.[43] And worker mobility is a staple of today's economy.[44] Nevertheless, it is possible that the inability to retain a key team may, in a given case, favor reorganization over an asset sale.

A greater concern is that, even if an asset sale can in principle preserve going concern surplus just as effectively as a reorganization, the conditions under which the sale is conducted may not be revenue maximizing.[45] The failure of a 363 sale to ***266** yield the best available price for the assets is problematic both because it reduces the recovery for creditors and because the assets might not go to the purchaser that can put them to their most productive use. There are several reasons why a 363 sale might not maximize the value of the debtor's assets.[46] The auction process may not be sufficiently robust. In particular, as discussed below, secured creditors may succeed in negotiating a quick sale to the first interested bidder.[47] If the deal is approved before being sufficiently shopped to other potential purchasers, or if the initial "stalking horse" bidder is given excessive deal protections such that others are deterred from bidding, the sale may not be revenue maximizing.[48] Timing considerations also impact the effectiveness of a 363 sale. An industry-wide economic downturn, for example, is likely to be a bad time to pursue a sale, particularly if the debtor's assets are industry specific.[49] If bidders are liquidity constrained, they may have trouble financing the acquisition and will demand a higher return on their investment, which will reduce the revenue that a 363 sale can generate.[50] At the same time, bear capital markets will also make it difficult for the debtor to secure DIP financing,[51] and may put pressure on the debtor to effect a quick sale as a means to raise capital, notwithstanding that a better strategy might be to secure a moderate amount of financing and delay an asset sale until the acquisition market recovers. A 363 sale could also fail to maximize revenue if bidders are able to collude, either with each other or with the DIP.[52] One particular concern is that the DIP may negotiate a cheap sale of the debtor's assets to a buyer that promises to retain incumbent management.[53]

***267** The most common criticism of 363 sales is that they circumvent the procedural protections of Chapter 11,[54] particularly its disclosure and voting requirements.[55] The absence of these procedures is not in itself a deficiency, but may be concerning to the extent that it increases the possibility for substantive infirmities in the sale process. These substantive shortcomings can take two forms. The first has already been discussed: It is the failure of a 363 sale to maximize revenue. Such a failure can be attributed to procedural shortcomings because certain classes of creditors and equity holders, if given the opportunity, would not vote for a sale that they believed failed to maximize the value of the estate.[56]

The second potential substantive problem with 363 sales is that they may subvert the absolute priority rule, which requires that senior creditors be paid in full before junior claimants are paid anything--the fair and equitable requirement--and that creditors of equal priority are treated equally--the non-discrimination principle.[57] One way in which the absolute priority principle can be violated in a 363 sale is when a purchaser assumes only certain unsecured liabilities of the debtor, since those creditors may ultimately get paid ahead of other unsecured creditors or even secured creditors.[58] The potential for 363 sales to violate absolute priority is directly a function of the lack of explicit Chapter 11 procedural safeguards in the 363 process--in particular, the specific allocation of payments among the different classes of claimants which the Code sets forth as a condition precedent to the confirmation of a plan of reorganization.[59] As a general matter, violations of absolute priority are concerning for two reasons. Ex post, they contravene the contractually agreed upon priority scheme. Ex ante, they increase a solvent firm's borrowing costs insofar as creditors price in the possibility of such violations. This makes it more likely that a firm's equity holders will forego

positive value projects on account of the interest rate that subordinated lenders demand being sufficiently high that the net effect of undertaking ***268** the project would be to devalue the equity. [60]

C. The Incentives of the Parties

It is impossible to understand the economics of 363 sales without recognizing the often conflicting incentives of senior and junior claimants. A brief examination of those incentives shows that senior claimants typically support 363 sales and junior claimants typically oppose them, but neither group's incentives align perfectly with the optimal outcome in all scenarios. [61]

Senior creditors usually support 363 sales, and may do so even if a particular transaction is not value maximizing. This is because variance works to their detriment, and a reorganization increases the variance of the return to the estate relative to a 363 sale since a sale typically yields immediate cash proceeds, [62] and cash is essentially a zero variance asset. [63] Assume that a secured creditor has a claim for $100 and a first priority lien on all of the debtor's assets. Assume further that an immediate asset sale would yield $100 in proceeds, but that a full blown reorganization, whether or not culminating in a sale, might yield $200 or $50 (all amounts net of administrative expenses), each with equal probability. The expected value of a reorganization is .5*200 + .5*50 = $125, which exceeds the $100 that an immediate asset sale would yield; thus, a reorganization is efficient. But in a reorganization, the secured creditor has a 50% chance of getting paid in full and a 50% chance of receiving only $50; so its expected payout is $75, $25 less than it stands to receive from an asset sale. The secured creditor would therefore prefer the asset sale. By contrast, unsecured creditors, as residual claimants, [64] would get nothing in an asset sale, but in a reorganization ***269** would have a 50% chance of receiving $100; they would therefore prefer a reorganization. Note that the different incentives of secured and unsecured creditors has nothing to do with their risk preferences (i.e., the extent to which, holding constant their expected payout, they would prefer a recovery that is certain to one which is variable). It is instead a direct result of the fact that the secured creditor bears all of the downside risk from a higher-variance reorganization but shares none of the upside potential because its possible recovery is bounded from above by the amount of its claim, whereas the unsecured creditor enjoys all of the upside potential and bears none of the downside risk. In this example of an inefficient 363 sale, unsecured creditors' incentives align with the optimal decision not to sell, whereas those of secured creditors do not.

But a similar story can be told about unsecured creditors. Unlike secured creditors, they benefit from greater variance, and will frequently oppose even a value maximizing 363 sale. [65] Consider the numerical example described above, but assume instead that a reorganization will yield either $150 or $0 in value, each with equal probability. In that case, the expected value of a reorganization is .5*150 + .5*0 = $75, which is less than the $100 that an immediate asset sale will generate. Secured creditors will again support the sale, which promises to pay their $100 claim in full, whereas their expected payoff in a reorganization would be .5*100 + .5*0 = $50. Unsecured creditors will continue to oppose the sale even though it is efficient; they stand to receive nothing from an immediate sale, but have a 50% chance of receiving $50 in a reorganization.

These examples raise two concerns. The first is that senior creditors may "capture" the DIP and convince it to sell the firm's assets quickly even if the sale will, in expectation, generate less revenue than either a reorganization or a more protracted (and hence higher variance) sale process. [66] The second concern is that unsecured creditors or equity holders may hold up an efficient asset sale. [67] It is difficult to quantify the relative likelihood of these two scenarios. [68] On one hand, the DIP may ***270** be controlled by the corporation's old equity holders, who could therefore succeed in holding up a sale. On the other hand, corporate governance goes on in bankruptcy, and (at least where the debtor's stock is not widely held) secured creditors can try to protect themselves ex ante by taking a security interest in the debtor's stock, which, in certain circumstances, they may be able to vote without violating the automatic stay [69] and thereby take control of the DIP. Even if secured creditors are unable to exercise de jure governance rights in this manner, it may be that the proposed 363 sale would only dispose of some

of the debtor's assets, and the debtor may agree to the sale in order to appease a secured creditor from whom it hopes to be able to borrow in the future.[70] In addition, because DIP lenders enjoy administrative-priority status under the Bankruptcy Code,[71] their incentives are similar to those of secured creditors.[72] As such, they may push for a quick sale,[73] or provide in their loan agreement that failure to submit bid procedures by a certain date constitutes an event of default.[74] A DIP lender's bias towards an immediate sale may be magnified in the usual case in which it is also the company's prior secured creditor.[75]

What is clear is that neither senior nor junior claimants have the right incentives all the time when it comes to 363 sales. As such, scholarly proposals to import a voting system into the sale process may be misguided.[76] Professor Skeel in particular has suggested that the Bankruptcy Code should provide for a vote of unsecured creditors on a proposed sale, on the theory that they represent the residual owners of the firm and thus bear most of the marginal costs and benefits from the sale.[77] He argues by analogy to solvent firms, where common stockholders, as the firm's residual claimants, are thought to have the proper incentives to exercise the franchise.[78] ***271** However, when a firm is solvent, conflicts between equity holders and creditors are relatively muted. In the bankruptcy context, by contrast, the above discussion suggests that unsecured creditors may have an incentive to hold up an efficient sale. Thus, bankruptcy courts should not abdicate to unsecured creditors their role in approving 363 sales, but in evaluating the merits of a proposed transaction courts should be weary of the incentives of both senior and junior claimants. The balance of this Article argues that although the basic doctrine governing 363 sales reflects these incentives, some specific features of the statute and of the way courts have applied it do not.

II. The Law Governing 363 Sales

A. The Lionel Standard

Section 363(c)(1) of the Bankruptcy Code authorizes the DIP to use, sell, or lease property of the estate in the ordinary course of business without notice or a hearing unless the court orders otherwise.[79] Section 363(b)(1) permits the DIP to use, sell, or lease property of the estate outside of the ordinary course of business only after notice and a hearing.[80] Courts have interpreted the procedural distinction that the Code draws between asset sales in the ordinary course of business and those outside of the ordinary course to impliedly require courts to engage in substantive review of the merits of a proposed sale of all or a substantial portion of a debtor's assets. Thus, bankruptcy courts insist on a business justification before approving such sales under section 363(b).

The leading case articulating the business justification test is the Second Circuit's decision in Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.).[81] Lionel involved an appeal from an order authorizing the sale by the Lionel Corporation of its 82% common stock holdings in Dale Electronics for $50 million, which represented 34% of Lionel's consolidated assets.[82] The CEO of Lionel testified that the Dale stock was not a depreciating asset, that the sale could be accomplished as part of a reorganization plan, and that the only reason for the immediate sale was the Creditors' Committee's insistence on it.[83] The company's equity holders challenged the sale on the ground that it deprived them of the Bankruptcy Code's procedural safeguards of disclosure, solicitation, and acceptance of a plan of reorganization, ***272** and argued that section 363(b) permits substantial asset sales only in emergency situations. The secured creditors argued that a bankruptcy judge should have complete discretion to approve a sale under section 363(b).[84]

The court settled on a middle ground. Although the predecessor statute to section 363 had principally been applied where the debtor's assets were rapidly declining in value, the court noted that the Bankruptcy Code, as amended in 1978, did not on its face impose an "emergency" standard on 363 sales outside the ordinary course of business.[85] Even when a company's assets are not

perishable, the court reasoned, a "good business opportunity" might be available that requires the company to act quickly, and "[i]n such cases therefore the bankruptcy machinery should not straightjacket the bankruptcy judge so as to prevent him from doing what is best for the estate." [86] But the court also declined to give bankruptcy judges "carte blanche" to approve asset sales under section 363(b). The statutory requirements of notice and a hearing would, according to the court, be meaningless unless the court is required to provide reasons before authorizing a sale. [87] The court also expressed concern that 363 sales might be used to "pacify large creditors with whom the debtor would expect to do business, at the expense of small and scattered public investors." [88] Thus, the court concluded, bankruptcy courts should insist on a "good business reason" before authorizing an asset sale outside of the ordinary course of business. [89] The court expounded a non-exhaustive list of relevant factors that bear on whether a proposed sale should be approved, including the proportionate value of the asset to the estate, the time elapsed since the filing of a bankruptcy petition, the likelihood that a plan would be proposed and confirmed in the near future, the effect of the proposed sale on future plans of reorganization, the purchase price as compared to any appraisals of the property, and "most importantly perhaps, whether the asset is increasing or decreasing in value." [90] Because the debtor had not advanced a business justification for the sale beyond the secured creditors' desire to liquidate the Dale stock as quickly as possible, the court reversed the order approving the sale.

The Lionel test has had a major influence on other circuits. [91] Its reasoning can be criticized, however, for failing to give sufficient weight to the cost saving benefits of asset sales under section 363(b). The majority dismissed the bankruptcy court's ***273** concern that a failure to approve the sale would result in substantial delay, citing Supreme Court precedent for the proposition that "[t]he need for expedition . . . is not a justification for abandoning proper standards." [92] In this respect, although the court properly recognized that secured creditors have an incentive to support a quick asset sale that may not be in the best interests of the corporation, it arguably failed to recognize the equally troubling incentives of equity holders (and frequently unsecured creditors) who have the equivalent of an out-of-the-money option on the firm and hence an incentive to prolong the reorganization process. Indeed, this was the theme of Judge Winter's short but spirited dissent in Lionel, in which he likened the equity holders' argument to a "Hail Mary pass in football." [93] In practice, however, Judge Winter's dissent may have had as much influence on the doctrine as the majority opinion, as courts typically accept business justifications that involve savings of time or expense. [94]

B. Monitoring the Sales Process

Since Lionel, substantial asset sales under section 363(b) have become increasingly common. [95] Courts continue, however, to monitor the procedures under which such sales are conducted. In large part, the concern driving judicial review is closely connected to the Lionel court's concern that 363 sales not be carried out in a shotgun manner at the behest of senior creditors and to the detriment of junior claimants.

Bankruptcy courts seek to maximize the revenue generated by a sale in one of two ways. First, they sometimes require a robust pre-signing auction. Alternatively, to the extent courts permit the debtor to sign up a private deal with a so-called stalking horse bidder without holding a formal auction, courts scrutinize any deal protections to ensure that they will not chill superior post-signing bids. In such a privately negotiated 363 sale, the purchaser typically insists on various contractual provisions designed to reduce the risk that the assets will be sold to another party and to compensate it for its investment of time and diligence in that event. Typical economic deal protections include expense reimbursement provisions, the right to receive a breakup fee if the assets are sold to a competing bidder, [96] a minimum overbid amount by which competing bids must exceed the stalking horse's bid for ***274** the debtor to entertain them, [97] and potentially the right to match a competing bid. [98] There is an ongoing scholarly debate as to the extent to which such economic incentives are in fact necessary to induce bidders in bankruptcy, [99] and

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courts are split as to whether deal protections should be evaluated under the deferential business judgment rule [100] or should instead be subject to enhanced scrutiny, [101] although the latter approach appears to be the more popular one. [102] But there seems to be a consensus among bankruptcy courts that "no shop" provisions in purchase agreements, which prohibit the debtor from soliciting other bids, are generally impermissible because of their bid chilling effect, [103] except in special circumstances such as when the debtor has already undertaken an extensive and unsuccessful search for buyers. [104]

Outside of bankruptcy, by contrast, companies enjoy greater discretion in fashioning deal protections, particularly no shop provisions. If the purchaser is not acquiring all or substantially all of the corporation's assets, then the assets need not be auctioned and the agreement can be completely locked up at signing. By comparison, even a sale of a division under section 363 must be approved by the court, [105] and because a court is likely to award the assets to the party that submits the highest bid, the sale has the characteristics of an auction even if not formally conducted as one. [106] Even in the case of a merger or sale of substantially all assets, outside of ***275** bankruptcy there is no strict requirement [107] that the target proceed through a pre-signing auction or an affirmative post-signing market check, even if the transaction involves a sale of control in which the board's Revlon duties are triggered. [108] Although merger agreements in public company deals customarily contain a fiduciary out clause that permits the board to entertain unsolicited alternative proposals that the board considers superior to the existing deal, this is considerably less inviting to potential outside bidders than the certainty of being able to conduct diligence without first making a firm offer.

Courts' more stringent treatment of deal protections such as no shop provisions in 363 sales as compared to in the solvent mergers and acquisitions context is justified by the possibility that secured creditors may capture the DIP and try to lock up a quick asset sale even at a bargain price. When a solvent firm seeks to sell itself, by contrast, there are far fewer conflicts between secured creditors, unsecured creditors, and equity holders, which to some extent diminishes the need to strictly monitor the sale process. At the same time, the increasing willingness of courts to approve substantial asset sales based on considerations of time and cost savings arguably reflects an understanding of the advantages of 363 sales over reorganizations and of the possibility that the objections of junior claimants might be calculated to hold up an efficient sale. [109] Thus, in broad strokes at least, courts seem to recognize the economics of 363 sales and the incentives of the interested parties. [109]

III. Credit Bidding and Sales Free and Clear

Notwithstanding this general recognition of the advantages of, and possible concerns with, 363 sales and the incentives of senior and junior claimants, several specific features of such sales are misguided and potentially problematic. The next Part addresses one such feature--courts' permissive approach to sales that violate absolute priority. This Part considers two provisions in section 363 itself-- ***276** section 363(k), which gives secured creditors the right to credit bid at a sale of their collateral, and section 363(f), which imposes limitations on the DIP's ability to sell assets free and clear of liens and other interests. Each of these provisions is designed to protect secured creditors against a sale of their collateral at an inadequate price. Credit bidding, however, can chill outside bids and impede a robust auction. If not appropriately restricted, it would, in certain circumstances, also allow a secured creditor to circumvent absolute priority. Moreover, given that secured creditors (at least senior lienholders) are the most likely proponents of 363 sales, they do not need the protections that credit bidding is meant to furnish. The statutory limitations on the sale of assets free and clear of liens, which are similarly intended to protect secured creditors against fire sales, have been construed by some courts to give junior lienholders the power to block efficient sales. Thus, this Part argues, both of these features of section 363 should be rethought.

A. Credit Bidding

1. Challenging the Basic Rationale for Credit Bidding

Section 363(k) of the Bankruptcy Code provides that at any sale under section 363(b) "of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." [110] The use of the phrase "allowed claim" might seem to suggest that the amount of the credit bid is limited to the economic value of the collateral on the theory that § 506(a) of the Code bifurcates an allowed claim into two distinct claims--a secured claim to the extent of the value of the creditor's interest in the collateral and an unsecured claim to the extent of any deficiency. ***277** [111] However, the legislative history indicates that secured creditors can bid the full amount of their claim, including the deficiency portion, [112] and courts have uniformly agreed. [113] In In re Submicron Systems Corp., the Third Circuit explained the analytical problem with capping a credit bid at some appraised "value" of the underlying collateral: because the highest bid in an auction of the collateral becomes by definition the value of the creditor's secured claim, any bid that the secured creditor makes up to the total amount of its claim ipso facto constitutes the secured portion of the claim. [114]

The right of secured creditors to credit bid the full amount of their claim at a sale of the underlying collateral is intended to protect them against a sale of that collateral at an inadequate price. [115] In Submicron, the Third Circuit analogized the right to credit bid under section 363(k) to the section 1111(b) election available to secured creditors in a reorganization. Section 1111(b) gives secured creditors the option to elect to have their entire claim treated as a secured claim if the debtor retains the collateral in a reorganization, rather than have it bifurcated under section 506 into a secured claim for the value of the collateral and an unsecured claim for the deficiency. [116] This entitles the creditor, by virtue of the absolute priority rule, [117] to receive deferred payments under the plan equal in present value to the value of its interest in ***278** the collateral and equal in face value to the full amount of its claim. [118] The 1111(b) election thus provides secured creditors some protection against the possibility that the court may undervalue their collateral [119] or that the debtor may file for bankruptcy at a time when the price of the property is depressed in order to propose a plan in which the debtor will retain the property, pay the secured creditor its current appraised value, and capture any future appreciation for itself. [120] This latter protection is again a function of the absolute priority rule, which provides that the holder of a secured claim retains the lien securing that claim, meaning that a secured creditor that makes the election has a lien for the full amount of its claim, which will attach to the proceeds of any subsequent sale of the collateral by the debtor. [121]

The Code expressly denies recourse secured creditors the election option if the property securing the creditor's claim is sold pursuant to section 363 or a plan of reorganization. [122] According to the Submicron court, Congress considered the ability of secured creditors to credit bid the full amount of their claim in a 363 sale to provide sufficient protection against the dangers to secured creditors that animated section 1111(b). [123] In other words, section 363(k) is designed to protect secured creditors when their collateral is sold, just as section 1111(b) is designed to protect them against an erroneous judicial valuation and strategic lien stripping in the context of a plan that proposes to retain their collateral. [124]

The economics of 363 sales, however, belie this comparison between the danger to secured creditors posed by a reorganization in which the debtor retains their collateral and that posed by a sale of the collateral under section 363. For one thing, the threat of an erroneously low judicial valuation of the collateral is not present in a 363 sale, where the market determines the value of the property and displaces the judicial appraisal process. [125] Of course, it is possible that a 363 sale may, if not properly managed, fail to maximize the price at which the collateral is sold--as when a stalking horse bidder is given excessive deal protections or the timeframe is too tight to give interested bidders the opportunity to conduct meaningful diligence. ***279** It is also conceivable that senior managers may try to negotiate the sale of the debtor's assets at a bargain price to an acquirer that

promises to retain them, [126] or to an affiliate or other related entity. [127] But to the extent that a bankruptcy court's institutional competence is better geared towards managing a sale process and rooting out such insider abuses than valuing collateral on its own, [128] the risks that secured creditors face in a sale of their collateral under section 363 are likely to be more benign than those to which they are exposed in a reorganization in which the debtor retains the collateral. Absent such insider abuse, as explained in Part I, secured creditors are the group most likely to support a 363 sale because it often increases their expected return relative to a reorganization. [129] Since secured creditors are frequently the leading proponents of 363 sales, there seems to be little need to protect them against a sale at an inadequate price by allowing them to bid for the collateral themselves (and to do so without putting up any cash).

The other justification for protecting secured creditors via the 1111(b) election--the potential for the debtor to strip down a secured creditor's lien to the value of the collateral and then retain for itself any post reorganization appreciation--is equally inapplicable to 363 sales for the obvious reason that the debtor does not retain property sold via section 363 and therefore cannot benefit from its later appreciation. Thus, short of a conflict transaction where the debtor seeks to sell its assets at a bargain price to an affiliate or other purchaser in which the debtor or its management has an interest, [130] secured creditors do not require the protection that section 363(k) is intended to furnish. [131]

***280** 2. Inefficiencies in Credit Bidding

The ability of secured creditors to credit bid is not only an unnecessary protection, it may also have undesirable consequences. Allowing secured creditors to bid at a sale of their collateral can chill outside bidding and impede a robust, value-maximizing sale process. Courts should also disallow or limit credit bidding in situations in which it would permit a secured creditor to jump other creditors of equal or greater priority.

a. Bid Chilling

In bankruptcy, acquisition due diligence is typically constrained by the relatively tight timeframe of the 363 sale process. As such, potential outside purchasers have to decide on the basis of imperfect information whether to submit a bid at all--and if so, how much to bid. This raises the question of whether credit bidding may alter the total mix of information available to outside bidders in a way that discourages their participation in the auction.

There are two distinct but mutually reinforcing ways in which credit bidding may have a bid chilling effect. First, outside bidders may fear that secured creditors, as quasi insiders, have superior information regarding the true value of the debtor's assets. [132] As a result, they may be concerned that if they outbid a secured creditor, they will have overpaid for the assets. Such a winner's curse may deter them from bidding altogether. [133] This source of bid chilling, moreover, is a function of allowing secured creditors to bid generally. The problem is only enhanced by the fact that section 363(k) eliminates the need for financing. [134]

Nevertheless, we do not in the usual course prohibit insiders from acquiring a company simply because they have an informational advantage. Management participation, for example, is a standard feature of leveraged buyouts of solvent companies. ***281** But in the bankruptcy context, allowing secured creditors to bid may deter outside bidders for another reason. The bankruptcy court for the Western District of Virginia articulated the basic concern as follows:

[A]n auction sale in which one bidder is an existing lender who does not have to put up new money, but can rely upon money previously advanced and which the lender has no other actual way to recover, is not a sale in which the bidders are on a level playing field. Such a sale is like getting into an auction in which the other party is actually the owner of the property being

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sold, whose interest is not in actually obtaining the subject property but in playing poker to see what is the highest bid which the independent bidder is willing to make. [135]

In other words, outside bidders may fear that the secured creditor will use its ability to credit bid to drive the price of the assets above their true value. Again, this concern is, in the first instance, a product of allowing secured creditors to bid at all, but is magnified by the ability of secured creditors to make a bid without raising additional funds. In the price zone below the amount of its claim, the credit bidder's interests and incentives are those of a seller, not a buyer. Its goal is not to buy the assets itself, but rather for the assets to be sold to an outside bidder that is willing to pay more for the assets than they are worth to the creditor.

This has a peculiar effect on the creditor's bidding strategy. In most auction settings, it is presumed that a bidder's maximum bid is his private valuation of the item to be sold. When the bidder is a secured creditor and the item to be sold is the collateral underlying its claim, however, the bidder's private value does not establish a ceiling on its bid. Assuming that it expects to receive less than 100 cents on the dollar for its deficiency claim, the secured creditor would rather own the collateral outright than accept any outside bid below its private value (at least in a situation in which the creditor's private value is less than the face amount of its claim). If an outsider bids, therefore, it should expect the secured creditor to quickly bid the assets up to at least that creditor's own private value. But the secured creditor will go farther: Because it is entitled to each additional dollar that a sale yields (up to the amount of its claim), it has an incentive to continue to try to bid up the assets above even its own private value. The only risk the secured creditor takes by continuing to bid is that it may eventually chase away a higher valuing outside bidder. This risk, moreover, amounts to only a portion of the overall risk of aggressive bidding that is borne ***282** by the bankruptcy estate as a whole, which is at risk of also losing a bidder willing to pay more for the assets than the amount of the creditor's claim. The secured creditor, by contrast, suffers no incremental harm from any foregone bid to the extent it exceeds the amount of the creditor's claim. It can, therefore, be expected to adopt a bidding strategy that is more aggressive than that which would maximize the expected overall return to the estate.

Consider the following example. A secured creditor has a claim of D, and privately values its collateral at V, where $V < D$. Assume the creditor expects to earn a pro rata payment of R on its deficiency claim, where $0 < R < 1$. An outside bidder has already bid V (the secured creditor's private value) and the creditor is contemplating a single increase of its bid to some amount B, where $V < B < D$. With probability P, such an increase will cause the outside bidder to drop out, in which case the creditor will obtain the assets and will have reduced its deficiency claim from $(D - V)$ to $(D - B)$. But with probability $(1- P)$, the outside bidder will slightly out-bid the creditor by e and purchase the assets for $B + e$. In these circumstances, the creditor will increase its bid from V to B provided that: $(1- P)*[(B + e)+ R*(D - (B + e))] + P*[V+ R*(D - B)] > V + R*(D - V)$. As long as the secured creditor expects to earn little for its deficiency claim, it can be expected to increase its bid above its private value, V. In the case where unsecured claims are under water and the secured creditor's deficiency claim is virtually worthless (i.e., $R = 0$), it will necessarily bid above its private value: The above inequality simplifies to $(1- P)*(B + e) + P*V > V$, which holds for any value of P less than one.

This creates a particularly perverse kind of winner's curse: The outside bidder knows that if it gets involved in a bidding contest with the secured creditor, it will have to compete with a bidder who is willing to bid above its own private value for the assets. This winner's curse is exacerbated by the fact that the outside bidder might reasonably expect the secured creditor, as an insider, to have superior information concerning the value of the assets. In contrast, the outside bidder will be bidding on the basis of whatever limited diligence on the debtor it was able to conduct. That is not a recipe for a robust, value-maximizing auction. It might be expected that many outside bidders, anticipating that their returns are going to be diminished in this way, will simply not undertake the investigation and diligence costs necessary to pursue an acquisition in the first place. Notably, because outside bidders know that any bid they make is at risk of getting bid up by an under-secured creditor, the bid chilling effect discussed above can manifest itself even prior to a secured creditor actually submitting an initial credit bid. Moreover, the same analysis

applies if the credit bidder is a junior rather than senior lienholder. Until the purchase price reaches the level at which the creditor's claim will be paid in full, its incentives are those of a seller, not a buyer.

***283** One might argue that there is nothing wrong with this auction structure because it simply allows secured creditors to function as quasi-sellers of their own collateral. If a secured creditor wants to bid up the price of its collateral at the risk of deterring outside bidders, why should it not be permitted to do so? The problem is that secured creditors do not actually own the collateral; they own only a claim. While they have the right to look to the collateral that secures their claim for repayment, they have no right to any value or equity in that collateral in excess of their claim. But, if the prospect of credit bidding chills outside bidders, a secured creditor can use its credit bid to acquire the collateral and retain for itself any value above the amount of its claim, to the detriment of junior lienholders or possibly equity holders. Therefore, not only does the credit bidder suffer no harm from deterring outside bids in excess of the amount of its claim (unlike the estate, which seeks without limitation to maximize the proceeds of the sale), it can affirmatively benefit from such deterrence. Of course, this only works insofar as it is not apparent to outside bidders that the value of the assets exceeds the secured creditor's claim; otherwise, the secured creditor has no incentive to bid up the price of the assets and hence outsiders will not be deterred from bidding on that basis. But where there is substantial uncertainty as to the value of the assets (which will often be the case in a going concern sale of an entire business), and outside purchasers could reasonably think that the valuation range may extend below the amount of the creditor's claim, credit bidding can impede a robust auction and enable a secured creditor to capture value in the assets to which it is not entitled.

Proponents of credit bidding have missed this insight. Instead, they see credit bidding as an absolute good that expands the universe of potential bidders and makes for a more competitive bidding process. [136] It may be true that, in the standard auction setting, increasing the number of bidders increases the expected revenue from the auction. But in a bankruptcy auction, the introduction of a credit bidder distorts the informational dynamics and incentive structure of the process in a way that the introduction of a third-party bidder does not. Credit bidding does not invariably make an auction more competitive; in many cases, its effect (and purpose) will be the opposite.

b. Subverting Priority

In addition to the effect of credit bidding on the auction process, courts must be careful of which secured creditors they allow to credit bid. Although the right to credit bid is expounded broadly to apply to any creditor with an allowed claim that ***284** is secured by a lien on the property to be sold, [137] it is clear that the right must be denied to certain creditors under certain circumstances to prevent them from strategically using their credit bid to, in effect, convert their unsecured deficiency claim into a secured claim. Permitting credit bidding in such circumstances would be inconsistent with the absolute priority rule, reduce the recovery to the estate, and could produce a deadweight loss.

One such circumstance would be if an undersecured creditor tried to credit bid at a sale where the property subject to the creditor's lien was being sold in conjunction with other assets of the debtor in which the creditor did not have a security interest. As an example, the creditor's claim might be secured by only the debtor's inventory and the debtor might be auctioning off its entire assets (inventory, equipment, real property, etc.). On its face, section 363(k) does not bar the creditor from credit bidding. But the ability to credit bid would severely distort the creditor's incentives and might enable it to recover more than its pro rata share of its deficiency claim. To see this, assume that the secured creditor has a claim of D and that it values its collateral at V_S and values the rest of the debtor's assets at A_S. Assume that the debtor is selling all of the assets at once, and that the only other outside bidder is willing to pay V_B for the collateral and A_B for the rest of the debtor's assets, where $V_S + A_S < V_B + A_B < D$. On the whole, therefore, the debtor's assets are worth more to the outside bidder than to the secured creditor. Assume further that if the outside bidder purchases the assets, the bankruptcy court will allocate the purchase price correctly. Hence, the secured creditor would receive a payoff of V_B from the sale, but would get only a pro rata payoff of R on its deficiency claim,

where $0 < R < 1$. If the secured creditor were permitted to credit bid for all of the debtor's assets then it would bid some amount $V_B + A_B + \# < D$, win the auction, and end up with assets that it values at $V_S + A_S$.[138] It will credit bid provided that $V_S + A_S + Rx(D - (V_B + A_B + \#)) > V_B + Rx(D - V_B)$. This result is, of course, inefficient, since it was posited that the assets were worth more to the outside bidder than to the secured creditor.[139] Additionally, it harms unsecured creditors, who will receive nothing from the sale to the secured creditor but would have been entitled to their pro rata share of A_B had the outside bidder purchased the assets. In effect, the secured creditor, will have used its credit bid to expand the scope of its security interest to cover all of the debtor's ***285** assets. Accordingly, when collateral is being sold along with other assets of the debtor, courts should find cause to deny a secured creditor the right to credit bid, or at least to limit the credit bid to the fair market value of the collateral in which the creditor has a security interest.[140]

There is a dearth of case law concerning the ability of secured creditors to credit bid when their collateral is sold along with other assets of the debtor. But the problems illustrated above may have been what motivated the district court to reject a credit bid in In re WPRV-TV, Inc.[141] There, a secured creditor offered to purchase all of the debtor's assets for $4.85 million, of which $4.8 million represented its credit bid and the remaining $50,000 would be paid in cash. The creditor had a lien on some but not all of the debtor's assets.[142] The DIP recommended, and the court approved, an alternative all cash offer for $4.83 million on the ground that it would confer a greater benefit on the estate and its unsecured creditors than would the secured creditor's bid.[143] Although the court's discussion of the benefit to the estate is somewhat general, it appears that the creditor tried to convert its deficiency claim into a secured claim and that the court was correct to rebuff that effort.

Courts should similarly limit the right to credit bid when the collateral being auctioned is over-encumbered and subject to multiple liens of equal priority. Because each lienholder stands to receive only a fraction of the proceeds from a sale of the collateral to an outside bidder, it would have a strong incentive to try to credit bid and take the entire collateral for itself.[144] Consider a situation in which two creditors have claims of D_1 and D_2 respectively and value the collateral at V_1 and V_2. The only outside bidder is willing to pay V_B for the collateral, where $V_i < V_B < D_i$ for both i = 1, 2. Moreover, if R is the pro rata payoff to each creditor on its deficiency claim, assume that $(D_i \div (D_1 + D_2))xV_B + Rx(D_i - V_B\, x(D_i \div (D_1 + D_2))) < V_i$ for both i = 1, 2. In other words, each creditor would rather own the collateral outright than share the proceeds from a sale to the outside bidder. If permitted, each creditor would therefore ***286** credit bid. Which creditor can be expected to win the auction would depend largely on the relative size of their claims. The winning bidder will have improved its position. The other creditor, by contrast, will be worse off than it would have been had the outside bidder purchased the collateral, since it will not receive its pro rata share of the value of the collateral. This result would violate the non-discrimination principle of the absolute priority rule. It would also be inefficient, because the collateral would not end up in the hands of the bidder that values it most--the outside bidder. Therefore, though section 363(k) does not on its face prohibit credit bidding in such circumstances, courts should prohibit credit bidding or limit the right to credit bid to the fair value of the creditor's lien when the underlying collateral is encumbered by multiple liens of equal priority.[145]

Again, there is not much authority addressing the ability of a creditor to credit bid in this scenario. One case on point is In re Takeout Taxi Holdings, Inc., in which the bankruptcy court denied a motion to sell the debtor's assets on the ground that several secured creditors, whose interests would be affected by the sale, had not been given adequate notice of the proposed sale or an opportunity to object.[146] The court observed that these creditors were secured by the same security agreement and financing statement as the creditor that sought to credit bid its claim and therefore they could be expected to object to the credit bid, since the sale would not produce any cash proceeds to satisfy their claims.[147] The foregoing analysis suggests that the court was correct to deny on that basis the creditor's attempt to credit bid.

It goes without saying that courts should likewise find cause under section 363(k) to deny junior lienholders the right to credit bid unless they include enough cash in their bid to cover all senior liens, lest the junior lienholder be permitted to jump senior lienholders and circumvent the Bankruptcy Code's priority scheme. [148] For the same reason, if a secured creditor attempts to credit bid for substantially all of the debtor's assets, it should be required to include sufficient cash or other consideration in its bid to cover the debtor's administrative expenses. [149]

***287** In short, credit bidding has the potential to chill outside bidders and thereby impede a value-maximizing auction and, in certain circumstances, if not properly restricted, can allow a secured creditor to circumvent absolute priority and improve its position at the expense of other creditors. Section 363(k) authorizes courts to deny a creditor the right to credit bid for cause, and courts should be able to effectively police the violations of absolute priority discussed in this Subsection. Their ability to detect bid chilling, however, is likely to be far more limited. Doing so requires courts to ascertain why outsiders are not coming forward to participate in a sale. Determining the causes of such a non-event is a difficult task, and in the vast majority of cases there will be no way to establish that the dearth of interested bidders is not simply a product of natural economic conditions.

But in fact there is no compelling reason to allow secured creditors to bid in the first place. The right to credit bid is an unnecessary protection for senior secured creditors, who are usually the principal proponents of 363 sales. True, the right to credit bid can protect secured creditors against abusive transactions in which the debtor has a material financial interest. But no prophylactic mechanism is needed to protect creditors against such sales; that function is sufficiently performed by bankruptcy court review under section 363(b). Policing self-dealing transactions is a function that the law presumes courts are well equipped to perform. [150]

The case for credit bidding is actually stronger with respect to junior lienholders (as long as they are required to include enough cash with their bid to cover any senior liens), who are more vulnerable than senior lienholders to non-value-maximizing sales as a consequence of their subordinated status. The bid chilling concern discussed above, however, applies equally to credit bidding by a junior lienholder. Moreover, the Bankruptcy Code already provides ample protections for under-secured creditors (senior and junior lienholders alike) who believe that their collateral is at risk of being disposed of at an insufficient price. The creditor can object to the sale under section 363(b), or it can move to have the automatic stay lifted under section 362(d) and seek to foreclose on the property under state law. It need not be empowered with an additional strategic tool in the form of credit bidding. Instead, when a debtor undertakes to sell its assets, it should be able to design and implement a process that has the best chance of giving rise to a robust, revenue-maximizing auction, where each bidder has the incentives of a buyer, not an insider-seller, and without running the risk that a credit bidding lender will tilt the process ***288** to its advantage.

B. Restrictions on Sales Free and Clear of Interests

The right to credit bid is not the only ill-conceived protection for secured creditors contained in section 363. A provision potentially more troubling than section 363(k) is 363(f), which permits a DIP to sell property free and clear of liens and other interests only if one of five conditions is met: (1) applicable nonbankruptcy law permits the sale of such property free and clear, (2) the entity with the interest consents, (3) "such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property," (4) the interest is in bona fide dispute, or (5) the entity with the interest "could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest." [151] These restrictions do not apply to sales of estate property affected pursuant to a plan of reorganization, where the property can be sold free and clear of liens provided that the liens attach to the proceeds of the sale. [152] They are designed to protect secured creditors against a sale of their collateral at a price that they perceive to be insufficient. [153] Like credit bidding, however, the Code's restrictions on sales free and clear of liens and other interests represents an unnecessary protection for senior secured creditors, the usual proponents of 363 sales. While these restrictions may protect junior lienholders against a sale at an inadequate price, they can

also, depending on how the statute is read, give junior lienholders significant holdup power by effectively empowering them to veto sales of over-encumbered property. This section examines the ways in which courts have interpreted the two most important provisions in section 363(f), and then addresses the policy concerns with certain of these interpretations.

1. Section 363(f)(3)

Section 363(f)(3) applies only to liens. It permits a sale of property free and clear of liens if the purchase price is "greater than the aggregate value of all liens on ***289** such property."[154] Courts have interpreted this language in two different ways. Some have adopted an economic value test that requires only that the purchase price equal the aggregate economic value of all liens, i.e., the value of the collateral, even if the price does not exceed the aggregate face value of the claims secured by those liens.[155] These courts have relied on the canon of statutory interpretation which instructs that words with a particular meaning in one part of a statute are to be given a consistent construction in other parts of the statute.[156] Generally, when the Bankruptcy Code refers to the total face value of a debt owed to a creditor, it uses the term "claim."[157] Moreover, section 506(a) clearly differentiates between the face amount of a claim and the value of a lien or other interest by providing that "[a]n allowed claim of a creditor secured by a lien on property . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property."[158] This suggests that the word "value" in section 363(f)(3) denotes something different from the full face amount of the claims, and refers to the actual economic value of the liens as determined by a court.[159]

Other courts have criticized this reading of section 363(f)(3) and have instead limited its applicability to cases where the price at which the property is sold exceeds the aggregate amount of all claims secured by liens on the property, i.e., when there remains equity in the property. This interpretation was adopted by the Bankruptcy Appellate Panel (BAP) of the Ninth Circuit in Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC).[160] In that case, a junior lienholder appealed the bankruptcy court's approval of a sale of the debtor's real estate to a credit bidding senior lienholder free and clear of the junior creditor's lien, arguing that section 363(f)(3) cannot be used to authorize a free and clear sale of property if the total amount of claims secured by the property exceeds the price at which the property is sold.[161] The BAP agreed, and reversed the decision of the bankruptcy court approving the sale. It rejected the economic value test, reasoning that, had Congress intended such an expansive construction ***290** of section 363(f)(3), it would have been more explicit.[162] More importantly, it observed, if the phrase "aggregate value of all liens" were read to mean the aggregate economic value of the liens, then 363(f)(3) could never be used to authorize a free and clear sale of over-encumbered property, since "[i]n any case in which the value of the property being sold is less than the total amount of claims held by secured creditors, the total of all allowed secured claims will equal, not exceed, the sales price, and the statute requires the price to be 'greater than' the 'value of all liens.'"[163] The court concluded that "§ 363(f)(3) does not authorize the sale free and clear of a lienholder's interest if the price of the estate property is equal to or less than the aggregate amount of all claims held by creditors who hold a lien or security interest in the property to be sold."[164]

The Clear Channel court's reasoning has some appeal, but is not unassailable. As an initial matter, one court has suggested that in any 363 sale, the purchase price will be strictly greater than the economic value of the liens once adjusted for expenses that would be incurred in a liquidation.[165] That logic, however, would make section 363(f)(3) a tautology. A better interpretation is that section 363(f)(3) presupposes that, absent the consent of all lienholders, the bankruptcy court will make a finding as to the economic value of the liens prior to authorizing a free and clear sale.[166] Indeed, insofar as section 363(f) is designed to furnish additional protection for secured creditors (especially junior lienholders) in order to mirror the procedural protections that they enjoy in asset sales under a plan of reorganization by virtue of their voting rights, a finding by the court that the purchase price exceeds the appraised value of the collateral should suffice. Such a finding is tantamount to a determination that the proposed sale yields the best price reasonably available for the property, in which case junior lienholders suffer no harm on

account of the sale. This approach would parallel the protection that junior lienholders enjoy outside of bankruptcy by virtue of the requirement that a senior lienholder that forecloses on its collateral must dispose ***291** of the property in a commercially reasonable manner. [167] Most importantly, as discussed below, it would avoid an otherwise significant holdout problem.

2. Section 363(f)(5)

Section 363(f)(5) provides an alternative basis for a court to authorize the sale of property free and clear of interests so long as the holder of such an interest "could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest." [168] Because an interest can almost always be satisfied and discharged if the creditor receives full payment of its claim, courts have wisely interpreted "money satisfaction" to mean payment of some amount less than the full amount of the claim. [169] Rather, the major area of dispute concerns which "proceedings" qualify for the purposes of section 363(f)(5).

Several courts have held a hypothetical cram-down of a plan of reorganization to be a qualifying "proceeding," on the theory that a cram-down only entitles the secured creditor to an amount equal to the present value of its interest in the collateral, which may be less than its full claim. [170] Other courts have, for several reasons, rejected this interpretation. One is that it arguably ignores the availability of an 1111(b) election, which would entitle the secured creditor to receive cash payments with a face value, though not a present value, equal to the full amount of its claim. [171] A more fundamental objection was offered by the BAP for the Ninth Circuit in Clear Channel, which, in addition to holding (as discussed above) that over-encumbered property cannot be sold free and clear of a junior lien pursuant to section 363(f)(3), also concluded that a cram-down did not qualify as a hypothetical proceeding that might justify such a sale under section 363(f)(5). The court explained that it would be "circular reasoning" to "sanction[ ] the effect of cram-down without requiring any of § 1129(b)'s substantive and procedural protections" [172] and that "this reasoning undercuts the required showing of a separate proceeding." [173]

Clear Channel did not consider the possibility that the DIP might be able to rely on another hypothetical proceeding under section 363(f)(5) to sell the debtor's assets free and clear of a nonconsenting junior lien: a foreclosure sale. Because a junior lienholder could be compelled to accept less than full payment for its claim through a ***292** foreclosure sale that yields insufficient revenue to satisfy its claim in full, some courts have disagreed with Clear Channel and have held that section 363(f)(5) does permit a sale free and clear of an impaired junior lien. [174]

3. Implications of Section 363(f)

A reading of section 363(f) that adopts a face value requirement for 363(f)(3) and a narrow construction of 363(f)(5) to exclude foreclosure sales gives junior lienholders significant power to hold up efficient asset sales. [175] No bidder could be expected to purchase over-encumbered property if he were unable to take the property free and clear of junior liens. [176] A junior lienholder could therefore threaten to withhold his consent [177] and veto any proposed sale free and clear of its lien. The exercise of this veto power, moreover, is essentially costless to the junior lienholder, which need not proffer any reasons for its opposition to the sale or even provide its own valuation analysis to counter that of the sale's proponents. [178]

It might be argued that, rather than permit the sale of over-encumbered property pursuant to section 363, courts should always lift the automatic stay and allow secured parties to exercise their state law remedies (e.g., foreclosure), leaving the state courts to deal with any remaining disputes among creditors. [179] But there may be synergies that make the debtor's assets more valuable if sold together, as a going concern, rather than piecemeal. [180] The ability to block a 363 sale is thus a powerful ***293** weapon

in the hands of a junior lienholder and can enable it to hold up an efficient sale in the hope that its claim will appreciate in value, or to negotiate a better deal for itself at the expense of senior creditors and the estate. [181]

Even if section 363(f)(5) is understood to include hypothetical foreclosure sales, a narrow reading of section 363(f)(3) to impose a face value test may still produce problems. A number of courts have read section 363(f)(5) to apply only to interests in property other than liens on the theory that section 363(f)(3) singles out liens for special treatment. [182] This interpretation is compelling because it gives effect to both sections 363(f)(3) and 363(f)(5) without making the former essentially surplusage (since a sale free and clear of a junior lien would otherwise always be authorized through a hypothetical foreclosure sale under section 363(f)(5)). [183] Based on this reading of the statute, applying a face value test under section 363(f)(3) is alone sufficient to give junior lienholders absolute power to veto revenue-maximizing sales. This veto power is even more problematic than the concerns associated with credit bidding discussed in the previous section. Under section 363(k), courts can deny secured creditors the right to credit bid for cause (though the courts have yet to flesh out exactly what is needed to establish such cause). By contrast, section 363(f) operates as a flat prohibition on sales free and clear of liens and other interests unless one of the five enumerated conditions is satisfied. When none of those conditions is satisfied, section 363(f) displaces the bankruptcy court as the ultimate steward of the sales process and substitutes in its place junior lienholders.

In some cases, the restrictions imposed by section 363(f) may provide legitimate protection for a junior secured creditor against an inefficient sale of its collateral at an inadequate price. For example, at the behest of an over-secured senior creditor the DIP may agree to a quick asset sale that fails to maximize the recovery to the estate and yields little or no value for junior lienholders. Alternatively, in a sale of multiple ***294** assets, the DIP may try to allocate the purchase price across those assets incorrectly and in a way that prejudices one secured creditor. Both of these potential dangers, however, can be monitored by the bankruptcy court without giving the creditor an absolute veto over the sale, and therefore neither justifies the blunt approach of section 363(f). As this Article has emphasized throughout, protecting against these kinds of flawed sales processes is precisely the role of the bankruptcy court under section 363(b). There is no reason to think that bankruptcy courts are not up to the task; in fact, the central assumption underlying the Lionel standard itself is that courts are capable of distinguishing good transactions from bad ones, and of managing a process that maximizes the value of the estate. Like the right to credit bid, the ability of junior lienholders to hold up a sale free and clear of their liens under section 363(f) (at least as it has been construed by some courts) needs to be rethought.

IV. Violations of Absolute Priority in 363 Sales

In addition to credit bidding and the restrictions on sales free and clear of liens, another troubling aspect of 363 sales is the willingness exhibited by some courts to approve transactions that violate the absolute priority principle. As explained in Part I, one of the primary concerns with 363 sales is that, because of the inapplicability of the procedural protections that govern the plan confirmation process, a 363 sale may effect an end-run around the Bankruptcy Code's priority scheme. [184] This Part begins by examining the ways in which a 363 sale can in practice circumvent absolute priority. [185] It then argues that permitting such violations of absolute priority is problematic for three reasons. First, it may allow a purchaser to transfer wealth from senior creditors to a preferred junior claimant; second, it encourages junior creditors to object to efficient 363 sales; and third, it may enable secured creditors to sanitize to the bankruptcy court inefficient sales by purchasing the consent of a junior class. This Part concludes by addressing possible arguments in favor of permitting violations of absolute priority in 363 sales.

A. Violating Absolute Priority

A 363 sale violates the absolute priority principle when, as a result of the sale, a junior claimant receives value on account of its antecedent claim (or equity interest) while a senior creditor remains impaired, or when a claimant receives greater value than other claimants of equal priority. [186] A number of courts have permitted 363 sales to violate absolute priority on the theory that the absolute priority rule does ***295** not apply when an entity other than the debtor, such as a purchaser or a secured creditor, makes a distribution to a particular claimant in connection with the sale. [187] Conceptually, violations of absolute priority in 363 sales can be categorized along two dimensions, one based on the identity of the party giving value to the favored claimant and the other on that party's motivation for doing so.

As to the identity of the party giving value, a 363 sale can circumvent the Code's priority scheme either because the purchaser makes payments to (or assumes the preexisting claims of) a junior claimant or because a party other than the purchaser--typically a secured creditor--makes such payments (or assumes such liabilities). In both types of cases, courts that have permitted these seeming violations of absolute priority have fixated on the fact that the challenged payments were made by an entity other than the debtor and hence did not implicate the absolute priority rule.

The highly publicized sale of Chrysler provides an example of a transaction in which the purchaser was the entity giving value to junior creditors while senior creditors remained impaired. In that case, New Chrysler as purchaser gave the company's pensioners equity in New Chrysler and a $4.6 billion note and assumed in full the company's liabilities to its trade creditors. [188] As a result, these unsecured creditors received fifty to one hundred cents on the dollar while Chrysler's secured creditors received only twenty-nine cents on the dollar. [189] The bankruptcy court approved the sale of Chrysler under section 363 of the Code notwithstanding these apparent violations of absolute priority because, in its view, unsecured creditors did not "receiv[e] distributions on account of their prepetition claims. Rather, consideration to these entities [was] being provided under separately-negotiated agreements with New Chrysler." [190] The Sharper Image bankruptcy provides another recent example of a 363 sale in which the purchaser voluntarily made payments to an unsecured creditor class arguably in circumvention of the Code's priority scheme. Like the Chrysler bankruptcy court, the court there approved the payment on the ground that the absolute priority rule does not apply to a transfer of property from a purchaser to a junior class since that property does not belong to the estate. [191]

Alternatively, it may be that a secured creditor pays over to a junior claimant part of its recovery from the sale. Such a "carve out" payment was challenged and upheld in In re World Health Alternatives, Inc. [192] The court relied on the same logic as ***296** the Chrysler and Sharper Image bankruptcy courts, explaining that "[a]lthough the general unsecured creditors will receive money before the priority creditors, that money does not belong to the estate--it belongs to [the secured creditor making the payment]." [193]

However, not all courts have accepted the argument that distributions made by a purchaser or secured creditor do not implicate property of the estate. A bankruptcy court in the Eastern District of Virginia rejected the distinction relied upon in the cases discussed above between estate property and property of a purchaser or secured creditor, and declined to give effect to a provision in a purchase agreement that would have established a trust for unsecured creditors while higher priority administrative claims remained unpaid. [194] The court concluded that the proceeds from the 363 sale constituted property of the estate, and that the unsecured creditors' trust was properly considered part of those proceeds. [195]

In addition to the identity of the party giving value, the other and perhaps more important basis on which payments to a junior claimant can be differentiated is the motivation behind such payments. There are two principal possibilities. [196] First, the purchaser or a secured creditor (whichever is making the payment) may be attempting to secure the junior claimant's cooperation in the sale. This characterizes the payments made to unsecured creditors in connection with the sales of both Sharper Image and World Health Alternatives. In the Sharper Image case, the purchaser agreed to pay the committee of unsecured creditors in

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exchange for the committee's promise to withdraw its objection to the proposed sale, which would otherwise not have resulted in any distribution to unsecured creditors. [197] In the sale of World Health Alternatives, it was a secured creditor, rather than the purchaser, that gave a portion of its lien to the debtor's unsecured creditors in return for their agreement to abandon their previous objections to the sale. [198]

The second possibility is that a purchaser in particular may have a business purpose for giving value to a junior claimant in connection with its acquisition. Such ***297** a business purpose can take multiple forms, however. The purchaser may fear that a particular junior claimant will cease to do business with the purchaser unless its claim is at least partly paid, or that an existing shareholder with managerial expertise on which the purchaser is dependent may refuse to stay on unless it receives something of value for its shares. In those circumstances, allowing the purchaser to pay off the junior claimant may be necessary to induce the purchaser to proceed with the transaction. In the Chrysler bankruptcy, the court accepted this proffered justification for New Chrysler's assumption of Chrysler's liabilities to its pensioners and trade creditors. [199] But it is also possible that, even if the purchaser does not believe that giving value to the junior claimant on account of its preexisting claim (or equity interest) is necessary to ensure their continued relationship, the purchaser may nevertheless wish to allocate part of the purchase price to the claimant in order to curry favor. In that case, the payment, though made for a business reason, represents in substance a wealth transfer from senior to junior claimants.

With these possible motivations in mind, the following section considers the normative implications of allowing violations of absolute priority in 363 sales.

B. Should We Be Concerned About Violations of Absolute Priority in 363 Sales?

1. Problems with Sales that Violate Absolute Priority

Permitting a purchaser or secured creditor in a 363 sale to circumvent the absolute priority principle presents problems of three varieties. First, it allows a purchaser to favor a preferred business creditor or shareholder at the expense of senior claimants and effectively transfer wealth from the latter to the former. Second, it incentivizes holdout behavior by junior claimants. Third, it may increase the likelihood that an inefficient sale will be approved by the court.

a. Favoring a Preferred Claimant

The first concern with permitting violations of absolute priority in 363 sales is that a purchaser might intentionally try to redistribute part of the purchase price from senior creditors to a preferred junior claimant. That claimant might be a creditor with whom the purchaser expects to have continued dealings and thus has a vested business interest in appeasing. It could also be a powerful equity holder (or group); if the purchaser is a repeat acquirer of distressed companies, it might have an interest in developing a reputation for treating such equity holders favorably in order ***298** to gain an edge in securing stalking horse status in future deals. Mechanically, such a redistribution would be achieved by the purchaser reducing its purchase price by the value it gives the junior claimant (in whatever form), thus effectively converting part of the consideration for the transaction from cash--which would be distributed in accordance with the absolute priority rule--into a side payment to the junior claimant.

It is important to draw a distinction here between situations in which a purchaser agrees to satisfy or assume certain junior claims of the debtor because it believes that doing so is necessary to maintain a relationship with a particularly important claimant (whether a creditor or an old shareholder) from situations in which the purchaser acts not out of bona fide business necessity but merely to appease or benefit a favored claimant. In the first scenario, which will be discussed more fully below, the payment to the junior claimant cannot be said to injure any other creditor, since by assumption the purchaser would not proceed with the

transaction (or at the very least would significantly reduce its purchase price) were it unable to ensure the continuation of its relationship with that claimant. In the second scenario, by contrast, the purchaser's decision to satisfy the junior claim directly reduces the payoff to senior creditors because, absent the payment to the junior claimant, the purchaser would increase the cash portion of its purchase price available to satisfy senior claims. Violating the absolute priority principle in this way poses the same concerns as violations of absolute priority generally: It contravenes the contractually determined priority structure ex post, increases firms' cost of capital ex ante and may make it harder to finance positive net present value projects. [200]

There remains a question as to how likely it is that a purchaser would actually be willing to reduce its purchase price in order to satisfy a junior claim merely to curry favor with a particular creditor or shareholder. This might be a risky bidding strategy if there is a competitive process with a large number of bidders seeking to acquire the debtor's assets, since a bankruptcy court is likely to favor a transaction with the highest bidder over one with a lower bidder that agrees to also pay some junior claims of the debtor. On the other hand, even where there are multiple bidders, they might each seek to structure the transaction in a way that reallocates part of the purchase price towards a preferred junior claimant. And if the auction environment is less competitive, a purchaser assumes little risk by trying to allocate its purchase price in this way. This might be the case in a relatively concentrated industry in which the number of potential bidders is small, particularly in an economic environment in which non-strategic buyers may have difficulty obtaining acquisition financing, or if the purchaser is an insider with superior information about the value ***299** of the company--such as a DIP lender or a management buyout group--in which case other potential acquirers may be deterred from bidding. When auction dynamics are such that structuring a transaction to allocate part of the consideration towards junior claimants presents less risk to the purchaser, doing so might prove to be a profitable strategy.

But even if the absolute priority rule were strictly applied to 363 sales, could bankruptcy courts prevent a purchaser in a 363 sale from reducing its purchase price with the tacit agreement to transfer some portion of the purchase price to a junior claimant after the sale, such as by honoring its preexisting claims? Bankruptcy courts are obviously not institutionally capable of monitoring the ongoing relationship between the junior claimant and the purchaser after the transaction. But without any mechanism by which the parties can enforce such an implicit arrangement, it seems highly unlikely that a purchaser would voluntarily pay off a junior claimant once the sale closes. To the extent that the purchaser unilaterally decides to transfer value to the junior claimant after the sale, it seems reasonable to conclude that such a payment is not a redistribution from senior creditors to a junior claimant but rather an independent and distinct business transaction between the purchaser and a creditor or shareholder with which it will have continued dealings, and the concerns discussed above are inapposite.

b. Incentivizing Holdout Behavior

In addition to the possibility that a purchaser may try to transfer part of the purchase price to particular junior claimants, another concern with sanctioning 363 sales that violate absolute priority is that it incentivizes holdout behavior. Thus, a junior claimant can threaten to object to a 363 sale in order to extract a payment from the purchaser or from a secured creditor even if the sale is efficient and even if the junior claimant would not otherwise object to the sale. Knowledge that junior claimants may behave this way could discourage some potential purchasers from bidding. [201] Even if a purchaser is not altogether deterred from bidding, it can be expected to reduce its bid by the amount of the payout it anticipates having to make, which is economically equivalent to a redistribution of wealth from senior to junior claimants. Such ex post wealth redistributions increase firms' cost of capital ex ante [202] and make it more difficult to finance positive net present value projects. [203] A ***300** hard and fast rule prohibiting payments to junior claimants ahead of creditors of equal or greater priority might lead to fewer objections to efficient 363 sales, and would better honor the priority scheme that the parties have agreed to ex ante than does the prevailing judicial approach to such payments. [204]

This analysis relies implicitly on two assumptions. First, it assumes that, without a rule enabling junior claimants to extract a payout from a purchaser or secured creditor, they would not otherwise object to the sale. As discussed below, this assumption

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will not always hold insofar as junior claimants typically have an incentive to oppose and/or delay 363 sales. But it will hold when the costs that such a claimant would incur in opposing the sale exceed the option value it expects to gain from prolonging the reorganization process. Empirically, this will be the case for a high percentage of junior creditors. [205]

Second, the power of junior claimants to extort a purchaser or secured creditor depends on the latter's willingness to acquiesce to the extortion demand, which it might do for one of two reasons. First, the purchaser/secured creditor may not know whether the objecting claimant actually expects to gain enough value by prolonging the reorganization to justify the procedural costs of pursuing an objection to the sale. Second, even if the purchaser/secured creditor knows that objecting to the sale is not a cost-effective strategy and that the junior claimant is only objecting in the hope of extracting a payout, it may still be in its interests to agree to pay to the junior claimant some amount that is less than the surplus that an immediate sale will yield for the purchaser/secured creditor. The interaction between the parties can be modeled as a sequential bargaining game. The junior claimant first chooses whether to object to the sale; if it objects, the purchaser/secured creditor then must decide whether to bribe the junior claimant to withdraw its objection. The purchaser/secured creditor should be willing to pay up to the amount that it stands to gain by avoiding a lengthy process (which includes litigation costs and the costs that inhere in deal uncertainty). By backwards induction, the junior claimant would always object at stage one, since it knows that doing so enables it to extract a bribe at stage two. [206] It is therefore possible that a purchaser or secured creditor may rationally ***301** bribe a junior claimant not to object to a 363 sale even if it knows that the claimant would not gain enough option value from delaying the transaction to independently justify objecting. Perversely, the more efficient a particular 363 sale is compared to the alternative reorganization route, the greater the junior claimant's bargaining power and the greater the bribe it can extort.

c. Silencing Opposition to an Inefficient Sale

Permitting violations of absolute priority in 363 sales not only encourages junior claimants to hold up efficient sales, it may also increase the number of inefficient sales that win the approval of bankruptcy courts. As this Article has emphasized, a principal concern with 363 sales is that they may be conducted at the behest of a senior secured creditor in a manner that fails to maximize revenue from the sale, often because economic conditions make the timing of the sale ill-advised. [207] By quelling a potential source of opposition, the ability of a secured creditor or a purchaser to in effect bribe a junior creditor into supporting the sale can exacerbate the problem by sanitizing the transaction in the eyes of the court, thereby making it more likely that the court will approve an inefficient sale.

A possible objection to this analysis is that courts understand the incentives of senior and junior claimants, and therefore, in deciding whether to approve a sale, will not be unduly influenced by the views of a junior claimant that has been paid to support a 363 sale. That argument is unavailing, however, because there may not be any other creditor with a claim sufficiently large to justify incurring the costs associated with objecting to the sale, or expending sufficient resources to wage a challenge that has any real prospect of succeeding. [208] This is particularly likely to be the case when a deal is struck between a purchaser or secured creditor and the unsecured creditors' committee. [209] In most cases, the Bankruptcy Code requires that the United States trustee appoint a committee to represent unsecured creditors, ordinarily consisting of the seven largest such creditors. [210] Because of the size of its representatives' claims, and its ability to employ legal and financial advisors at the debtor's expense, [211] the committee is in the best position to object to an inefficient sale. The ability of a buyer or secured creditor to effectively purchase the cooperation of the unsecured creditors' committee may eliminate the principal or only potential source of opposition to a 363 sale, even one that is against the interests of the debtor's other constituents, such as junior lienholders or equity holders. Without an objecting party ***302** (or one capable of sustaining a vigorous opposition campaign), a court is more likely to approve a 363 sale. [212] In this way, a payment made to secure the acquiescence of a junior class may increase the likelihood

of approval of an inefficient sale. This analysis also suggests that courts should be suspicious of proposed sales that violate absolute priority even if no one objects to the sale. [213]

d. Doctrinal Implications

The three concerns discussed above undermine the formalistic distinction that courts have drawn (and based on which they have upheld apparent violations of absolute priority in 363 sales) between payments to junior claimants of estate property and payments made directly by a purchaser or secured creditor. [214] If a purchaser or secured creditor makes such a payment out of its own pocket in order to garner the support of a junior class for an inefficient asset sale, the payment will in effect diminish the bankruptcy estate in an amount equal to the additional revenue that an efficient, value-maximizing sale would have yielded. To the extent that the payment is made by the purchaser for the purpose of bribing junior claimants not to object to an efficient 363 sale, the amount of the payment presumably would otherwise have been monetized into the purchase price and thus would have become part of the bankruptcy estate. [215] And if a purchaser consciously reduces its purchase price in order to make a payment to a favored creditor or shareholder, this also has the effect of diminishing the size of the bankruptcy estate that would otherwise be available for distribution to creditors. In short, the rationale underlying courts' tolerance of 363 sales that violate the absolute priority principle is logically and analytically unsound.

It is also noteworthy that a number of the potential concerns associated with violations of absolute priority discussed in this section are unique to sales and do not apply to the practice of "gifting" in the plan confirmation context, in which a senior creditor carves out part of its recovery to give to a junior claimant over the objection of an intermediate creditor. In particular, the increased likelihood of an inefficient sale and the possibility of the purchaser favoring a particular claimant are inapposite with respect to a traditional reorganization in which no sale is contemplated. Despite ***303** some older case law allowing gifting, [216] the Second Circuit recently adopted a strict construction of the absolute priority rule as prohibiting gifting in the reorganization context. [217] But the court's analysis focused on the text of the absolute priority rule itself, preserving the possibility that violations of the absolute priority principle in 363 sales, to which the plan confirmation requirements of section 1129(b) are technically inapplicable, might still be permissible. [218] Given that, as a policy matter, violations of absolute priority raise potentially greater concerns in the 363 sale context than in the context of a traditional reorganization, this asymmetry between 363 sales and reorganizations is both incongruous and troubling. [219]

2. Are there Countervailing Benefits?

Notwithstanding these concerns with 363 sales that violate absolute priority, there are two conceivable situations in which the giving of value to junior claimants might in fact serve a useful function. Neither situation, however, justifies relaxing or deviating from the absolute priority principle.

a. Eliminating Holdouts

First, if a particular sale is efficient, and if a junior claimant expects to generate enough value from challenging and hopefully delaying the sale to justify the costs of objecting, then it may be optimal for a party that favors the sale to pay the junior ***304** claimant not to object. Such a bargain can be achieved if the net option value to the junior claimant from potentially delaying and/or blocking the sale is less than the surplus that the party supporting the transaction (whether the purchaser or a senior creditor) expects to generate from an immediate sale. [220] This might suggest that courts should consider on a case by case basis whether a payment made to a junior claimant in exchange for its cooperation in the sale is justified. [221] But that approach imposes substantial costs of its own. It would require bankruptcy courts to ascertain whether a particular payment to a junior

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claimant is indeed necessary to prevent the claimant from objecting. The court's inquiry would need to go beyond determining whether the proposed sale is efficient and in the best interests of the estate, a determination which would have to be made in any event in order to approve a sale under section 363(b). The court would also have to find that the junior claimant is not only objecting to the sale in the hope of extracting a payout, but that the potential value that the claimant hopes to gain by prolonging the bankruptcy process would be a sufficient independent basis for its objection. Even if courts were capable of making such a determination--which is highly doubtful-- the costs of doing so would likely offset any savings from eliminating a source of opposition to the sale.[222]

Of course, an alternative to such a case-by-case inquiry into the "credibility"[223] of holdout threats would be to permit any and all payments made to junior claimants in connection with 363 sales even if in violation of absolute priority. This approach might be satisfactory if, as an empirical matter, objecting to an efficient 363 sale is generally a cost-effective strategy for junior claimants even disregarding the possibility of extracting a settlement from the purchaser or a senior creditor. But empirically there is reason to believe that is not the case.[224] Because a claimant seeking to block a sale bears all of the costs of objecting but captures only a portion of the benefits that accrue to all similarly situated claimants, a kind of free rider problem ***305** exists. Even the unsecured creditors committee--the constituent in the best position to object to a 363 sale given its ability to charge its expenses to the bankruptcy estate--in many cases will not have an incentive to oppose a sale.[225] Because these expenses are entitled to administrative priority,[226] every dollar incurred opposing the sale will reduce the recovery to unsecured creditors. Thus, although the committee may have an incentive to object to an efficient sale in cases in which the claims of unsecured creditors are completely under water, if they stand to receive some portion of the sales proceeds then they will ultimately bear the marginal costs associated with pursuing an objection,[227] and will only object to an efficient sale if these costs are outweighed by the option value they expect to gain in the form of delay.

One situation in which it may be reasonable to think that a holdout threat is presumptively "credible" is when the company's old equity holders retain control over the DIP, in which case they may refuse to entertain even a value-maximizing 363 sale unless they receive some value for their ownership interest. But permitting a purchaser or secured creditor to pay off equity holders in these circumstances raises another problem, one which also applies to payments ostensibly made to eliminate inefficient holdout behavior by junior creditors: It is virtually impossible to determine whether there is an ulterior motive behind such payments--whether, for example, they represent a wealth transfer to a favored claimant or an attempt to quell a potential source of opposition to an inefficient sale. In view of the substantial risk that a court may mischaracterize the nature of, or motive behind, a payment to a junior claimant, the possibility that permitting such payments might in certain cases eliminate an obstacle to an efficient sale is not a compelling justification for disregarding the Bankruptcy Code's priority scheme.

b. The Business Necessity Justification

The second possible argument in favor of permitting a purchaser in particular to give value to a creditor on account of its antecedent claim, or to a former stockholder with managerial expertise, seemingly in violation of the absolute priority principle, is that the purchaser may reasonably believe such a payment is necessary to maintain an important business relationship of the debtor following the sale. For example, the purchaser may hope to have continuing business dealings with a particular creditor post-sale and may fear that the creditor will cease doing business with the purchaser if its claims are not paid in full.[228] As discussed above, this was ***306** the justification offered for New Chrysler's assumption of Chrysler's preexisting pension liabilities and trade debts.[229] A purchaser might similarly give value to a former stockholder to induce it to continue to provide managerial services to the debtor after the sale.

It is possible to imagine circumstances in which a purchaser could plausibly argue that such a payment is necessary to salvage an important business relationship. If the creditor is a repeat player in a particular market-- whether it be a financial market or

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a product market--it has an interest in developing a reputation for insisting on full and prompt payment from its counterparties. It might be willing to punish one particular debtor in order to protect that reputation in the future. Likewise (though somewhat less plausibly), a shareholder with managerial skills on which the purchaser depends might demand some value for its shares as a way of signaling its importance to other companies with which it might in the future become involved.

These possible reputational effects notwithstanding, it is relatively unlikely that a former creditor or shareholder would actually cease to deal with a well-capitalized purchaser following a 363 sale simply because the purchaser refused to pay off its preexisting claim/equity. [230] Thus, the problem with permitting such payments on grounds of business necessity is once again that courts will have great difficulty determining when a particular payment to a junior claimant is truly made for a bona fide business purpose rather than for any of the more problematic reasons discussed above--to enlist the support of the claimant for an inefficient sale, as a bribe to an exploitative junior creditor or equity holder, or to reallocate part of the purchase price towards a preferred creditor or shareholder in a situation in which doing so is not necessary to maintain that particular business relationship. Moreover, if the purchaser really does have a legitimate business reason for giving value to a junior claimant, it is always free to do so sua sponte after the transaction closes. [231] As discussed above, such post-sale payments are less worrisome and more likely to ***307** constitute an independent business decision than a deliberate redistribution of wealth from senior to junior claimants. [232] Requiring a purchaser to wait until after the sale to give value to a junior claimant imposes a kind of market test to ensure that the debtor is getting equivalent value in return, in the form of the continuation of its business relationship with the creditor or shareholder.

This analysis comports with existing doctrine in two other areas of bankruptcy law: critical vendor payments and the supposed new value exception to the absolute priority rule. In In re Kmart Corp., [233] the leading case on critical vendor payments, the Seventh Circuit considered whether section 363(b)(1) permits a debtor to use property of the estate to pay in full the prepetition claims of the company's suppliers prior to the confirmation of a plan of reorganization out of fear that they might otherwise cease doing business with the debtor. [234] The court concluded that such critical vendor payments, if permissible at all, could only be approved upon a showing that the company's other creditors would be as well off in a reorganization as in a liquidation and, more importantly, that the critical vendors would actually cease dealing with the debtor if their prepetition claims were not paid immediately. [235] Undoubtedly, this second requirement reflected the panel's skepticism that a rational supplier would refuse to do business with a debtor until its prepetition claim was paid in full, rather than insist on adequate assurances that it would be paid for its future deliveries. [236] Since, as a practical matter, it will often be difficult to establish that any given vendor will stop supplying goods to a debtor unless immediately paid in full, [237] the Seventh Circuit's approach to critical vendor payments is more or less consistent with prohibiting payments made to junior claimants on account of their prepetition claims or equity interest in the context of a 363 sale. To the extent that the approach of some courts to critical vendor payments may be more flexible ***308** than a flat prohibition on analogous payments in 363 sales, [238] this may reflect the fact that one justification for critical vendor payments-- that they can induce the vendor to extend trade credit despite the debtor's precarious financial condition -- [239] is unlikely to apply in the 363 sale context, where the purchaser is by assumption well capitalized and far less of a credit risk than the debtor.

A strict application of the absolute priority principle to 363 sales is also consistent with the approach that the Supreme Court has taken towards the supposed "new value exception" to the absolute priority rule in the context of a plan of reorganization. The new value exception concerns whether a corporation's old equity holders can receive equity in the reorganized entity in exchange for contributing "new value" to the corporation. The Supreme Court has not definitively held that the absolute priority rule contains an implicit exception for property distributed to old equity holders on account of a new value contribution, but it has said that, at a minimum, old equity holders must not be given the exclusive opportunity to purchase equity in the reorganized entity without subjecting the transaction to market scrutiny in the form of competing bids or competing plan proposals. [240] Like the Seventh

Circuit's skepticism towards critical vendor payments, the Supreme Court's misgivings about plans that deliver value to equity holders while senior claimants remain impaired provides support for a strict application of the absolute priority principle to 363 sales in order to prevent the use of section 363 to effect an end-run around the rigors of Chapter 11's priority scheme.

Conclusion

Financially distressed corporations are increasingly turning to asset sales under section 363 of the Bankruptcy Code as an alternative to traditional reorganizations. Such sales offer a number of cost and timing advantages over the comparatively drawn out plan confirmation process and can typically preserve an insolvent firm's going concern surplus just as effectively. They also present some concerns, principally that the sale will be conducted (under pressure from secured creditors) with undue haste or at a time when capital markets or the economic environment makes a sale unwise, and as a result may fail to maximize the recovery to the estate. At the same time, however, even when a sale is efficient, junior claimants may oppose it in an effort to prolong the reorganization process and increase the value of their interest. This Article has argued that certain aspects of 363 sales ought to be rethought in light of the economics of such sales and the incentives of senior and junior ***309** claimants. Credit bidding, it has argued, is an unnecessary protection for senior secured creditors and may chill outside bidding and impede a robust auction. If not properly limited, it can also allow secured creditors to circumvent the absolute priority principle. The restrictions contained in section 363(f) on sales free and clear of liens, and the particular construction of that section recently adopted by the Ninth Circuit Bankruptcy Appellate Panel, are also concerning to the extent that they enable junior lienholders to hold up efficient sales. Finally, the permissive approach that several courts have taken towards violations of absolute priority in 363 sales can allow a purchaser to redistribute wealth from senior creditors to a favored junior claimant, may facilitate inefficient sales by enabling a proponent of the sale to eliminate a principal source of opposition, and may needlessly encourage junior claimants to object to efficient sales. Each of these features of 363 sales deserves to be reconsidered.

Footnotes

1 See Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 Stan. L. Rev. 751, 751 (2002).

2 See 11 U.S.C. §§ 1125-26 (2006).

3 See 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, 1271-72 (2004).

4 See, e.g., Samuel L. Bufford, Chapter 11 Case Management and Delay Reduction: An Empirical Study, 4 Am. Bankr. Inst. L. Rev. 85, 89-90 (1996) (discussing ways in which product markets punish near insolvent companies).

5 See Kuney, supra note 3, at 1270.

6 See Baird & Rasmussen, supra note 1, at 754.

7 Out-of-the-money junior creditors may oppose even a revenue-maximizing 363 sale. See infra section I.C.

8 See 11 U.S.C. § 1129(b) (2006); David A. Skeel, Jr. & Thomas H. Jackson, Transaction Consistency and the New Finance in Bankruptcy, 112 Colum. L. Rev. 152, 153 n.2 (2012).

9 This Article uses the term "claimant" broadly for both creditors and equity holders.

10 See 11 U.S.C. § 363(k).

11 See id. § 363(f).

12 Id. § 363(b)(1). See generally Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063 (2d Cir. 1983) (discussing bounds of section 363(b)).

13 See Harley E. Riedel & Edward Peterson, Practical Issues Surrounding section 363 Sales, 19 U. Fla. J.L. & Pub. Pol'y 75, 78 (2008).

14 See Baird & Rasmussen, supra note 1, at 752.

15 11 U.S.C. §§ 1125-26.

16 See James H.M. Sprayregan, Roger J. Higgins & Jonathan Friedland, Chapter 11: Not Perfect, but Better than the Alternative, 24 Am. Bankr. Inst. J. 1 (2005) (observing that a 363 sale is typically accomplished much faster than a sale of assets under a plan of reorganization); Bufford, supra note 4, at 86-9 (discussing studies finding median durations of bankruptcy proceedings to be between one and two years).

17 See Robert E. Steinberg, The Seven Deadly Sins in § 363 Sales, 24 Am. Bankr. Inst. J. 22 (2005); see also United Food & Commercial Workers Union, Local 211 v. Family Snacks, Inc. (In re Family Snacks, Inc.), 257 B.R. 884, 897 (B.A.P. 8th Cir. 2001) (noting that 363 sales often "occur on a very expedited basis").

18 See Nadia Khattak, section 363 Sales: New Stalking Horse Strategies, Practical Law Company, at 2 (Apr. 28, 2009), available at http:// us.practicallaw.com/6-385-9854#a637248.

19 In re Chrysler LLC, 576 F.3d 108, 115 n.6 (2d Cir.), vacated as moot, 130 S. Ct. 1015 (2009).

20 See James J. White, Death and Resurrection of Secured Credit, 12 Am. Bankr. Inst. L. Rev. 139, 164 (2004) (noting that 363 sales produce a "lower priced reorganization"). As an empirical matter it is not clear that 363 sales lead to faster distributions to creditors than do reorganizations. See Lynn M. LoPucki & Joseph W. Doherty, Bankruptcy Fire Sales, 106 Mich. L. Rev. 1, 26-27 (2007). But the reduction in administrative costs is independent of the timing of the distribution.

21 Bufford, supra note 4, at 92.

22 See 11 U.S.C. § 1129(a)(9)(A) (2006).

23 See Kuney, supra note 3, at 1271.

24 See Alan Schwartz, A Contract Theory Approach to Business Bankruptcy, 107 Yale L.J. 1807, 1813-14 (1998) (illustrating how increasing the bankruptcy payout to creditors reduces the interest rate that they demand).

25 Bufford, supra note 4, at 89-90; see Kuney, supra note 3, at 1273.

26 See 11 U.S.C. § 364(a).

27 See In re Chrysler LLC, 576 F.3d 108, 119 (2d Cir.) (observing that Chrysler was losing nearly $100 million daily after shutting several factories to conserve resources), vacated as moot, 130 S. Ct. 1015 (2009).

28 11 U.S.C. § 1129(b)(2)(A)(i)(II).

29 Id. § 1129(a)(11).

30 See, e.g., Barry E. Adler & Ian Ayres, A Dilution Mechanism for Valuing Corporations in Bankruptcy, 111 Yale L.J. 83, 90 (2001); Kuney, supra note 3, at 1284-85; Mark J. Roe, Bankruptcy and Debt: A New Model for Corporate Reorganization, 83 Colum. L. Rev. 527, 559 (1983). But see LoPucki & Doherty, supra note 20, at 10 (finding that courts' valuations in reorganization cases "were surprisingly accurate predictions of postreorganization trading values").

31 See articles cited supra note 30.

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32 See Baird & Rasmussen, supra note 1, at 768 ("[M]any assets work equally as well in one firm as another."); Kuney, supra note 3, at 1270 ("By selling the assets of a business as a unit, rather than in a piecemeal liquidation, going concern value can be captured for the benefit of the estate.").

33 See Baird & Rasmussen, supra note 1, at 754 (indicating that the "central idea in corporate reorganizations" is "preserving ... 'going-concern surplus'"). But see Harvey R. Miller & Shai Y. Waisman, Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?, 78 Am. Bankr. L.J. 153, 199 (2004) ("Beyond pure economics, Chapter 11 provides a court with the opportunity to weigh the public interest in preserving employment and other social benefits.").

34 See Kuney, supra note 3, at 1270.

35 Baird & Rasmussen, supra note 1, at 755.

36 See id. at 773, 776 ("[T]eams have value, but their value need not be tied to any particular firm.").

37 See Mark J. Roe & David Skeel, Assessing the Chrysler Bankruptcy, 108 Mich. L. Rev. 727, 735 (2010).

38 See Baird & Rasmussen, supra note 1, at 773 ("Writing the contracts to ensure that teams remain together entails costs ....").

39 See 11 U.S.C. § 365(a) (2006).

40 Employees often seek other opportunities when the firm is in economic distress. See Baird & Rasmussen, supra note 1, at 775.

41 See Steinberg, supra note 17 (discussing how a failure to properly address employee issues can impact the ability of a 363 sale to maximize value).

42 See Baird & Rasmussen, supra note 1, at 776-77.

43 Id. at 763-64.

44 Id. at 774.

45 See generally LoPucki & Doherty, supra note 20, at 3-4 (finding that, empirically, sales of large corporations yield less value than reorganizations).

46 One general concern with a sale of all assets as opposed to a piecemeal liquidation is that in some cases it may be more difficult to find a group of investors willing to bear the more concentrated risks associated with a purchase of the entire company. See Philippe Aghion, Oliver Hart & John Moore, Improving Bankruptcy Procedure, 72 Wash. U. L.Q. 849, 855-56 (1994).

47 See infra section I.C.

48 See Khattak, supra note 18, at 2-3 (discussing the advantages enjoyed by stalking horse bidders).

49 See Aghion, Hart & Moore, supra note 46, at 856 n.16.

50 See LoPucki & Doherty, supra note 20, at 9 (arguing that an advantage of reorganizations over sales is that reorganizations eliminate the need to pay such a high return on investment to a purchaser).

51 See Kattak, supra note 18, at 1 (discussing the lack of available DIP financing during the recent credit crunch).

52 section 363(n) prohibits collusion, but it may be difficult to make the required showing that the parties' intention or objective was to influence the price. See Lone Star Indus., Inc. v. Compania Naviera Perez Companc (In re N.Y. Trap Rock Corp.), 42 F.3d 747, 752 (2d Cir. 1994).

53 See LoPucki & Doherty, supra note 20, at 32 (arguing that empirically the expectation that senior management will be hired by the purchaser influences the DIP's decision to sell); Elizabeth B. Rose, Chocolate, Flowers, and § 363(b): The Opportunity for Sweetheart Deals Without Chapter 11 Protections, 23 Emory Bankr. Dev. J. 249, 277 (2006).

54 See, e.g., Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating L.L.C.), 478 F.3d 452, 466 (2d Cir. 2007) (explaining that 363 sales that amount to sub rosa reorganization plans are prohibited "based on a fear that a debtor-in-possession will enter into transactions that will, in effect, short circuit the requirements of Chapter 11 for confirmation of a reorganization plan" (internal quotation marks and brackets omitted)).

55 See Craig A. Sloane, The Sub Rosa Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11, 16 Bankr. Dev. J. 37, 60 (1999).

56 As discussed below, some might not favor a sale even if they believed it would maximize the value of the estate. See infra section I.C.

57 The term comes from James C. Bonbright & Milton M. Bergerman, Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization, 28 Colum. L. Rev. 127 (1928); its present form is codified at 11 U.S.C. § 1129(b) (2006).

58 See Roe & Skeel, supra note 37 (arguing that the sale of Chrysler to Fiat was a sub rosa reorganization plan and violated absolute priority).

59 See 11 U.S.C. § 1129(b).

60 See Alan Schwartz, The Absolute Priority Rule and the Firm's Investment Policy, 72 Wash. U. L.Q. 1213, 1222 (1994) (explaining how deviations from absolute priority can exacerbate the debt overhang problem and make it harder for companies with preexisting debt in their capital structure to finance new projects with debt).

61 See generally Richard M. Hynes, Reorganization as Redemption, 6 Va. L. & Bus. Rev. 183, 199 (2011) ("Senior claimants are likely to prefer a quick sale that minimizes both expenses and the risk of depreciation, while junior claimants are likely to prefer a lengthy process that maximizes the chance of a very high bid."); White, supra note 20, at 149 ("The shareholders, employees, and perhaps the unsecureds want the bankruptcy prolonged in the hope that they can capture some latent upside and the secureds want liquidation so they can cash out and move on."); Jason Brege, Note, An Efficiency Model of section 363(b) Sales, 92 Va. L. Rev. 1639, 1669-72 (2006) (discussing these incentives).

62 Even if the consideration in a 363 sale is the purchaser's stock rather than cash, upon distribution, a secured creditor can convert that stock to cash by selling it in the market (assuming the stock is publicly traded).

63 See Harvey R. Miller & Shai Y. Waisman, Is Chapter 11 Bankrupt?, 47 B.C. L. Rev. 129, 173 (2005) (noting that secured lenders typically support 363 sales "as their preference is inherently toward the certainty of recovery that a sale can provide").

64 The incentives of equity holders mirror those of unsecured creditors in this example. Indeed, since equity holders are the firm's true residual claimants, their opposition to asset sales runs deeper than that of unsecured creditors, so sometimes unsecured creditors are in-the-money and support a 363 sale while equity holders do not. This is particularly true of equity holders that also have managerial positions in the company, since they enjoy non-pecuniary control privileges they might lose if the company is sold. See Schwartz, supra note 24, at 1821.

65 See White, supra note 20, at 161 (explaining that unsecured creditors are likely to oppose 363 sales). Unsecured creditors may come around to favor a 363 sale if they get some value in exchange for their support. See infra Part IV.

66 See Brege, supra note 61, at 1670.

67 Id. at 1671.

68 Without transaction costs and imperfect information, senior and junior claimants could contract around the inefficient result. But because of the presence of many creditor classes who may have different perceptions of the firm's auction value as compared to its

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reorganization value, such a Coasean bargain is costly. See Douglas G. Baird & Thomas H. Jackson, Bargaining After the Fall and the Contours of the Absolute Priority Rule, 55 U. Chi. L. Rev. 738, 753-54 (1988). Moreover, as discussed in Part IV, permitting the parties to bargain ex post has distributional effects that may make it harder to finance positive value projects ex ante.

69 See Official Bondholders Comm. v. Chase Manhattan Bank (In re Marvel Entm't Grp.), 209 B.R. 832 (D. Del. 1997) (permitting bondholders to vote stock in the debtor that had been pledged by the debtor's parent on the theory that the stock was property of the parent rather than of the debtor).

70 See Brege, supra note 61, at 1670-71.

71 See 11 U.S.C. § 364(a) (2006).

72 See David A. Skeel, Jr., The Past, Present and Future of Debtor-in-Possession Financing, 25 Cardozo L. Rev. 1905, 1924 (2004) (suggesting that DIP lenders may be overly risk averse if their investment horizon is short).

73 LoPucki & Doherty, supra note 20, at 37.

74 Khattak, supra note 18, at 4.

75 See Skeel, supra note 72, at 1926 ("Nearly sixty percent of the time, the debtor's post-petition financer is a bank (or banks) that had already lent money to the debtor prior to bankruptcy.")

76 See Kuney, supra note 3; David Arthur Skeel, Jr., The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, 78 Va. L. Rev. 461, 498 (1992).

77 Skeel, supra note 76, at 497, 500-01.

78 See id. at 500; see also Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395, 416 (1983) (observing that shareholders vote because "as residual claimants, [they] have the most to lose (or to gain) as a result of fundamental corporate changes").

79 11 U.S.C. § 363(c)(1) (2006).

80 Id. § 363(b)(1).

81 722 F.2d 1063 (2d Cir. 1983).

82 Id. at 1063, 1065.

83 Id. at 1065.

84 Id. at 1066.

85 Id. at 1069.

86 Id.

87 Id.

88 Id. at 1070 (citation omitted).

89 Id. at 1071.

90 Id.

91 See, e.g., Stephens Indus., Inc. v. McClung, 789 F.2d 386, 389-90 (6th Cir. 1986) (adopting the Lionel standard); Institutional Creditors of Cont'l Air Lines, Inc. v. Cont'l Air Lines, Inc. (In re Cont'l Air Lines, Inc.), 780 F.2d 1223, 1226 (5th Cir. 1986).

92 Lionel, 722 F.2d at 1071 (quoting Protective Comm. for Indep. Stockholders of T.M.T. Trailer Ferry, Inc. v. Anderson, 290 U.S. 414, 450 (1968)).

93 Id. at 1072 (Winter, J., dissenting) (internal quotation marks omitted).

94 Hon. 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, 7 (1992); Rose, supra note 53, at 269.

95 See Baird & Rasmussen, supra note 1.

96 See Kenneth E. Naglewski, The 'Stalking Horse' in a US Chapter 11 '363' Sale, Financier Worldwide, May 2006, available at http://www.focusmg.com/articles/stalking-horse.

97 Id.; Steinberg, supra note 17.

98 Khattak, supra note 18, at 2.

99 Compare Bruce A. Markell, The Case Against Breakup Fees in Bankruptcy, 66 Am. Bankr. L.J. 349 (1992) (arguing that deal protections are not necessary to induce bidders in bankruptcy), and Paul B. Lackey, Note, An Empirical Survey and Proposed Bankruptcy Code section Concerning the Propriety of Bidding Incentives in a Bankruptcy Sale of Assets, 93 Colum. L. Rev. 720 (1993) (same), with Kermit Roosevelt III, Understanding Lockups: Effects in Bankruptcy and the Market for Corporate Control, 17 Yale J. on Reg. 93 (2000) (arguing that deal protections should be enforced in the bankruptcy context).

100 See In re Integrated Res., Inc., 135 B.R. 746 (Bankr. S.D.N.Y. 1992).

101 See In re Tiara Motorcoach Corp., 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997); In re S.N.A. Nut Co., 186 B.R. 98, 102-03 (Bankr. N.D. Ill. 1995); In re Am. W. Airlines, Inc., 166 B.R. 908, 912 (Bankr. D. Ariz. 1994); In re Hupp Indus., Inc., 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992).

102 See Roosevelt, supra note 99, at 122; Rachael M. Jackson, Survey, 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, 488.

103 See In re Big Rivers Elec. Corp., 233 B.R. 726, 736-38 (Bankr. W.D. Ky. 1998); In re Bidermann Indus. U.S.A., Inc., 203 B.R. 547, 551-53 (Bankr. S.D.N.Y. 1997); C.R. Bowles & John Egan, The Sale of the Century or a Fraud on Creditors: The Fiduciary Duty of Trustees and Debtors in Possession Relating to the "Sale" of a Debtor's Assets in Bankruptcy, 28 U. Mem. L. Rev. 781, 819-27 (1998).

104 See, e.g., Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.), 147 B.R. 650, 654-55 (S.D.N.Y. 1992); In re Crowthers McCall Pattern, Inc., 114 B.R. 877, 878-81, 889-90 (Bankr. S.D.N.Y. 1990); Bowles & Egan, supra note 103, at 821.

105 11 U.S.C. § 363(b)(1) (2006).

106 Roosevelt, supra note 99, at 121. But see LoPucki & Doherty, supra note 20, at 42 (arguing that because stalking-horse bidders are rarely displaced, the selection of the stalking horse is the true sale and the auction may be merely a formality).

107 See In re Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1000 (Del. Ch. 2005) ("[T]he duty to take reasonable steps to secure the highest immediately available price does not invariably require a board to conduct an auction process or even a targeted market canvass in the first instance ... there is 'no single blue-print' for fulfilling the duty to maximize value." (quoting Barkan v. Amsted Indus., 567 A.2d 1279, 1286 (Del. 1989))).

108 Under Revlon, once the board determines to sell control of the corporation it has a duty to seek the best price reasonably available for shareholders. Courts have invalidated excessive lockups and deal protections under Revlon. See Paramount Commc'ns Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

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When Revlon is not triggered, such as in a stock for stock merger after which control of the combined entity will remain dispersed in the market, the board's duties relax.

109 But see LoPucki & Doherty, supra note 20, at 39-40 (finding that courts frequently approve non-value-maximizing 363 sales).

110 11 U.S.C. § 363(k) (2006). The Bankruptcy Code also contemplates the right to credit bid at a sale of collateral pursuant to a plan of reorganization. See id. § 1129(b)(2)(A)(ii). The Circuits had been split as to whether that right is mandatory. Compare In re Phila. Newspapers, L.L.C., 599 F.3d 298, 317-18 (3d Cir. 2010) (holding that under section 1129(b)(2)(A)(iii) a plan may provide for the sale of assets free and clear of a secured creditor's lien without allowing the creditor to credit bid if it provides the creditor with the "indubitable equivalent" of its claim), and Bank of N.Y. Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.), 584 F.3d 229, 246-47 (5th Cir. 2009) (same), with Radlax Gateway Hotel, LLC v. Amalgamated Bank (In re River Rd. Partners, LLC), 651 F.3d 642, 651-53 (7th Cir.) (holding that a plan that seeks to sell encumbered assets must allow secured creditors to credit bid). The Supreme Court recently resolved that issue, holding that secured creditors must be allowed to credit bid at a sale of their collateral pursuant to a plan of reorganization. Radlax Gateway Hotel, LLC v. Amalgamated Bank, __S. Ct.__, No. 11-166, 2012 WL 1912197, at *6 (May 29, 2012). The Court's decision focused on the text of Section 1129(b)(2)(A), and did not address the "pros and cons of credit-bidding," which "are for the consideration of Congress, not the courts." Id.

111 11 U.S.C. § 506(a).

112 See In re Submicron Sys. Corp., 432 F.3d 448, 460 n.15 (3d Cir. 2006).

113 See, e.g., id. at 459 (holding that section 363(k) "empowers creditors to bid the total face value of their claims--it does not limit bids to claims' economic value"); In re Suncruz Casinos, L.L.C., 298 B.R. 833, 839 (Bankr. S.D. Fla. 2003) (observing that the term "allowed claim" in section 363(k) does not distinguish between secured and unsecured claims and concluding that "the plain language of the statute makes clear that the secured creditor may credit bid its entire claim, including any unsecured deficiency portion thereof"); In re Midway Invs., Ltd., 187 B.R. 382, 391 n.12 (Bankr. S.D. Fla. 1995) (same); Daniel P. Winikka & Debra K. Simpson, Will Bankruptcy Courts Limit the Right to Credit Bid?, 17 J. Bankr. L. & Prac. 6 Art. 6 (2008) (discussing unsuccessful challenges to credit bids that allegedly exceed the value of the collateral).

114 Submicron, 432 F.3d at 460. The ability of a creditor to credit-bid the full face-value of its claim may create anomalies where certain administrative expenses, such as the fees payable to an investment bank, are calculated based on the price at which the assets are sold under section 363. Because courts typically count the credit bid for purposes of determining the purchase price on which the bank's compensation is based, the bank will receive a windfall if the value of the collateral is less than the credit bidding creditor's claim. See John T. Gregg, A Review of Credit Bidding Under 11 U.S.C.A. § 363(k), 2008 Ann. Surv. of Bankr. Law 17.

115 See Gregg, supra note 114 (observing that secured creditors have "used credit bidding to protect against what they perceive to be undervalued asset sales in bankruptcy"); Alan N. Resnick, Denying Secured Creditors the Right To Credit Bid in Chapter 11 Cases and the Risk of Undervaluation, 63 Hastings L.J. 323, 329 (2012) ("[S]ection 363(k) provides an important protection designed to assure that property is not sold by the bankruptcy estate outside of a chapter 11 plan at a price that is below true market value.").

116 11 U.S.C. § 1111(b)(2).

117 See id. § 1129(b)(2)(A).

118 See John Collen, An Introduction to Bankruptcy Code section 1111(b), at 7 (2006) available at http:// abiworld.net/newsletter/ realestate/vol3num2/RealEstateenewsletterJan14th.pdf (explaining the significance of the 1111(b) election).

119 Id. at 11.

120 See Cohen v. K.B. Mezzanine Fund II, L.P. (In re Submicron Sys. Corp.), 432 F.3d 448, 460 n.15 (3d Cir. 2006).

121 11 U.S.C. § 1129(b)(2)(A)(i)(I).

122 Id. § 1111(b)(1)(B).

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123 Submicron, 432 F.3d at 460 n.15.

124 See Bruce A. Markell, Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations, 44 Stan. L. Rev. 69, 122-23 (1991) (describing the right to credit bid as protection against the possibility of the debtor taking advantage of a low valuation).

125 See supra notes 30-31 and accompanying text.

126 See Rose, supra note 53, at 277.

127 See Michael E. Rubinger & Gary W. Marsh, "Sale of Collateral" Plans Which Deny a Nonrecourse Undersecured Creditor the Right To Credit Bid: Pine Gate Revisited, 10 Bankr. Dev. J. 265, 287 (1994) (discussing the risk to secured creditors of a non-arm's length transaction at a below-market price).

128 See id. (suggesting that courts can scrutinize asset sales to determine whether a relationship exists between the debtor and the purchaser); see also In re Abbotts Dairies of Pa., Inc., 788 F.2d 143, 148-50 (3d Cir. 1986) (remanding for a finding as to whether a purchaser acted in good faith given that the debtor's CEO had been retained by the purchaser as a consultant and been offered a permanent position, conditioned on the closing of the transaction); In re Med. Software Solutions, 286 B.R. 431, 445 (Bankr. D. Utah 2002) (holding that where "the asset sale is to a purported insider, the purchaser has a heightened responsibility to show that the sale is proposed in good faith and for fair value"); In re W.A. Mallory Co., 214 B.R. 834, 837 (Bankr. E.D. Va. 1997) (holding that sales to insiders of the debtor "must face ... higher scrutiny").

129 See supra Subpart I.C.

130 See supra notes 126 and 128 and accompanying text.

131 Admittedly, junior lienholders are in greater need of protection from an inadequately priced sale. As discussed below, the case is therefore somewhat stronger for allowing junior lienholders to credit bid (provided they include sufficient cash along with their bid to satisfy all senior liens). The bid-chilling concerns discussed below, however, apply to bids by both junior and senior lienholders.

132 See Vincent S. J. Buccola & Ashley C. Keller, Credit Bidding and the Design of Bankruptcy Auctions, 18 Geo. Mason L. Rev. 99, 120 (2010) ("Through its history of monitoring the debtor, the credit bidder may be privy to information about the true value of the collateral the debtor is selling that is not apparent to other would-be bidders.").

133 See Roe & Skeel, supra note 37, at 748.

134 That a secured creditor may be privy to private information about the true value of the debtor's assets does not imply that it is better positioned than outside bidders to run the business. Many secured lenders have little experience running companies. Increasingly, under the existing legal regime, secured claims are bought up by distressed debt investors, some of whom may purchase the debt with an eye towards later submitting a credit bid. But as to those investors whose principal investment objective is to pursue an acquisition of the company, prohibiting credit bidding would not exclude them from the bidding process. It would simply require them to choose their role at the outset, whether it be that of a creditor (in which case they can purchase the debt but would be foreclosed from bidding at a 363 sale) or that of an acquirer (in which case they can forego the debt investment and pursue an acquisition on the same terms as all other outside bidders).

135 In re Antaeus Technical Servs., Inc., 345 B.R. 556, 564 (Bankr. W.D. Va. 2005). But see In re Morgan House Gen. P'ship, Nos. 96-MC-184, 96-MC-185, 1997 WL 50419, at *1 (E.D. Pa. Feb. 7, 1997) (summarily rejecting a bid chilling argument); In re River Rd. Hotel Partners, LLC, No. 09 B 30029, 2010 WL 6634603, at *2 (Bankr. N.D. Ill. Oct. 5, 2010) (declining to deny a secured creditor the right to credit bid based on an argument that "credit bidding generally chills the bidding process," absent specific evidence of such an effect in that particular sale).

136 See Buccola & Keller, supra note 132, at 119-20.

137 11 U.S.C. § 363(k) (2006).

138 The same problems illustrated by this hypothetical might result even if $V_B < D < V_S + A_S < V_B + A_B$, in which case the secured creditor would have to provide the difference between the outside bid and the secured creditor's claim (D) in cash. The secured creditor would be willing to make such a bid provided that $V_S + A_S - (V_B + A_B - D) > V_B + Rx(D - V_B)$.

139 In theory, the secured creditor might be able to resell the assets to the outside bidder and eliminate this inefficiency. In practice, however, transaction costs will often preclude such a resale.

140 See Keith A. Simon, Credit Bidding by a Syndicated Lending Group: Understanding the Complexities of § 363(k) of the Bankruptcy Code, 18 J. Bankr. L. & Prac. 6 Art. 5 (2009) (suggesting that, if the assets being sold include unencumbered assets of the debtor, then the credit bidding lender should be required to provide additional value for these assets on top of its credit bid because "[o]therwise, the credit bidding lender is basically acquiring the unencumbered assets for free.").

141 143 B.R. 315 (D.P.R. 1991), vacated on other grounds, 165 B.R. 1 (D.P.R. 1992).

142 Id. at 318 (noting that a different creditor had a lien on some of the debtor's real estate).

143 Id.

144 If creditors are members of a lending syndicate then they likely will have contractually agreed to pro rata treatment of their claims. See Simon, supra note 140. Thus, the analysis here is limited to equal priority creditors that are not part of such a lending syndicate. In addition, this analysis assumes that the collateral would be sold free and clear of the other creditors' liens, an issue which will be discussed below. See infra section III.B.

145 See Buccola & Keller, supra note 132, at 103. A separate issue related to credit bidding that courts have been called on to decide involves the question of whether a majority of lenders in a syndicate can bind nonconsenting lenders to credit bid their claim. See, e.g., In re GWLS Holdings, Inc., No. 08-12430 (PJW), 2009 WL 453110, at *4-6 (Bankr. D. Del. Feb. 23, 2009) (interpreting a credit agreement to empower the collateral agent to credit bid on behalf of all parties to the agreement without unanimous consent); Simon, supra note 140.

146 307 B.R. 525, 531 (Bankr. E.D. Va. 2004).

147 Id. at 536.

148 See In re Theroux, 169 B.R. 498 (Bankr. D.R.I. 1994) (denying a junior lienholder's attempt to credit bid where the cash component of the bid was inadequate to cover the senior lien); see also In re Diebart Bancroft, Bankr. No. 92-3744, 92-3745, 1993 WL 21423, at *5 (E.D. La. Jan. 26, 1993) (affirming a bankruptcy court's decision to require that a secured creditor's bid include sufficient cash to cover the IRS's alleged first priority lien).

149 See In re Gulf Coast Oil Corp., 404 B.R. 407, 413-14, 428 (Bankr. S.D. Tex. 2009) (declining to approve an auction of all of the debtor's assets where the only anticipated bid was a credit bid by a secured creditor and the transaction could not be expected to pay all of the debtor's administrative expenses). Courts typically also require the credit bidder to put cash in escrow when the validity of the creditor's lien is in dispute. See Gregg, supra note 114.

150 See Rubinger & Marsh, supra note 127, at 287; supra note 129.

151 11 U.S.C. § 363(f) (2006).

152 See id. §§ 1129(b)(2)(A)(ii),1141(c).

153 Professor Kuney suggests that section 363(f) might have also been designed as a protection for certain types of unsecured creditors, in particular holders of successor liability claims. He argues that because section 1141(c) authorizes the sale of property free and clear of "claims and interests" in the context of a plan of reorganization, whereas section 363(f) refers only to "interests," Congress did not intend to permit sales of property under section 363 free and clear of successor liability claims. See George W. Kuney, Misinterpreting Bankruptcy Code section 363(f) and Undermining the Chapter 11 Process, 76 Am. Bankr. L.J. 235, 237 (2002). In

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practice, however, courts have interpreted section 363 to extinguish successor liability claims against the purchaser as well as liens and other interests. See id. at 263-64.

154 11 U.S.C. § 363(f)(3) (emphasis added).

155 See, e.g., In re WPRV-TV, Inc., 143 B.R. 315, 320 (D.P.R. 1991), vacated on other grounds, 165 B.R. 1 (D.P.R. 1992); In re Beker Indus. Corp., 63 B.R. 474, 476 (Bankr. S.D.N.Y. 1986).

156 Beker, 63 B.R. at 475 ("It is well settled that in construing statutory language, terms of particular meaning to the subject matter of the statute are to be interpreted in line with that meaning, and in light of other provisions of the statute." (citation omitted)).

157 A claim is defined broadly to include a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5)(A).

158 Id. § 506(a)(1) (emphasis added).

159 Beker, 63 B.R. at 476.

160 391 B.R. 25 (B.A.P. 9th Cir. 2008).

161 Id. at 32, 39.

162 Id. at 40.

163 Id.

164 Id. at 41.

165 See Milford Grp. v. Concrete Step Units, Inc. (In re Milford Grp.), 150 B.R. 904, 906 (Bankr. M.D. Pa. 1992).

166 See In re Bos. Generating, LLC, 440 B.R. 302, 332-33 (Bankr. S.D.N.Y. 2010) (adopting the economic value test and approving a sale free and clear of junior liens based on its finding that the sales price of the property accurately reflected its true value); In re Terrace Gardens Park P'ship, 96 B.R. 707, 713 (Bankr. W.D. Tex. 1989) (authorizing a sale of two office buildings free and clear of liens where the sales price of the buildings exceeded the court's valuation). One commentator has suggested that section 363(f)(3) should be interpreted so as not to include liens that have no value in order to prevent the holder of a lien that is hopelessly out of the money from gaining holdup value. See Alec P. Ostrow, The Odd Free and Clear Sale, or Clear-Channeling the Spirit of Subsections (3) and (5) of section 363(f), 2009 Ann. Surv. of Bankr. Law 91. This proposal, though appealing, presents line drawing problems.

167 See U.C.C. § 9-610(b).

168 11 U.S.C. § 363(f)(5) (2006).

169 See In re Healthco Int'l, Inc., 174 B.R. 174, 176 (Bankr. D. Mass. 1994); In re WPRV-TV, Inc., 143 B.R. 315, 321 (D.P.R. 1991), vacated on other grounds, 165 B.R. 1 (D.P.R. 1992).

170 See, e.g., In re Grand Slam U.S.A., Inc., 178 B.R. 460, 462 (E.D. Mich. 1995); Hunt Energy Co. v. United States (In re Hunt Energy Co.), 48 B.R. 472, 485 (Bankr. N.D. Ohio 1985).

171 See Kuney, supra note 153, at 253.

172 Clear Channel Outdoor, Inc. v. Knupfer (In re P.W., L.L.C.), 391 B.R. 25, 46 (B.A.P. 9th Cir. 2008).

173 Id.

174 See In re Bos. Generating, LLC, 440 B.R. 302, 333 (Bankr. S.D.N.Y. 2010) (declining to follow Clear Channel on the ground that "the existence of judicial and nonjudicial foreclosure and enforcement actions under state law can satisfy section 363(f)(5)"); In re Jolan, Inc., 403 B.R. 866, 869-70 (Bankr. W.D. Wash. 2009) (identifying "judicial and nonjudicial foreclosures" and the default

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remedies of Article 9 of the U.C.C. as qualifying "proceedings" under section 363(f)(5)); see also Kuney, supra note 153, at 251-52; Joel H. Levitin, Stephen J. Gordon & Richard A. Stieglitz, Jr., Ninth Circuit BAP Dresses Down Lienstripping: Could This Be the Last Dance for 363 Sales?, 27 Am. Bankr. Inst. J. 1 (2008) ("Presumably it is clear that in the context of a foreclosure proceeding, if nothing else, a senior secured creditor can credit bid and eliminate the liens of junior secured creditors."); Ostrow, supra note 166 (expressing surprise that the BAP in Clear Channel did not consider whether a foreclosure would constitute a qualifying proceeding under section 363(f)(5)). However, there is a strong textual argument that section 363(f)(5) cannot be used to authorize a sale free and clear of liens at all (as opposed to other property interests). See infra notes 182-183 and accompanying text.

175 See Bos. Generating, 440 B.R. at 333.

176 See Levitin, Gordon & Stieglitz, supra note 174.

177 Consent is one of the five available routes for authorizing a free and clear sale under section 363(f). 11 U.S.C. § 363(f)(2) (2006).

178 Such an analysis is customary when creditors object to a sale on grounds of an insufficient business justification. See LoPucki & Doherty, supra note 20, at 38.

179 The Bankruptcy Code requires the court to lift the automatic stay and permit creditors to foreclose on property of the estate if the debtor has no equity in the property and the property is not necessary to an effective reorganization. 11 U.S.C. § 362(d)(2).

180 See, e.g., In re WPRV-TV, Inc., 143 B.R. 315, 321 (D.P.R. 1991) vacated on other grounds, 165 B.R. 1 (D.P.R. 1992) (defending the sale of certain over-encumbered assets on the basis that "the proposed sale of the encumbered assets furthers the sale of other assets at an enormous benefit for the estate."). This justification for not lifting the automatic stay is consistent with the proviso that a court need not lift the stay if the property is "necessary to an effective reorganization." See 11 U.S.C. § 362(d)(2)(B).

181 See infra Part IV (discussing the ability of junior creditors to extract a bribe from a secured creditor or purchaser in a 363 sale).

182 See In re Canonigo, 276 B.R. 257, 265 (Bankr. N.D. Cal. 2002); In re Beker Indus. Corp., 63 B.R. 474, 478 (Bankr. S.D.N.Y. 1986).

183 See Ostrow, supra note 166 ("section 363(f)(5) should not be construed to apply to liens because it would render section 363(f)(3) superfluous ...."). Section 363(f)(3) might not be entirely superfluous even if section 363(f)(5) were interpreted to apply to liens, since 363(f)(5) arguably would not authorize a sale free and clear of a senior lien.

183 See Ostrow, supra note 166 ("section 363(f)(5) should not be construed to apply to liens because it would render section 363(f)(3) superfluous ...."). Section 363(f)(3) might not be entirely superfluous even if section 363(f)(5) were interpreted to apply to liens, since 363(f)(5) arguably would not authorize a sale free and clear of a senior lien.

184 See supra section I.B.

185 For a discussion of other potential indirect violations of absolute priority through credit bidding, see supra Subsection III.A.2.b.

186 See 11 U.S.C. § 1129(b) (2006).

187 See Hollace T. Cohen, The Absolute Priority Rule Revisited--How Absolute Is It?, 18 J. Bankr. L. & Prac. 3 Art. 1 (2009) (noting that the absolute priority rule has been held not to apply to distributions of non-estate property to unsecured creditors).

188 Roe & Skeel, supra note 37, at 733.

189 Id.

190 In re Chrysler LLC, 405 B.R. 84, 99 (Bankr. S.D.N.Y. 2009).

191 In re TSIC, Inc., 393 B.R. 71, 75 (Bankr. D. Del. 2008).

192 344 B.R. 291 (Bankr. D. Del. 2006).

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193 Id. at 297; see also Official, Unsecured Creditors' Comm. v. Stern (In re SPM Mfg. Corp.), 984 F.2d 1305, 1312-13 (1st Cir. 1993) (permitting a distribution from a secured creditor to unsecured creditors following a 363 sale, but pursuant to an agreement entered into before the sale, on the ground that the distribution involved non-estate property).

194 In re On-Site Sourcing, Inc., 412 B.R. 817, 825-27 (Bankr. E.D. Va. 2009).

195 Id. at 825.

196 In unusual circumstances, such a payment may be made for other reasons. For example, an argument can be made that New Chrysler only agreed to assume Old Chrysler's pension liabilities because of pressure from the federal government, which financed the purchase of Old Chrysler and presumably had political reasons for protecting the company's pensioners. See Roe & Skeel, supra note 37, at 752 (arguing that New Chrysler's decision to assume these liabilities was not a spontaneous and independent business decision).

197 In re TSIC, Inc., 393 B.R. 71, 74 (Bankr. D. Del. 2008).

198 World Health Alts., 344 B.R. at 294.

199 In re Chrysler LLC, 405 B.R. 84, 99 n.18 (Bankr. S.D.N.Y. 2009). But see Roe & Skeel, supra note 37, at 752 (arguing that while New Chrysler's decision to pick up the company's obligations to active employees might be justified by business necessity, its assumption of the claims of inactive employees did not represent the decision of an arms-length, third-party purchaser).

200 See supra notes 59-60 and accompanying text.

201 See In re On-Site Sourcing, Inc., 412 B.R. 817, 828 (Bankr. E.D. Va. 2009) (observing that permitting unsecured creditors to capture a portion of the proceeds from a 363 sale could "discourage prospective purchase[r]s or cause them to underbid in the expectation that there will be objections that have to be resolved on an individual basis").

202 See Barry E. Adler, Douglas G. Baird & Thomas H. Jackson, Bankruptcy Cases Problems and Materials 728 (4th ed. 2007) (alluding to the potential ex ante benefits from prohibiting sharing agreements in the context of a plan of reorganization).

203 See Schwartz, supra note 60, at 1222.

204 Based on this reasoning, an argument can be made that even if all creditors consent to a particular carve-out ex post, it may still be optimal ex ante to prohibit them.

205 See LoPucki & Doherty, supra note 20, at 38 (suggesting that few creditors have a stake in the sale sufficient to justify the expenses that objecting to a sale entails, including the expenditures associated with conducting an independent valuation).

206 A similar equilibrium is possible if the interaction is conceptualized as an infinite-horizon bargaining scenario in which the present value of each party's payoff declines as time goes on, which might be a more accurate model than the finite game described above insofar as the bribe can be paid or the junior claimant's objection withdrawn at any time. See Robert Gibbons, Game Theory for Applied Economists 68-71 (1992). Game theory predicts that such a bargaining scenario will result in a settlement early on. Id. at 71.

207 See supra notes 49-51 and accompanying text.

208 See LoPucki & Doherty, supra note 20, at 38.

209 See, e.g., In re TSIC, Inc., 393 B.R. 71, 74 (Bankr. D. Del. 2008).

210 11 U.S.C. § 1102(b)(1) (2006).

211 Id. § 1103.

212 See, e.g., TSIC, 393 B.R. at 76 (noting that no creditor objected to the settlement).

213 In a reorganization, by contrast, the absolute priority rule only applies if a plan is crammed down over the objection of a dissenting class. This difference is justifiable because the Code imposes voting requirements with respect to plans of reorganization that allow objecting parties to protect themselves at little cost. No such voting procedures exist with respect to 363 sales. See also supra note 204.

214 See supra notes 190-193 and accompanying text.

215 See In re On-Site Sourcing, Inc., 412 B.R. 817, 828 (Bankr. E.D. Va. 2009) (suggesting that purchasers will underbid if they expect to have to pay off objecting creditors). But see TSIC, 393 B.R. at 75-76 (rejecting as speculative the claim that had the purchaser not settled with the debtor's unsecured creditors it might have increased its bid).

216 See generally Harvey R. Miller & Ronit J. Berkovich, The Implications of the Third Circuit's Armstrong Decision on Creative Corporate Restructuring: Will Strict Construction of the Absolute Priority Rule Make Chapter 11 Consensus Less Likely?, 55 Am. U. L. Rev. 1345, 1390-1409 (2006) (discussing cases permitting gifting).

217 DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.), 634 F.3d 79 (2d Cir. 2011).

218 See id. at 98 (distinguishing the leading case authorizing gifting on the ground that it involved Chapter 7 rather than Chapter 11, and the former "does not include the rigid absolute priority rule"); Charles H. Jeanfreau, In re DBSD North America, Inc.: Congress Meant What It Said and Said What It Meant, Absolute Priority One Hundred Percent, 20 J. Bankr. L. & Prac. 3 Art. 1 (2011) (suggesting that even after DBSD senior creditors could "enter into an agreement with junior creditors or equity holders to support a section 363 sale and subsequent conversion to Chapter 7 in exchange for a distribution from the secured creditors sale proceeds"); Ralph Brubaker, Taking Chapter 11's Distribution Rules Seriously: "Inter-Class Gifting Is Dead! Long Live Inter-Class Gifting!", 31 Bankr. L. Letter No. 4 (Apr. 2011) (observing that parties can "try to effectuate an inter-class 'gift' by structuring the reorganization as a 'sale' transaction rather than using a traditional plan structure"). The Second Circuit declined to reach the question of whether the Code would permit gifting "outside of the plan." DBSD, 634 F.3d at 95.

219 One argument in favor of permitting settlements that violate strict absolute priority in the context of a plan of reorganization is that it allows the parties to contract around the possibility of an erroneous judicial valuation. See Douglas G. Baird, The New Face of Chapter 11, at 31 (unpublished), available at http://denning.law.ox.ac.uk/news/files/baird.pdf. This argument is inapplicable to 363 sales, where the market rather than the court determines the value of the firm's assets.

220 See In re World Health Alts., Inc., 344 B.R. 291, 300 (Bankr. D. Del. 2006) (suggesting that a carve-out payment to the debtor's unsecured creditors was necessary to remove the only challenge to an efficient sale); cf. DBSD, 634 F.3d at 100 (acknowledging in the reorganization context that gifting "may be a powerful tool in accelerating an efficient and non-adversarial ... Chapter 11 proceeding" (internal quotation marks omitted)); Miller & Berkovich, supra note 216, at 1422 (suggesting that gifting may expedite the Chapter 11 process).

221 Cf. Baird & Jackson, supra note 68, at 780-81 (suggesting that bribes may be appropriate if "the junior owners are bargaining away rights to procedures that are not worth using in that particular case, but which are worth using generally").

222 Cf. Adler, Baird & Jackson, supra note 202, at 728 (questioning whether, in the context of a plan of reorganization, "a class skipping distribution will truly buy peace for the reorganization plan rather than substitute one objecting class for another").

223 As discussed above, threatening to object to a sale can, in fact, be a rational strategy even if the costs of objecting exceed the option value that the junior creditor would gain from objecting. See supra notes 205-206 and accompanying text.

224 See supra note 205.

225 See supra notes 208-211 and accompanying text.

226 11 U.S.C. § 503(b)(3)(F) (2006).

227 See LoPucki & Doherty, supra note 20, at 38.

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228 See In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004) (discussing the possibility that a company's vendors may stop doing business with the company if their antecedent debts are not paid in full); Douglas G. Baird, The New Face of Chapter 11, 12 Am. Bankr. Inst. L. Rev. 69, 97 (2004) (suggesting that, where a business purpose exists for paying a creditor in full prior to the confirmation of the plan, "the debtor is not honoring a pre-petition debt at all, but rather striking an unusual bargain by which it is getting post-petition goods or services").

229 See supra note 199 and accompanying text.

230 Cf. Travis N. Turner, Note, Kmart and Beyond: A "Critical" Look at Critical Vendor Orders and the Doctrine of Necessity, 63 Wash. & Lee L. Rev. 431, 469-70 (2006) (arguing that courts have permitted critical vendor payments even where vendors would have been willing to accept less than full payment of their debts).

231 It is possible that a purchaser might be reluctant to consummate the sale without first being sure that it will be able to maintain a business relationship with the particular creditor or shareholder in question. But this point should not be overstated. A junior creditor would likely be eager to continue to deal with the purchaser if, after the transaction, the purchaser offers to pay the creditor's preexisting claim. The same is true of a former shareholder.

232 See supra Subsection IV.B.1.a.

233 359 F.3d 866 (7th Cir. 2004).

234 Id. at 872.

235 Id. at 873.

236 See id.; see also In re CoServ, L.L.C., 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002) (requiring a showing that the debtor has no way to deal with the critical vendor without paying its antecedent claim).

237 See Mark A. McDermott, Critical Vendor and Related Orders: Kmart and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 14 Am. Bankr. Inst. L. Rev. 409, 418 (2006) ("[D]ebtors who seek to make pre-plan payments to unsecured creditors may face very difficult standards under which they must affirmatively prove their cases with thorough and convincing evidence that there simply are no realistic alternatives to payment of the claims and that absent payment, the estate's value will be seriously and substantially jeopardized."). But see David B. Stratton & Evelyn J. Meltzer, Disgorgement of Critical Vendor Payments, 26 Am. Bankr. Inst. J. 24 (2007) (noting that bankruptcy courts continue to authorize critical vendor payments notwithstanding Kmart); Frederick Tung, The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors, 57 Emory L.J. 809, 833 n.100 (2008) (suggesting that bankruptcy judges increasingly approve payments to critical vendors).

238 See articles cited supra note 237.

239 See Turner, supra note 230, at 438-39.

240 Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 456 (1999).

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