

American Bankruptcy Institute
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Complex Chapter 11 Developments
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I. Sales of Businesses in Chapter 11

1. The modern trend in chapter 11 is to liquidate the business as a going concern through a sale under section 363. This is particularly true in cases where the primary secured lender's debt exceeds the value of the business. In such cases, while losses will be funded out of cash collateral, the lender will reap the benefit of selling its collateral quickly as a going concern rather than in a fire sale courthouse steps liquidation. Other advantages include the ability to sell free and clear of liens and having an order approving the various terms and conditions that are needed in order to obtain the highest possible price for the business.

2. The sale is effected through section 363 which provides:

The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate, except that if the debtor in connection with offering a product or a service discloses to an individual a policy prohibiting the transfer of personally identifiable information about individuals to persons that are not affiliated with the debtor and if such policy is in effect on the date of the commencement of the case, then the trustee may not sell or lease personally identifiable information to any person unless—

(A) such sale or such lease is consistent with such policy; or

(B) after appointment of a consumer privacy ombudsman in accordance with section 332, and after notice and a hearing, the court approves such sale or such lease

(i) giving due consideration to the facts, circumstances, and conditions of such sale or such lease; and

(ii) finding that no showing was made that such sale or such lease would violate applicable non-bankruptcy law.

3. Procedural Aspects:

a. Often the debtor will file a chapter 11 with a buyer in hand. In other cases, a prospective buyer will be found after the filing. Because bankruptcy courts will not approve a sale as not being in the interests of creditors if there is another buyer

willing to pay more, a potential buyer of a business in bankruptcy is subject to being out bid by a latter competing bidder.

b. This initial prospective purchaser is called the “Stalking Horse.” This prospective bidder will take the risk of investing time and money and may still be out-bid by a higher bidder. In order to establish the rules that will govern the sale process and to obtain certain protections for the Stalking Horse bidder, the debtor will file a motion to establish sale procedures.

c. The order establishing bid procedures will typically contain provisions dealing with:

i. Advertising. It is very important that the prospective sale be adequately exposed to the market place. The debtor will need to present its game plan to achieve the widest possible dissemination of information about the sale in the relevant market.

ii. Due diligence. It is important to have a clear understanding about the time period and procedures for third parties to conduct due diligence. This is particularly important where the Stalking Horse has among its principals some of the debtor’s prior insider.

iii. Confidentiality Agreement. Because some of the prospective bidders will be competitors of the debtor, a form of confidentiality agreement will need to be prepared to be used in connection with due diligence by prospective purchasers.

iv. Asset Purchase Agreement. The form of asset purchase agreement (“APA”) entered into by the debtor and the Stalking Horse typically becomes the model for other bids with any changes to the APA to be highlighted in the competing bid.

v. Bid deadline & qualification. The date by which competing bidders must submit bids and a procedure for qualifying prospective purchasers must be addressed. For example, the absence of any financing contingency and the financial wherewithal to close is a typical bid requirement.

vi. Stalking Horse incentives. Courts generally defer to the debtor's business judgment that bidding incentives are necessary in order to induce the initial bidder to step forward. In *In re 995 Fifth Ave. Assocs., L.P.*, 96 B.R. 24, 28 (Bankr. S.D.N.Y. 1989), the court held that bidding incentives may be necessary to "convince a white knight to enter the bidding by providing some form of compensation for the risks it is undertaking". In *In re O'Brien Environmental Energy, Inc.*, 181 F.3d 527, 533 (3d Cir. 1999), the court concluded that bidding incentives benefit the estates where they:

1. promote "more competitive bidding, such as by inducing a bid that otherwise would not have been made and without which bidding would have been limited," or

2. induce a bidder to submit a bid that serves as a floor bid on which other bidders can rely.

vii. The most common type of bidding incentives is a provision to compensate the Stalking Horse for its time and expenses, including attorney's fees. If a higher bidder outbids the Stalking Horse, compensation is often provided via a break up fee. A break-up fee is a fee paid by the seller of a business to a potential acquiring party in the event that a contemplated transaction is not consummated. Break up fees are either expressed in terms of a fixed dollar amount or a percentage of the ultimate sale price.

viii. The purposes of a break up fee are:

1. To attract a successful bidder by encouraging potential purchasers to spend the time and money necessary to conduct their due diligence by reimbursing the unsuccessful purchaser for out-of-pocket expenses and for the lost opportunity costs and risks it has incurred;

2. To establish floor for other bidders, and

3. To attract additional bidders. *In re Integrated Resources, Inc.* 147 B.R. 650, 652 (S.D.N.Y 1992).

ix. In *In re O'Brien Environmental Energy, Inc.*, 181 F.3d 527, 533 (3d Cir. 1999), the bankruptcy court identified at least nine factors that it viewed in deciding whether to award a break-up fee and expenses:

1. Is the relationship of the parties who negotiated the break-up fee tainted by self-dealing or manipulation;

2. Does the fee hamper, rather than encourage bidding;

3. Is the amount of the fee unreasonable relative to the proposed purchase price;

4. Did the unsuccessful bidder place the estate property in a sales configuration mode to attract other bidders to the auction;

5. Did the request for a break-up fee serve to attract or retain a potentially successful bid, establish a bid standard or minimum for other bidders, or attract additional bidders;

6. Does the fee requested correlate with a maximization of value to the Debtor's estate;

7. Are the principal secured creditors and the official creditors committee supportive of the concession;

available; and

8. Were safeguards beneficial to the debtor's estate

9. Was there a substantial adverse impact on unsecured creditors, where such creditors are in opposition to the break-up fee.

- x. Other Stalking Horse incentives:

1. A "topping fee" -- payment of some percentage of the excess of the ultimately successful bid over the buyer's bid;
2. Some overbid requirement, requiring a competing bid to be a set amount above the buyer's bid;
3. A "lock up option," requiring the sale of a "crown jewel" to the buyer; or a "no shop" clause, forbidding the trustee from seeking other bidders.

- d. Sale of Personally Identifiable Information

- i. BAPCPA includes changes to 11 U.S.C. § 363(b) that will, in some circumstances, limit a debtor's ability to sell or lease consumer information. When a debtor with a privacy policy has collected personal information about consumers, the debtor can only sell or lease the information in compliance with applicable non-bankruptcy law and if either the sale is consistent with the privacy policy terms or the court approves the sale after the appointment of a consumer privacy ombudsman.

- ii. BAPCPA makes three changes to the Bankruptcy Code that create a new process for selling or leasing customer information using 11 U.S.C. § 363.

1. First, new § 101(41A) defines the term "personally identifiable information."
2. Second, amendments to § 363 limit the debtor's ability to sell or lease personally identifiable information.
3. Third, new § 332 controls the appointment of consumer privacy ombudsmen and defines their role in the sale process. *See* Warren E. Agin, *Handling Customer Data in Bankruptcy Mergers and Acquisitions: Coping with the Consumer Privacy Ombudsman Provisions of BAPCPA* 24-6 ABIJ 1 (2005).

4. Preserving the benefit of 11 U.S.C. § 1146(c)

a. 11 U.S.C. § 1146 subsection (c) exempts from stamp taxes the issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan.

b. In 2005, section 1146 of the Bankruptcy Code was amended and revised by deletion. Former subsection (a), dealing with the taxable period under state and local law, and subsection (b), dealing with state and local tax returns, were moved to section 346. Section 346 now contains numerous provisions designed to affect the treatment and outcome of state and local taxes in bankruptcy matters. Subsections (c) and (d) of section 1146 were re-designated (a) and (b), respectively.

c. To qualify for an exemption under this provision, three conditions must be satisfied:

- i. there must be a stamp tax or similar tax,
- ii. imposed upon the making or delivery of an instrument of transfer,
- iii. “under” a confirmed Chapter 11 plan. *In re T.H. Orlando Ltd.*, 391 F.3d 1287, 1291-1292 (11th Cir. 2004).

d. Typically there is there is no dispute that the first two conditions are met. The controversy centers on whether the transfer was “under” the debtor’s plan.

e. By its terms, § 1146(c) exempts from stamp taxes or similar taxes any instrument of transfer “under” a confirmed Chapter 11 plan. The Third Circuit has held that “the phrase ‘under a plan confirmed’ in 11 U.S.C. § 1146(c) was most likely intended to mean ‘authorized by a plan confirmed.’ ” *In re Hechinger Inv. Co. of Del.*, 335 F.3d 335 F.3d 243, 252 (3rd Cir.2003).

f. Similarly, the Fourth Circuit concluded that the term “under” may be construed as “[w]ith the authorization of” a Chapter 11 plan. See *In re NVR LP*, 189 F.3d 442, 457 (4th Cir.1999) (quoting Webster's II New Riverside University Dictionary 1256 (1988)). The Second Circuit has recognized that a chapter 11 plan impliedly authorizes any transfer that is necessary to the consummation of the plan. See *City of New York v. Jacoby-Bender*, 758 F.2d 840, 842 (2d Cir.1985) (“[W]here, as here, a transfer, and hence an instrument of transfer, is *necessary to the consummation* of a plan, the plan seems implicitly to have ‘dealt with’ the transfer instrument.”) (emphasis added). We agree with our sister circuits' interpretation of § 1146(c). A transfer “under a plan” refers to a transfer authorized by a confirmed Chapter 11 plan. In turn, a plan authorizes any transfer that is necessary to the consummation of the plan.

g. In *In re T.H. Orlando Ltd.*, 391 F.3d 1287, 1291-1292 (11th Cir. 2004), because the plan expressly authorized the transaction, which the bankruptcy court found was necessary to consummation of the plan, the mortgage extended pursuant to the plan was exempt from Florida's stamp tax under the plain language of § 1146(c) even though it involved a third-party transaction involving non-estate property. “Nothing in

the plain language of § 1146(c) restricts its application to transactions involving the debtor or estate property. We therefore conclude that the phrase ‘under a plan’ refers to a transfer that is necessary to the consummation of a confirmed Chapter 11 plan irrespective of whether the transfer involved the debtor or property of the estate.”

5. Fees based on substantial contribution by losing bidder –

a. 11 U.S.C. § 503(b)(3)(D) provides:

After notice and a hearing, there shall be allowed, administrative expenses, other than claims allowed under section 502(f) of this title including

(3) the actual, necessary expenses, other than compensation and reimbursement specified in paragraph (4) of this subsection, incurred by—

D) a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders other than a committee appointed under section 1102 of this title, in making a substantial contribution in a case under chapter 9 or 11 of this title.

b. In *In re Kidron, Inc.*, 278 B.R. 626, 632-33 (Bkrcty. M.D. Fla. 2002) had before it the issue of whether the provisions of section 503(b)(3)(D) could be used by a bidder at an auction that had neither been the Stalking Horse nor the successful bidder.

c. The court noted that irrespective of the creditor's motivation for its participation in a case, if such participation makes a “substantial contribution” to the case, then the creditor's expenses, including attorneys' fees, must be provided administrative priority under section 503(b)(3)(D) and (b)(4).

d. Importantly, by its own terms, such an award is predicated on the contribution being “substantial.” This term is not defined in the Bankruptcy Code. It is clear, however, that the courts that have analyzed what kinds of contribution will be considered “substantial” have generally concluded that creditors' actions that “incidentally” benefit the estate are not “substantial” for purposes of section 503(b)(3)(D).

e. Rather, the courts have required a showing that the creditors' actions must:

- i. “directly and demonstrably benefit” the estate, *Lebron v. Mechem Fin., Inc.*, 27 F.3d 937 (3d Cir.1994);
- ii. “foster and enhance, rather than retard or interrupt the progress of reorganization,” *Celotex* at 1338 (quoting *In re*

Consolidated Bancshares, Inc., 785 F.2d 1249, 1253 (5th Cir.1986)); and

- iii. be “considerable in amount, value or worth.” *DP Partners* at 672 (citing *Webster's Third New International Dictionary* 2280 (4th Ed.1976)).

f. Viewed in this context, the inquiry to be made by a court under these circumstances must focus on the precise nature of the services rendered. Expenses that are typical and ordinarily incurred by purchasers of assets in performing due diligence, participating as a buyer in connection with a sale procedures motion and a motion to approve a sale, obtaining financing, and participating as a bidder in the auction, will not ordinarily be entitled to administrative priority under section 503(b)(3)(D) because of its incidental benefits to the estate. However, where special or unusual circumstances are present and the unsuccessful bidder directly contributes to the sales process as necessitated by circumstances resulting in a demonstrable benefit to the estate, then such expenses should be allowed as administrative expenses under section 503(b)(3)(D).

g. In *Kidron*, the Court concluded that special and unusual circumstances existed due to the connection between the “stalking horse” bidder and the debtors, which relationship, in light of the compressed timeframe in which the sale occurred, appears to have initially hampered the flow of due diligence information to interested bidders for the debtors' assets. These circumstances required extraordinary efforts by the competing bidder to even the “playing field” so that an auction could proceed. The result of these efforts fostered and enhanced the sale of the debtors' assets for an amount exceeding the Stalking Horse bid by \$2 million.

II. Post Confirmation liquidating trusts

1. Pursuant to a confirmed plan, a debtor may create a liquidating trust. The debtor will distribute money, assets, and certain causes of action into the liquidating trust in satisfaction of the creditors' claims as prescribed in the plan.

2. A post confirmation fiduciary is appointed to administer the trust and distribute the funds to the creditors according to the trust agreement. These liquidating trusts can consist only of cash to more complex trusts where the trustees' responsibilities include winding down a business while maximizing recoveries.

3. The trustee's powers are restricted, but often include the power to sell certain property; to increase the fund by avoiding transfers of the debtor's property that are voidable under the Bankruptcy Code; to operate the property; to sue and be sued; to contest and settle disputed claims made against the debtor; to employ attorneys, accountants and agents; and to make distributions pursuant to bankruptcy court order. John D. Howard, *The Taxation of Liquidating Trusts, Escrows And Settlement Funds In Chapter 11 Bankruptcy Cases*, 64 Am. Bankr.L.J. 403 (1990).

4. A confirmed reorganization plan operated as a final judgment with res judicata effect. In *Beck v. Fort James Corp. (In re Crown Vantage, Inc.)*, 421 F.3d 963 (9th Cir. 2005). If a creditor fails to timely object to a plan or appeal a confirmation order, it cannot later complain about a certain provision contained in a confirmed plan, even if such a provision is inconsistent with the Bankruptcy Code. If a court preserves issues for later adjudication by adversary proceeding, then the merits of those actions are preserved for later adjudication. To raise identical issues in a different forum in contravention of the liquidating procedure approved in a confirmed plan is an impermissible collateral attack on the confirmed plan.

III. Proving a case for critical vendor status post K-mart

1. Chapter 11 debtors have used the “critical vendor doctrine” to pay pre-petition debts owed to vendors that the debtors deem to be “critical” to their reorganization efforts. These vendors would refuse to engage in post-petition business with the debtor unless, and until, their pre-petition obligations are paid in full. Because these vendors are integral to the debtor's ongoing business operation, their refusal to engage in prospective business would frustrate the debtor's reorganization efforts and injure the debtors' creditors. James H.M. Sprayregen, James A Stempel, *Down, but Not Out: The Status of Critical Vendor Payments Post-Kmart*: 23-5 ABIJ 26 (2004).

2. The *Kmart* decision.

a. The *Kmart* decision does not reject the critical-vendor doctrine, it limits the situations in which such orders will be deemed appropriate in the Seventh Circuit. Debtors seeking authority in the Seventh Circuit to pay critical vendors for pre-petition goods or services should seek an order pursuant to § 363(b)(1) and must establish:

- i. such payments are, in fact, “critical” to their reorganization,
- ii. discrimination among unsecured creditors is the only way to facilitate a reorganization,
- iii. non-critical vendors will be at least as well off as they would otherwise be if the critical-vendor order is not entered, and
- iv. such payments will not diminish the amount of funds that ultimately will be available for payment to non-critical vendors.

b. Debtors may not simply request broad authority to pay all “critical vendors” and instead will need to specify which pre-petition vendors are critical.

c. In *In re Tropical Sportswear Int'l Corp.*, 320 B.R. 15 (Bankr. M.D. Fla. 2005), the court granted critical vendor status because a sound business justification existed for the critical vendor payments because the critical vendors refuse to do business with the debtors absent critical vendor status. Additionally, the payments to the critical vendors were necessary to the reorganization process because the materials and services

supplied by the critical vendors were necessary for the debtors to maintain their business operations. The court also found that the terms of the payments to the critical vendors were negotiated at arms-length, and the debtors' estates would be improved for the benefit of all creditors including the disfavored creditors.

d. In *Osborne v. Howell Electric Motors (In re Fultonville Metal Prods. Co.)*, 330 B.R. 305, 313 (Bankr. M.D. Fla. 2005), the court stated that a request to pay selected pre-petition vendors is a clear departure from basic bankruptcy precepts. Therefore, such a request should be carefully scrutinized and only granted when the circumstances establish that the selected payments are necessary to the reorganization case and will ultimately benefit all creditors of the estate.

e. Status of critical vendor doctrine:

- i. The Seventh Circuit has limited the critical vendor doctrine;
- ii. The Ninth, Fifth and Fourth Circuits have rejected the doctrine;
and
- iii. The Third Circuit has consistently recognized the doctrine.

f. Due to the *Kmart* decision, practitioners should take care to manage their client's expectations, establish a specific factual record that establishes the need to pay critical vendors and lack of harm to non-critical vendors and consider providing notice to non-critical vendors. James H.M. Sprayregen, & James A Stempel, *Down, but Not Out: The Status of Critical Vendor Payments Post-Kmart*, 23-5 ABIJ 26 (2004).