

Bankruptcy Acquisitions and an Introduction to Second Tier Liens¹

A. Overview

1. Asset Sales Under 11 U.S.C. § 363

a. Controlled by the debtor in possession or the trustee, but subject to pressures of other constituencies, including secured lenders, creditors committee and bondholders.

b. Creditor is not entitled to initiate a sale of assets by the express terms of the statute. *See* 11 § U.S.C. 363; *see also Hartford Underwriters Insur. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1 (2000) (in Bankruptcy Code, “trustee” means only the trustee or the debtor in possession by virtue of 11 U.S.C. 1107); *In re Stangel*, 219 F.3d 498, 500 (5th Cir. 2000) (same).

c. Overview of 11 U.S.C. § 363(b). The Bankruptcy Code divides the trustee’s or DIP’s sale, lease, or other uses of property into one of two categories: (1) sales in the ordinary course of business; and (2) sales outside the ordinary course of business. *See* 11 U.S.C. §§ 363(b) (sale or use outside the ordinary course of business) and 363(c) (transactions in the ordinary course of business). The point of this dichotomy is to permit companies that are operating under court protection to do so without excessive judicial or creditor involvement in day-to-day operations, while balancing the legitimate interest of creditors in avoiding unusual or unjustified dissipation of assets available to satisfy their claims.

Distinguishing “ordinary course” transactions from those outside the ordinary course of business is rarely difficult, and courts typically rely on the perception of creditors and industry norms to draw the line. To determine whether a transaction is within or outside the ordinary course of business, courts typically engage in a two party inquiry consisting of a “horizontal” component and a “vertical” component. In the horizontal aspect of the inquiry, the court reviews whether the transaction under review is of the sort that other companies in the debtor’s industry would ordinarily undertake. The vertical aspect of the test asks whether the transaction involves the same sorts of risks that the debtor’s creditors would or should have contemplated when extending credit to the debtor.

For example, a bakery operating under the protection of Chapter 11 should be able to continue selling bread and cakes without a court order authorizing each sale because other bakeries customarily do so and because any creditor extending credit to the debtor-bakery should have foreseen such sales. If, however, the bakery elects to sell its fleet of bakery trucks as part of its restructuring, that transaction would require court approval because bakeries, generally, are not in the business of selling trucks, and because the debtor’s creditors would not have anticipated that such transactions would form part of the debtor’s business.

i) Ordinary Course of Business. A Chapter 11 DIP (or trustee if one is appointed) is presumptively authorized to operate the debtor’s business, unless the Court on motion orders otherwise. 11 U.S.C. §§ 363(c)(1) and 1108. Along with this authority comes the right to use,

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sell, or lease property in the ordinary course of business -- without any specific order of the court or, for that matter, without giving notice to creditors. Creditors are presumed to know that ordinary course of business transactions will continue in a chapter 11 proceeding.

So, in our hypothetical bankruptcy involving the bakery, the DIP need not notify creditors or the court that it intends to continue selling sticky buns. Such authority is assumed (by the creditors) and implied (by Section 363).

ii) Out of the Ordinary Course of Business. The Bankruptcy Code also authorizes the DIP (or trustee, if one is appointed) to enter into extraordinary transactions involving the property of the estate, but only “after notice and a hearing.” This phrase is actually a term of art, subject to a statutorily defined meaning and, as reflected in the Eastern District of Michigan’s local rules, does not necessarily require a court order – only a meaningful opportunity to get the court involved if necessary. *See* L.B.R. 6004-1(a) (Bankr. E.D. Mich.) (“Neither a court proceeding nor an order is necessary or contemplated to authorize the transactions set forth in the notice unless there is a timely-filed objection which is not formally withdrawn”).

As set forth in the Bankruptcy Code, the phrase “after notice and a hearing” or similar phrase:

(A) means after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances; but

(B) authorizes an act without an actual hearing if such notice is given properly and if—

(i) such a hearing is not requested timely by a party in interest; or

(ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act . . .

11 U.S.C. § 102(1). Returning to our hypothetical bakery that intends to sell its fleet of delivery trucks, it plainly appears that if the DIP wishes to have the authority to sell the trucks it must give creditors and other parties-in-interest meaningful notice of the proposed sale, so that they can object if they oppose it and obtain a hearing. After the hearing, the court will enter an order either authorizing the sale as requested, preventing it from occurring, or conditioning the sale (for example, upon the provision of adequate protection to creditors holding a lien or security interest in the trucks).

On the other hand, it is equally possible that no creditor will object to the sale, and that the failure to object will itself ripen into the DIP’s authority to consummate the sale. In such a case, the DIP should not expect the court to enter any order (at least not in our Eastern District of Michigan), and should proceed to close the sale it negotiated with its buyer. This procedure works well for non-controversial transactions involving relatively small asset values, or the absence of liens on the property, or incontrovertible benefit to the estate. Such transactions should proceed without much fanfare or judicial involvement.

Nevertheless, DIPs, trustees, and buyers naturally favor the “comfort” that comes with a court order that blesses their transaction. Different judges have different views on whether such comfort orders are either necessary or permissible. As set forth in the Eastern District of Michigan L.B.R. 6004-1(a), practitioners on that side of our state should not expect to receive a court order authorizing the sale. In the Western District of Michigan, Judges seem to have differing views with respect to comfort orders.

The Bankruptcy Rules provide that the DIP or the trustee must usually give creditors and other interested parties at least 20 days advance notice of a sale outside the ordinary course of business. Fed. R. Bankr. P. 2002(a)(2). In special circumstances, however, the Rules authorize the court to shorten the notice period. *See* Fed. R. Bankr. P. 9006(c); L.B.R. 9013 (i) & (j) (Bankr. W.D. Mich.) (procedures for emergency motions and motions requesting shortened notice); L.B.R. 9006-1(b) (Bankr. E.D. Mich.). The bankruptcy court enjoys considerable authority to regulate notice as the circumstances require. *See* 11 U.S.C. §§ 102 and 105; Fed. R. Bankr. P. 9007 and 9008. If the sale must take place sooner than 20-25 days (for example, if the buyer will walk without a fast closing or the items will perish), and if the parties persuade the court that exigent circumstances exist, they can likely secure an order shortening the time-frame otherwise prescribed in Fed. R. Bankr. P. 2002(a).

d. Overview of 11 U.S.C. § 363(f)

i) Generally. As noted above, the Bankruptcy Code's exceedingly broad definition of property of the estate (11 U.S.C. § 541(a)) necessarily means that some property that the debtor owns jointly with others or that is encumbered by a lien or security interest in favor of a non-debtor party, will be swept into the bankruptcy estate and available for the debtor's use or distribution to creditors in accordance with the Bankruptcy Code. Given that some property may be encumbered or jointly owned with non-debtors or that the estate's title may otherwise be clouded, how then can the trustee or DIP liberate the value of such property for the benefit of the estate and its creditors?

The answer lies primarily in § 363(f) which, when joined with the authority to sell property outside of the ordinary course of business under § 363(b), authorizes certain sales of property "free and clear of any interest in such property of an entity other than the estate . . ."

ii) Free and Clear. If the trustee's or DIP's buyer wishes to purchase estate property "free and clear" and thus get clean title, the trustee or the estate must invoke 11 U.S.C. § 363(f), and satisfy one of the grounds for effecting such a title-clearing sale. These grounds, any one of which will justify a sale free and clear, are listed as follows:

- 1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
- 2) such entity 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) such interest is in bona fide dispute; or
- 5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

- § 363(f)(1) (Applicable Non-Bankruptcy Law Permits) Perhaps without anyone giving it any thought, the provision of § 363(f)(1) is the most commonly used ground for effecting sales free and clear, since it applies to sales in the ordinary course of business in conjunction with UCC §§ 2-403 and 9-320 – the main Uniform Commercial Code provisions protecting buyers in the ordinary course of business.

Outside the ordinary course of business, Michigan's real property statutes also provide a several avenues for cleaning up title that may come into play by extinguishing certain interests

affecting real estate. *See, e.g.*, MCL §§ 565.101 (marketable record title act) and 565.382 (treating certain ancient mortgages as discharged unless affidavit of renewal is filed of record). The existence of these non-bankruptcy remedies may be used to justify a sale free and clear of specified interests.

- § 363(f)(2) (Consent) The Bankruptcy Code contemplates that the estate and its co-owner or lienor might agree that the sale is in everyone's best interest and, therefore, that the non-debtor interest holder may consent to the sale "free and clear" of its interest. Some difficulty has arisen, however, with respect to what constitutes "consent." Most courts agree that an entity that has been afforded appropriate notice of the proposed sale free and clear, and who fails to object, has impliedly consented to the sale free and clear of its interests. The Western District's Judge Hughes disagrees and has concluded, based upon a statutory interpretation of the term "consent" and the phrase "notice and opportunity," that a trustee or DIP wishing to rely on the consent prong of § 363(f) must obtain the affirmative consent from the other stakeholders. *In Re Roberts*, 249 B.R. 152 (Bankr. W.D. Mich. 2000) (collecting and distinguishing cases). Failure to object to a sale is not necessarily tantamount to consent.

- § 363(f)(3) (Sale Proceeds Exceed All Liens) This prong of § 363(f) recognizes that lien holders are legitimately interested in one thing – getting paid. Thus, if the sale accomplishes that purpose, there is no need to hold up the sale. The court's order will provide that the liens formerly encumbering the property to be sold will be transferred to the proceeds and the lien holders can divide the resulting pie later.

- § 363(f)(4) (Bona Fide Disputes) The theory behind § 363(f)(4) is that the liquidation of property shouldn't be delayed pending resolution of bona fide disputes concerning title. The warring parties are protected because, as with liens immediately above, the proceeds of the sale will stand for the property, and to the victor will belong the spoils.

- § 363(f)(5) (Compelling Monetary Satisfaction In a Proceeding) Section 363(f)(5) recognizes that, under certain circumstances, co-owners or other interested parties could be compelled in judicial proceedings to accept the payment of money in lieu of the property itself. For example, MCL §§ 600.3301 *et seq.*, authorizing partition of property to resolve certain disputes, recognizes that in some cases partition is not feasible and the property must be sold. In such cases, as a matter of non-bankruptcy law, a court has authority to compel interested parties to accept payment of money as their remedy in partition. To similar effect, *see* 11 U.S.C. § 363(g), (h), (i) and (j). A monetary remedy in partition proceeding exemplifies the sort of non-bankruptcy proceeding contemplated in § 363(f)(5).

It is worth noting, however, that § 363(f)(5) is not limited to non-bankruptcy remedies. Some courts have held that the bankruptcy "cram down" procedure, which authorizes the bankruptcy court to require a secured creditor to accept cash payments having a present value equal to the value of the security interest, is such a proceeding. *In re Grand Slam U.S.A.*, 178 B.R. 460, 462 (E.D. Mich. 1995); 11 U.S.C. § 1129(b)(2)(A) (cram-down of secured claims).

Procedurally, Fed. R. Bankr. P. 6004 governs property sales, including sales of property "free and clear." Parties should also consult the local rules governing such sales to ensure compliance with local idiosyncrasies. *See* Fed. R. Bankr. P. 2002(a) (regulating notice generally) and 6004(c) (requiring notice of proposed "free and clear" sale outside the ordinary course of business to include hearing and objection dates); L.B.R. 6004 (Bankr. W.D. Mich.) (requiring sale motions

and orders to include legal description and common address); L.B.R. 6004-1(b) (Bankr. E.D. Mich.) (specifying contents of sale notice in free and clear sales).

It should go without saying that the buyer of property through the bankruptcy court should be keenly aware of, and insist upon strict compliance with, the procedures and notices required to effect the sale, since the buyer is the entity with the greatest interest in obtaining clean and indefeasible title. Although § 363(m) protects buyers from the effects of a modification or reversal of a sale order on appeal, the protection is available only to entities that purchase in good faith. In addition, procedural rules typically stay the effect of a sale order for 10 days to give interested parties an opportunity to seek a stay pending appeal. Fed. R. Bankr. P. 6004(h). If the buyer needs to close on the sale ASAP, it should consider asking the court to include in its order a provision making the order immediately effective.

Because buyers are more interested in purchasing property than buying a lawsuit, it makes sense to ensure that the seller – the trustee or DIP – is playing strictly by the rules and giving ample notice to all parties entitled to receive it. It is far better to flush out a problem on the front-end of a transaction by beating the bushes with appropriate notice and procedural compliance than to discover a problem after expending time and resources on due diligence or property improvements.

MICHIGAN PRACTICE NOTE: *See In re Embrace Systems Corp.*, 178 B.R. 112 (Bankr. W.D. Mich. 1995); *see also In re Quality Stores, Inc.*, 272 B.R. 643 (Bankr. W.D. Mich. 2002).

iii) Potential Liabilities

a) Free and clear of *any interest* of a third party.

b) “Interest” is not defined, resulting in various interpretations. *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 545 (7th Cir. 2003).

c) Dispute as to whether claims affecting property are really interests in property, or whether claims are distinct from interests. Compare 11 U.S.C. § 363(f) (interests) with 11 U.S.C. § 1141(c) (claims and interests); *see supra* at p. 9.

d) Purchasers of assets are generally held accountable under the doctrine of successor liability where:

(ii) an express or implied assumption of liability exists;

(iii) the transaction amounts to a consolidation, merger, or similar restructuring of the entities;

(iv) the purchasing corporation is a mere continuation of the seller; or

(v) the transfer of assets to the purchaser is for the fraudulent purpose of escaping liability for the seller’s debts.

MICHIGAN PRACTICE NOTE: A bankruptcy court sale free and clear of liens, claims and interests bars successor liability claims. Bankruptcy courts have the power to approve sales of assets free and clear of any interest that could be brought against the bankruptcy estate during bankruptcy, either through 11 U.S.C. § 363(f) or the bankruptcy court's equitable powers. However, a sale free and clear does not include future claims that do not arise until after the conclusion of the bankruptcy proceeding. *In re AutoStyle Plastics, Inc.*, 227 B.R. 797, 801 (Bankr. W.D. Mich. 1998) (citations omitted).

e) Courts have found that the term “interests” includes:

- (i) leasehold interest – *FutureSource LLC v. Reuters Ltd.*, 312 F.3d 281, 285 (7th Cir. 2002);
- (ii) discrimination claims as well as the right to a travel voucher program established by settlement - *In re Trans World Airlines, Inc.*, 322 F.3d 283, 290 (3d Cir. 2003);
- (iii) unsecured personal injury claims – *Myers v. U.S.*, 297 B.R. 774 (S.D. Cal. 2003);
- (iv) claims for future pension and health benefit plan payments under the Coal Act, which expressly makes a successor in interest liable for the benefits – *In re Leckie Smokeless Coal Co.*, 99 F.3d 573, 582 (4th Cir. 1996);
- (v) claims for employee benefit premiums – *In re Lady H Coal Co., Inc.*, 199 B.R. 595, 608 (S.D. W. Va. 1996);
- (vi) employment discrimination claims – *In re New England Fish Co.*, 19 B.R. 323, 329 (Bankr. W.D. Wash. 1982); and

iv) Motion Establishing Bidding and Auction Procedures

a) Proffered purchase price must be the “highest and best” offer. *In re Integrated Resources, Inc.*, 135 B.R. 746, 750 (Bankr. S.D.N.Y. 1992, *aff’d*, 147 B.R. 650 (S.D.N.Y. 1992); *see In re Atlanta Packaging Products, Inc.*, 99 B.R. 124, 131 (Bankr. N.D. Ga. 1988) (trustee’s duty is to obtain highest price or greatest overall benefit for the estate).

b) “Best” bid involves an evaluation of competing offers based on:

- (ii) The form of payment;
- (iii) Contingencies of closing; and
- (iv) The ability of the purchaser to provide timely payment.

See In re Gulf States Steel Inc., 285 B.R. 497 (Bankr. N.D. Ala. 2002) (highest and best includes non-monetary considerations); *In re Quality Stores, Inc.*, 272 B.R. 642 (Bankr. W.D. Mich. 2002) (highest offer is not necessarily the best offer).

c) Retention of discretion as to whom will ultimately be the winning bidder at the auction. *See, e.g., In re After Six, Inc.*, 154 B.R. 876, 881 (Bankr. E.D. Pa. 1993) (courts should defer to trustee’s business judgment with respect to bidding); *In re Table Talk, Inc.*, 53 B.R. 937, 939 (Bankr. D. Mass. 1985) (approving procedures recommended by trustee).

d) Procedures for solicitation of competing bids:

- (i) Prohibiting the debtor from directly or indirectly soliciting other offers;
- (ii) Requiring competing bidders to submit bids within a certain time period prior to the hearing on the sale motion (often defined as “Qualified Bidders”);
- (iii) Execution of a confidentiality agreement;
- (iv) Requiring the terms and conditions of competing bids to be the same as, or substantially similar, to those contained in the purchase agreement of the stalking horse bidder; and

- (v) Furnishing a deposit as well as financial qualifications.
- e) Procedures for the auction include, among other things:
 - (i) The holding of an auction, but only in the event qualified competing bids are submitted prior to the final hearing on the sale;
 - (ii) Overbid and minimal increment bidding requirements;
 - (iii) Qualifications for trustee or debtor in possession's determination of "highest and best" bid; and
 - (iv) A provision allowing the purchaser the right to match any qualifying bid.
- f) Stalking Horse Bidder²
 - (i) Attract competing bidders willing to acquire assets on the same terms and conditions, but at a higher and better price;
 - (ii) Advantages:
 - a) Guaranteed opportunity to bid at auction;
 - b) Formulation of minimum requirements for bidding and the terms of sale;
 - c) Compensation pursuant to breakup and topping fees. *See infra* at p. 11;
 - d) Determine initial purchase price; and
 - e) More time to conduct due diligence and win favor from other constituencies.
 - (iii) Disadvantages:
 - a) Difficult and time consuming to negotiate stalking horse agreement;
 - b) Bidding procedures may be challenged and stalking horse may lose breakup and topping fee benefits; and
 - c) Stalking horse's bid may be too high in relation to market environments.
 - d) Breakup Fees and Topping Fees
 - (i) Requested by a stalking horse bidder in case the stalking horse bidder is not the winning bidder.
 - (ii) Payment made to the stalking horse bidder in the event that the contemplated transaction fails to be consummated.
 - (iii) Reimburse the stalking horse bidder for its out of pocket expenses related to the proposed acquisition and/or compensation for the time, efforts, resources, lost opportunity costs and risks incurred by the stalking horse bidder. *See, e.g., In re APP Plus, Inc.*, 223 B.R. 870 (Bankr. E.D.N.Y. 1998).

² See Corrine Ball and John K. Kane, *How to Handle Corporate Distress Sale Transactions*, SM036 ALI-ABA 415 (Am. L. Inst. 2006).

(iv) Range of breakup fees typically approved by bankruptcy courts is between 1% and 3%. *See, e.g., In re Worldwide Direct, Inc.*, Case No. 99-108 (Bankr. D. Del. Feb. 26, 1999) (approving breakup fee of 3.1% of proposed purchase price and 4% of the actual purchase price); *In re Integrated Resources, Inc.*, 135 B.R. 746, 749-53 (Bankr. S.D.N.Y.), *aff'd*, 147 B.R. 650, 663 (S.D.N.Y. 1992), *appeal dismissed*, 3 F.3d 49 (2d Cir. 1993) (approving break-up fee of 3.2% of out-of-pocket purchase price, depending on status of transaction at time of termination); *In re Trailmobile Trailer, LLC*, Case No. 01-43820 (Bankr. N.D. Ill., May 9, 2002) (break-up fee of 2.5% approved).

(v) Topping fee is paid only in the event that another bidder is the successful purchaser.

(vi) Topping fee is usually a percentage of the amount over the unsuccessful purchaser's bid. Since topping fees are based on the amount of the overbid, they do not usually add a preset cost to the purchase price.

(vii) Three part test to determine if fee is appropriate based on the business judgment of the debtor in possession or the trustee:

- a) whether the negotiation of the fees was tainted by self dealing and manipulation;
- b) whether the fees discourage or encourage bidding by other parties; and
- c) whether the fee is unreasonable relative to the proposed purchase price. *See, e.g., In re Integrated Resources, Inc.*, 147 B.R. 650, 657 (S.D.N.Y. 1992); *see also Mission Iowa Wind Co. v. Enron Corp.*, 291 B.R. 39, 40 (S.D.N.Y. 2003) (heightened scrutiny of motives and reasoning for proposed sale of assets).

(viii) Alternative approach is whether fee "unduly burdens" the debtor's estate by considering:

- a) whether the fee requested correlates with a maximization of value to the debtor's estate;
- b) whether the underlying negotiated agreement is an arms-length transaction between the debtor's estate and the negotiating acquirer;
- c) whether the principal secured creditors and the creditors committee are supportive of the concessions;
- d) whether the breakup fee constitutes a fair and reasonable percentage of the proposed purchase price;
- e) whether the dollar amount of the breakup fee is so substantial that it provides a chilling effect on other potential bidders;
- f) the existence of available safeguards beneficial to the debtor's estate; and
- g) whether a substantial adverse impact on unsecured creditors exists where such creditors oppose the breakup fee.

See In re S.N.A. Nut Co., 186 B.R. 98, 104 (Bankr. N.D. Ill. 1994) (rejecting the business judgment rule to analyze breakup fees because sale of substantially all assets is by definition outside the ordinary course of business); *see also In re America West Airlines, Inc.*, 166 B.R. 908 (Bankr. D. Ariz. 1994) (applying heightened scrutiny to proposed breakup fees);

but see *In re O'Brien*, 181 F.3d 527, 535 (3d Cir. 1999) (reviewed break up fees as administrative expense pursuant to 11 U.S.C. § 503(b)).

h) Upset Bids: the highest and best bidder at an auction is not necessarily the winning bidder where the auction and bidding procedures do not foreclose later bids. See, e.g., *Corporate Assets Inc. v. Paloian*, 368 F.3d 761 (7th Cir. 2004); *In re Gil-Bern Indus., Inc.*, 526 F.2d 627 (1st Cir. 1975).

v) Motion for Sale of Assets

a) Differences between purchase agreements in and out of bankruptcy:

- (i) few, if any, material representations and warranties;
- (ii) a lack of hold backs and escrows because creditors demand to know the net purchase price;
- (iii) deadlines for bankruptcy court approval of bid and auction procedures, as well as the sale itself;
- (iv) choice of venue provisions are subject to the discretion of the bankruptcy court, which typically retains jurisdiction over disputes arising from the sale of the assets;
- (v) the priming of senior lenders by breakup and/or topping fees; and
- (vi) a method for the cure of executory contracts and unexpired leases that must be cured.

b) Factors for determining sound business judgment for sale:

- (i) the proportionate value of the assets to the estate as a whole;
- (ii) the amount of time elapsed since the sale motion was filed;
- (iii) the likelihood that a plan will be proposed and confirmed in the near future;
- (iv) the effect of the proposed distribution on future plans;
- (v) the proceeds obtained from the sale as compared to the appraisal of the assets;
- (vi) whether the assets are increasing or decreasing in value;
- (vii) adequate and reasonable notice to interested parties;
- (viii) a fair and reasonable sale price; and
- (ix) the good faith of the purchaser.

See, e.g., *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983) (seminal case); *In re Calpine Corp.*, 2007 U.S. Dist. Lexis 1324, *24 (S.D.N.Y. Jan. 9, 2007) (applying *Lionel* factors); *In re Titusville Country Club*, 128 B.R. 396, 399 (Bankr. W.D. Pa. 1991).

MICHIGAN PRACTICE NOTE: A sale of assets is appropriate where the provisions of 11 U.S.C. § 363 are followed, the bid is fair, and the sale is in the best interests of the debtor's estate and its creditors. *In re Embrace Systems Corp.*, 178 B.R. 112, 123-24 (Bankr. W.D. Mich. 1995) (examining sound business judgment factors expounded in *Lionel*); see

Stephens Industries, Inc. v. McClung, 789 F.2d 386, 390 (6th Cir. 1986); *see also In re Dalen*, 259 B.R. 586 (Bankr. W.D. Mich. 2001) (discussing business judgment factors in context of settlement under Fed. R. Bankr. P. 9019(a)).

c) Notice

(i) Motion for sale free and clear must be served on “parties who have liens or other interests in the property to be sold.” Fed. R. Bankr. P. 6004(c); *see* 11 U.S.C. § 363(b).

(ii) Sale can be made pursuant to public or private sale. Fed. R. Bankr. P. 6004(f).

(iii) Unless otherwise ordered by the court, an objection must be filed no less than five (5) days before the date set for the sale. Fed. R. Bankr. P. 6004(b).

(iv) Unless otherwise ordered by the court, at least twenty (20) days notice of the sale must be given. Fed. R. Bankr. P. 2002(a).

(v) Notice of sale must include time and place of public sale, the terms and conditions of any private sale and the time fixed for filing objections. Fed. R. Bankr. P. 2002(c); *see In re Naron Wagner, Chartered*, 88 B.R. 85, 89 (Bankr. D. Md. 1988) (imposing additional requirements of disclosure of terms, identity of purchaser, the effect of the sale on the debtor’s continued business and explanation as to why sale price is reasonable and why sale before plan confirmation in best interests of the estate).

(vi) Hearing and court approval are not required for sale unless objections are made. *In re Telesphere Communications, Inc.*, 179 B.R. 544, 552 (Bankr. N.D. Ill. 1994) (proposed sale in compliance with Fed. R. Bankr. P. and without objection does not required court approval).

(vii) MICHIGAN PRACTICE NOTE:

In the Bankruptcy Court for the Eastern District of Michigan, a notice of the proposed sale must be served by the trustee or DIP. The notice must include a statement that the time fixed for filing an objection is fifteen (15) days from the date the notice is served. Neither a court proceeding nor an order is necessary to authorize the transactions (i.e., the sale) set forth in the notice unless a timely objection is made. *See* L.B.R. 6004-1(a) (Bankr. E.D. Mich.). A motion for authority free and clear of liens and other interests may be granted without a hearing, subject to certain conditions. *See* L.B.R. 6004-1(b) (Bankr. E. D. Mich.); *see In re Crowell*, 225 B.R. 334 (E.D. Mich. 1997) (where no objection to proposed sale made, sale order in complex situations may nonetheless prove important and necessary).

The Bankruptcy Court for the Western District of Michigan does not have a similar local rule, but has adopted a local rule requiring the debtor in possession or trustee to file a written report of the sale. *See* L.B.R. 6004 (Bankr. W.D. Mich.).

2. Benefits Over Non-Bankruptcy Dispositions. For a secured creditor, a bankruptcy sale under § 363(f) provides a number of benefits in the form of a procedure familiar to the parties and the court, a decision-maker with relevant expertise in debtor-creditor matters, quicker realization of value, and transfer of better title. Judge Hughes, in *In re Roberts*, 249 B.R. 152 (Bankr. W.D. Mich. 2000), described the lender’s support for a section 363(f) sale as “a concerted effort . . . to circumvent the Michigan foreclosure laws” This remark left the impression that the lender was up to no good, but in point of fact the lender in *Roberts* like

lenders who support 363(f) sales generally was simply pursuing an available federal remedy under the circumstances

a. No Redemption Period. If foreclosure by advertisement is not available or desirable (perhaps because the mortgage did not contain a power of sale, or perhaps because of other title problems), a mortgagee who proceeds to foreclose through judicial proceedings under MCL §§ 600.3101 *et seq.* can expect to encounter the usual delays associated with all civil litigation, plus the delays associated with a 6 month redemption period.

Even the typical foreclosure of real estate by advertisement under MCL §§ 600.3201 *et seq.*, which offers advantages over judicial foreclosure, also takes time. In non-judicial foreclosure, the redemption period is generally 6 months (unless commuted in the case of abandoned property, and provided the lender jumps through a number of statutory hoops). MCL § 600.3240 (time for redemption).

This means that the mortgagor, junior lienor or other person claiming through the mortgagor has 6 months from the date of the foreclosure sale to redeem the property by paying the indebtedness, interest, and other costs. During this time, the mortgagor may continue to occupy the premises. At the conclusion of the redemption period, if the mortgagor or junior lienor has not redeemed, the mortgagor is obligated to quit the premises. Sometimes, however, the mortgagor does not leave the premises without the compulsion of a court order. And, although summary proceedings are available to remove the hold-over mortgagor, MCL § 600.5714(f) and MCR § 4.201, these proceedings do add expense and further delay beyond the usual six month redemption period. Effectively, § 363(f) fast-forwards the foreclosure process by giving the buyer clean title (and the lender the value of the collateral) without the delay associated with redemption and summary proceedings to recover possession. The same order that directs the sale can dispossess the debtor or others in possession.

Because a bankruptcy sale brings certainty and speed to the process of realizing collateral value, it is popular with secured lenders. It is also popular with DIPs and trustees who find it easier to attract more buyers to a bankruptcy sale than a foreclosure sale, and who rightly believe that a bankruptcy sale is likely to fetch a higher price. Foreclosure sales rarely produce a surplus.

Since buyers can count on gaining access to the property almost immediately after the bankruptcy court approves the sale, rather than waiting the roughly 8 months it takes from foreclosure to possession, and since they don't have to worry about the possibility of redemption frustrating their purchase, and since they know they're getting clean title, they naturally are willing to pay a higher price for the property. In short, §363 sales reduce risk, and with less risk comes greater recovery for the estate and its creditors.

b. Speed Associated With “Notice and Opportunity” Procedure

The Bankruptcy Code and Rules contemplate that sales outside the ordinary course of business require “notice and a hearing” but, as noted above, this phrase requires only notice and an *opportunity* for a hearing. If the parties do not require a sale free and clear, the sale can occur – in the absence of objection – without any court involvement whatsoever.

In practice, many extraordinary sales occur after mailing notice to creditors and other interested parties, waiting usually 20-25 days, and (in the absence of timely objection) advising the court that no objections have been filed. If the sale is intended to divest interests other than

the estate's interest (i.e., if it relies on § 363(f)). Most courts will issue an order after being advised of the absence of objection. If the sale is "subject to" interests other than the estate's interest (which will be transferred by the trustee's or DIPs deed or bill of sale), an order is neither necessary nor contemplated. If an order is entered, the relatively short time to appeal – 10 days not counting weekends or holidays – further accelerates closure. *See* Fed. R. Bankr. P. 8002(a) (notice of appeal must be filed within 10 days after entry of order); *id.* 9006(a) (unless the last day of a period falls on a weekend or holiday, exclude weekends and holidays when computing any period of time prescribed by law that is longer than 8 days). The whole procedure is designed to be fast and cost-effective.

c. Protection of the Sale Transaction Against Direct or Collateral Challenges [Appeal Mooted Under 11 U.S.C. § 363(m)]

Finality of the bankruptcy sale is another major advantage over a foreclosure sale, from the point of view of both the secured creditor and the buyer. Although most Michigan non-judicial foreclosures are not set aside, the mortgagee's failure to precisely follow the procedures for posting and publication and conduct of the sale could jeopardize the finality of the sale if the mortgagor and persons claiming through the mortgagor can make some showing of prejudice. Judicial foreclosure sales similarly run the risks associated with reversal on appeal – after months or years on appeal.

Bankruptcy sales, in contrast, enjoy considerable protection against being unwound even on appeal, provided that (1) the buyer purchases in good faith and (2) the sale's antagonist does not obtain a stay pending appeal. 11 U.S.C. § 363(m). Moreover, bankruptcy appeal times are exceedingly short. The appellant must file a notice of appeal within 10 days after entry of the sale order, must file the record on appeal within days after that, quickly get a transcript, and then adhere to a strict briefing schedule – usually 15 days after entry of the appeal on the docket. *See generally* Fed. R. Bankr. P. 8002-8009.

In addition to complying with the rocket docket of the appellate process, the appellant must obtain a stay of the sale in order to prevent the closing of the sale from rendering the appeal moot. 11 U.S.C. § 363(m). The appellant must seek the stay from the bankruptcy court in the first instance, and from the appellate court if the trial court withholds relief. Fed. R. Bankr. P. 8005. As in other appeals, the court may condition the stay upon the posting of a bond.

Similarly, creditors and other interested parties who receive notice of the proposed sale but who fail to object will have a difficult time attacking the sale collaterally, given the principles of collateral estoppel that attach to sale orders.

In short, the Bankruptcy Code and Rules afford considerable advantages to the buyer at a bankruptcy sale, over the advantages available in the foreclosure process.

But see In re BCD Corp., 119 F.3d 852, 860 (10th Cir. 1997) (aggrieved bidder had standing to challenge results of sale after debtor and winning bidder deviated from the terms of significant sale term).

d. Transfer Taxes. Under 11 U.S.C. § 1146(a), sales effected "under a plan confirmed" are exempt from state transfer taxes. Some courts have extended this protection to pre-plan sales, and the Michigan Department of Treasury appears to have conceded the propriety of extending the exemption to a pre-plan sale. *See* Michigan Department of Treasury Website (FAQ) at <http://www.michigan.gov/taxes/0,1607,7-238-43868-154527--F,00.html> (noting that "[c]ase law

provides that a transfer taking place before plan confirmation will still be exempt under Section 1146(c)[sic]). Exempting pre-plan transfers, however, remains controversial. See Paul D. Leake & Mark G. Douglas, *Practitioner Note: Testing The Limits Of The Chapter 11 Transfer Tax Exemption: In Search Of The Meaning Of "Under A Plan Confirmed"*, 1 N.Y.U.J. L. & Bus. 839 (Summer 2005).

e. Pay to Play – Carve-Out and Surcharge of Collateral As the Price of the Bankruptcy Sale. It should come as no surprise that the benefits of a §363 sale almost always come at a cost, usually borne by the secured creditor in the form of a “surcharge” or “carve-out.” Relying on 11 U.S.C. § 506(c), DIPs, trustees, or committees argue that the secured creditor should bear the expense of the sale (including attorneys fees, trustee fees, advertising expenses, commissions and the like) since the secured creditor typically derives the majority of the benefits of the transaction.

In addition, because bankruptcy courts do not exist simply to serve secured creditor interests, the estate or its committee frequently seeks a “carve out” from the sale proceeds so that something trickles down to the unsecured creditors (usually after trickling through the hands of estate professionals who get paid first). The size of the carve-out will depend upon the value of the collateral and extent of the liens, and the relative bargaining power of the estate, the secured creditors and the buyer whose bid, after all, generates the proceeds.

It may be useful to think of a § 506(c) surcharge as analogous to a special assessment in real estate tax practice: because the transaction peculiarly benefits a particular piece of property, that property should bear the expense. Continuing the analogy, the “carve-out” is akin to general property or sales taxes, since it exists to spread the benefit of the transaction more widely to the estate and its administrative and pre-petition creditors.

3. Overview of Assumption and Assignment of Executory Contracts/Unexpired Leases. Contract and lease rights are another form of property rights that the DIP or trustee must deal with under the Bankruptcy Code. If the contract is “executory” or the lease is “unexpired,” then § 365 will govern the rights and responsibilities of the parties to these agreements.

It is usually a simple matter to identify an unexpired lease, as the parties can readily review the bargained-for term provision. The effect of a default on the term of the lease may cloud the issue somewhat if the default is contested, but in the run-of-the-mine cases the parties can determine whether the lease is expired or not on the petition date.

On the other hand, whether a contract is “executory” (and therefore within the ambit of § 365) or executed (not within § 365) depends upon whether performance remains due to some extent on both sides of the bargain. *In re Terrell*, 892 F.2d 469, 471 (6th Cir. 1989) (“Congress apparently had in mind the definition of executory contracts set forth in Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439, 460, 255 N.W. 486 (1973)” where Professor Countryman defined an executory contract as “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other”).

For example, if the debtor and the non-debtor enter into a contract which obligates the debtor to sell an automobile for \$10,000, and the buyer has fully paid the purchase price and is simply waiting for delivery, the contract is not likely to be regarded as “executory” because the buyer

has fully performed. Because performance remains due only on the part of the debtor – it must deliver the automobile – the buyer has a claim against the debtor for the car or its value but the debtor has already received its bargained-for performance from the buyer in the form of the purchase price. On the other hand, if the buyer has made only a down-payment, and the debtor has not delivered the vehicle, this is a far better case for treatment as an executory contract. If the debtor has struck a bad bargain, § 365 will permit the estate to escape some of the consequences by putting a brake on the transaction.

From the estate's point of view, treating the contract as executory (or the lease as unexpired) gives the trustee or DIP greater flexibility to deal with its relationship to the non-debtor counterparty. This flexibility initially takes the form of two choices for the estate's representative: either (1) reject the contract or unexpired lease and give the counterparty a pre-petition damage claim for the resulting breach; or (2) make the obligations binding on the estate by assuming the contract or unexpired lease.

The first option – rejecting the contract or lease – presents no meaningful opportunity for acquisition through the bankruptcy court since the decision to reject effectively removes from the bankruptcy estate the benefits of the contract. The effect of the DIP's decision to reject an unexpired lease or contract is that the contract or lease is treated as having been breached just prior to the filing of the bankruptcy petition. 11 U.S.C. § 365(g). This gives the counterparty a pre-petition claim against the debtor and, with respect to leases in which the debtor was the lessee, requires the DIP or trustee to surrender the leased property or premises to the lessor. In effect, the rejection means that the DIP no longer has a possessory interest in the premises or property subject to the lease.

The second option – assumption of the contract or lease – presents one of the Bankruptcy Code's prime acquisition opportunities, since contract and lease rights can be among the estate's most valuable assets. If the trustee or DIP assumes the lease or contract, in many cases it will be permitted to assign the lease or contract to a third party – even if the terms of the lease or contract purport to prohibit assignment. *See* 11 U.S.C. § 365(f)(1) (rendering most restrictions on assignment unenforceable in bankruptcy).

Assume, for purposes of illustration, that the DIP, as lessee, is leasing office space that it does not need for its reorganization. Assume, further, that the rental rate under the lease is \$10 per square foot, but that the current market rate for comparable properties is \$15 per square foot. Under the two-step approach available through § 365, the DIP may assume the lease (and thereby insist that the landlord continue to lease the space at \$10 per square foot) and then may find a “buyer” or assignee who would be willing to pay up to \$14.99 per square foot for the right to possession. Depending on the deal that the DIP strikes with the proposed assignee, the DIP can pocket the difference and the landlord is stuck with a new tenant that it never bargained for or with.

The point of § 365 is to give the estate the option of jettisoning burdensome contracts or leases, and keeping the valuable ones. In some cases the estate can derive value from the worthwhile contracts by assigning them to someone else in exchange for negotiated consideration. This assignment presents a prime bankruptcy acquisition opportunity.

In addition to giving the DIP or trustee the right to decide whether to reject or assume executory contracts and unexpired leases (and possibly assign them), Congress gave the estate's representatives time in which to make the decision.

- In Chapter 7 proceedings, the trustee has 60 days from the order for relief (usually the petition date) in which to decide to assume or reject unexpired leases of residential real property or personal property where the debtor is lessee. With respect to nonresidential real estate leases where the debtor is lessee, the trustee must decide within 120 days of the order for relief whether to assume such leases. The trustee's failure to make the election within either the 60 or 120 period results in automatic rejection at the expiration of the period. In certain circumstances, the trustee can seek modest extension of these periods. *See* 11 U.S.C. § 365(d)(1) & (d)(4).

- In Chapter 11 proceedings, the DIP or trustee has until the confirmation of a reorganization plan to decide whether to assume or reject an executory contract or unexpired lease or residential real estate or personal property. With respect to non-residential real estate which the debtor held as lessee, such leases will be deemed rejected if the trustee fails to assume or reject by the earlier of 120 days after the order for relief (usually the petition date) or the date the court enters the confirmation order. *See* 11 U.S.C. § 365(d)(2) and (d)(4). In certain circumstances, the DIP or trustee can seek modest extension of these periods.

Given the quandary that the landlord or contractual counterparty might confront in such a situation, it is reasonable to assume that Congress would have balanced this hardship against the DIPs value-creation opportunity by affording the non-debtor counter-party some protection. As discussed below, *supra* at p. 21, this protection takes two forms: (1) cure (§ 365(b)(1)(A) and (B)) and (2) in most circumstances, adequate assurance of future performance (§ 365(b)(1)(C)).

a. Types of Agreements

1) Personal Property. The variety of unexpired contracts that fall within the scope of § 365 is as limitless as the variety of contracts in commerce. From routine service contracts to more elaborate automotive supply contracts to software licenses, employment and pension agreements – if performance of contractual obligations remains due to some extent on both sides, the agreement must be either rejected or assumed under § 365. Similarly, unexpired leases of personal property – copiers, cars, or container-ships – fall within § 365.

2) Real Property. Real estate-related agreements within the ambit of §365 include leases, real estate purchase agreements, land sale contracts, and other arrangements. *In re Delex Management*, 155 B.R. 161, 164 (Bankr. W.D. Mich. 1993) (*citing Terrell v. Albaugh (In re Terrell)*, 892 F.2d 469 (6th Cir. 1989) for proposition that land sale contract is executory contract under § 365).

In addition, options to purchase real estate may be treated as executory contracts falling within § 365, depending upon whether the court regards the option as an agreement relating to property, simply an offer to sell property, or perhaps an interest in the property itself. *Bronner v. Chenoweth-Massie P'shp. (In re National Fin. Realty Trust)*, 226 B.R. 586, 589 (Bankr. W. D. Ky. 1998) (noting that “the contingent nature of the obligations arising from an option agreement” has “puzzled many courts, resulting in two distinct lines of cases”). If the holder of the option has exercised it prior to the petition date, the court is more likely to treat the option agreement as an executory contract on the theory that the exercise of the option by the optionee amounts to the acceptance of the optioner's offer to sell. On the other hand, if the holder has not exercised the option before the petition date, it is more difficult to conclude that the counterparty has any obligation to perform because (until the option is exercised) there is no mutuality of obligation: the option is merely an unaccepted offer to sell.

In any event, it is possible that the parties to the option contract may have recorded a memorandum of their agreement with the Register of Deeds, because an option to sell real estate given by the owner of the premises may be regarded as an obligation that runs with the land. *See generally* John G. Cameron, Jr., Michigan Real Property Law Principles and Commentary (3d ed. ICLE 2005), § 15.47. This raises an interesting issue concerning the overlap of Bankruptcy Code sections 363(f) (dealing with sales of property free and clear of interests in that property) and 365 – an issue that arises not just with options but also with leasehold interests. How should the DIP or the trustee and the potential purchaser of real estate deal with the existence of a prepetition option to purchase real estate or existing leasehold interest? Both would seem to be “interests” subject to § 363 and “executory contracts” subject to § 365.

In *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003), the Seventh Circuit held that Section 363(f) authorizes a DIP or trustee to sell real estate in bankruptcy free and clear of leasehold interests, even though the DIP had neither assumed nor rejected the unexpired lease under § 365 at the time of the sale. Harmonizing the two sections, the appeals court concluded that the lessee’s right to request adequate protection as part of the sale process under § 363(e) would have permitted the lessee to protect the interests that § 365(h) also protects by permitting the lessee to remain in possession after the rejection of the lease. Thus, although the lessee in *Qualitech* would have been entitled to remain in possession under § 365(h) if the DIP had proceeded under that section rather than § 363(f), the court found that the lease was an interest in property that was extinguished in a sale “free and clear.” The lessee should have opposed the sale. Similarly, the holder of an exercised option must take care to see that a proposed bankruptcy sale does not result in a forfeiture of its interests. From the point of view of the buyer of the land that may be subject to an option, the buyer should make sure that the holder of any option (recorded or otherwise) receives notice of the proposed sale. Again, the buyer wants to buy the land, not a lawsuit as in *Qualitech*. The decision in *Qualitech* also exemplifies the protections afforded to bankruptcy sales against collateral attack.

b. Miscellaneous

1) Shopping Center

a) Assumption and assignment of shopping center lease is subject to restrictions (such as radius, location, use or exclusivity) included in the lease to be assigned, any other tenant lease or financing agreement or master agreement. 11 U.S.C. § 365(b)(3)(C).

b) Court must consider whether sale of lease will affect the success or failure of other tenants. 11 U.S.C. § 365(b)(3)(D).

c) Court will consider direct and indirect financial effect on the shopping center landlord. 11 U.S.C. § 365(b)(3)(D).

d) Criteria for determining if property is a “shopping center”:

- (i) Combination of leases;
- (ii) All leases held by single landlord;
- (iii) All tenants engaged in the commercial retail distribution of goods;
- (iv) The presence of a common parking area;
- (v) The purposeful development of the area as a shopping center;

- (vi) The existence of a master lease;
- (vii) The existence of fixed hours during which all the stores are open;
- (viii) Joint advertising;
- (ix) Contractual interdependence of the tenants evidenced by restrictive use provisions in their leases;
- (x) The existence of percentage rent provisions;
- (xi) Right of tenants to terminate if the anchor tenant terminates;
- (xii) Joint participation in trash removal and other maintenance;
- (xiii) Existence of a tenant mix; and
- (xiv) Contiguity of the stores.

See, e.g., In re Joshua Slocum, Ltd., 922 F.2d 1081, 1087-88 (3d Cir. 1990); *In re Sun TV and Appliances, Inc.*, 234 B.R. 356 (Bankr. D. Del. 1999); *see also In re Goldblatt Bros., Inc.*, 766 F.2d 1136, 1140-41 (7th Cir. 1985) (debtor was not tenant in shopping center where no master lease, no common areas, no fixed hours and no joint advertising); *In re Ames Dep't Stores, Inc.*, 127 B.R. 744, 751 (Bankr. S.D.N.Y. 1991).

e) Adequate Assurance

- (i) Source of rent and other consideration, as well as the financial condition and operating performance of proposed assignee. 11 U.S.C. § 365(b)(3)(A).
- (ii) Percentage rent due under the lease will not substantially decline. 11 U.S.C. § 365(b)(3)(B).
- (iii) Assumption and assignment is subject to provisions of the lease. 11 U.S.C. § 365(b)(3)(C).
- (iv) No disruption of tenant mix. 11 U.S.C. § 365(b)(3)(D).

2) Aircraft. The DIP's use of aircraft presents special issues requiring special provisions, at least where the DIP (e.g. (US Air, Delta, Northwest) is a carrier holding an air carrier operating certificate issued under chapter 447 of title 49, United States Code. As a result, Congress supplemented the provisions of § 365 by enacting § 1110, which applies only in chapter 11 proceedings in which an air carrier is a debtor.

In a nutshell, if the aircraft transaction (whether a lease or secured financing) falls within the protected class of transactions, the DIP-airline must agree to perform the lease or loan agreement and must promptly cure monetary and non-monetary defaults within 60 days after the bankruptcy filing, or risk losing the right to use the aircraft or engine at issue. In other words, failing to comply with § 1110(a) during the first 60 days of the case automatically vacates the automatic stay on the sixtieth day after the order for relief. *See* 11 U.S.C. § 1110(a). Because the automatic lifting of the automatic stay gives the lessor/lender the right to immediate possession of the aircraft, aircraft financiers and lessors enjoy more leverage under § 1110(a) than the average non-aircraft counterparty does under § 365. Like most sections of the Bankruptcy Code, however, § 1110 encourages interested parties to reach a resolution of their disputes through negotiation. Thus, aircraft financing parties can and frequently do agree to

extend the 60 day “1110 Period” on terms and conditions usually requiring rent or interest payments, regular maintenance, and insurance coverage, among other conditions.

3) Collective Bargaining/Pension/Health Benefits

a) Debtor must make a proposal to the authorized representative for the collective bargaining agreement (*i.e.*, the labor union).

b) Proposal must “provide for those necessary modifications . . . that are necessary to permit the reorganization of the debtor and assures that all creditors, the debtor and all of the affected parties are treated fairly and equitably.” 11 U.S.C. § 1113(b)(1)(A).

c) Majority of courts hold that a debtor must satisfy various requirements by a preponderance of the evidence in order to reject collective bargaining agreements. *See, e.g., In re National Forge Co.*, 289 B.R. 803, 809-10 (Bankr. W.D. Pa. 2003); *In re Lady H. Coal Co., Inc.*, 193 B.R. 233, 241 (Bankr. S.D. W. Va. 1996).

d) Procedures for modifying retiree insurance benefits are similar to those for modifying collective bargaining agreements. Compare 11 U.S.C. § 1113(b)(1)(A) with 11 U.S.C. § 1114(f)(1).

e) A plan of reorganization cannot be confirmed unless it the plan specifically provides for the continued payment of all retiree benefits in accordance with 11 U.S.C. § 1114. *See* 11 U.S.C. § 1129(a)(3).

c. Cure as Condition to Assumption

If debtor in default under executory contract or unexpired lease, trustee or debtor in possession, pursuant to 11 U.S.C. § 365(b)(1), must:

1) cure any defaults (other than a default under an *ipso facto* clause) or provide adequate assurance that it will be cured; and

2) compensate the other party to the contract or lease for the actual pecuniary loss suffered by that party on account of the default.

MICHIGAN PRACTICE NOTE: For a discussion of cure requirements, *see In re Urbanco, Inc.*, 122 B.R. 513 (Bankr. W.D. Mich. 1991).

d. Adequate Assurance of Future Performance. If the debtor has breached the lease or contract, the non-debtor counterparty is entitled to insist that the DIP provide adequate assurance of future performance as a condition of the DIP’s or trustee’s assuming the lease or contract. *See* 11 U.S.C. § 365(b)(1)(C). If, however, the debtor has fully complied with its end of the bargain, it need not provide adequate assurance of performance unless the DIP or trustee intends to assign the agreement after assuming it. 11 U.S.C. § 365(f)(2)(B).

The concept of “adequate assurance” is borrowed from the UCC’s Article 2 on sales, specifically § 2-609, which is intended to protect the contracting parties expectation of performance from the other party. *See* MCL § 440.2609 (“When reasonable grounds for insecurity arise with respect to the performance of either party the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return”).

In practice, at least when the lease or contract is to be assigned, adequate assurance of future performance requires the *assignee* to establish its credit worthiness and its capacity to perform the obligations that it will be assuming under the assigned contract, although the burden technically remains on the DIP or trustee. The court will determine whether the DIP (or the assignee) has made this showing.

e. Notice

1) Notice of a motion to assume or reject, other than part of plan, must be given to other parties to the contract or lease, and any other party in interest as directed by the bankruptcy court. Fed. R. Bankr. P. 6006(c).

2) Order authorizing assignment under 11 U.S.C. § 365(f) is stayed until the expiration of ten (10) days after the entry of the order, unless the court determines otherwise. Fed. R. Bankr. P. 6006(d).

4. Plan of Reorganization/Liquidation. Debtor in possession or trustee may sell all or any part of property of the estate, either subject to or free of any lien, as part of a plan. 11 U.S.C. § 1123(a)(5)(B) and (D).

a. Benefits

1) Exemption from state and local transfer taxes.

2) More flexibility in terms of form and timing of payment by allowing for negotiation of claims and issuing debt or equity securities.

3) Obtain more protection from successor liability via 11 U.S.C. § 1141(c) and broad third party releases.

b. Requirements

1) The plan complies with all of the provisions of the Bankruptcy Code.

2) The proponent of the plan has complied with all of the provisions of the Bankruptcy Code.

3) The plan is proposed in good faith and not by any means forbidden by law.

4) The plan discloses all payments to be made under the plan.

5) The proponent of the plan must disclose the identity and affiliations of all individuals proposed to serve under as directors and officers of the reorganized debtor and the nature and amount of compensation to be paid to those directors and officers.

6) All regulatory approvals have been obtained.

7) The plan is in the best interests of the creditors (i.e., a greater return to each individual creditor than such creditors would receive in Chapter 7).

8) Each class of creditors has accepted the plan (one-half in number of claimants and two-thirds in dollar amount of the claims of the class).

9) Priority claimants will be paid in full when the plan becomes effective unless otherwise agreed to by the priority claimant.

10) The plan is feasible (i.e., no substantial likelihood for another reorganization or liquidation).

11) All retiree benefit programs must be continued, unless altered through 11 U.S.C. §§ 1113 and 1114.

See 11 U.S.C. §§ 1123 and 1129.

MICHIGAN PRACTICE NOTE: The bankruptcy judges in the Bankruptcy Court for the Eastern District of Michigan have promulgated rules for use when filing a combined plan and disclosure statement. It should be noted that rules may vary depending on the bankruptcy judge in front of whom the case is pending.

c. Sub Rosa Plans

1) all asset sale subject to potential objection by a creditor arguing that the sale is a “sub rosa” plan.

2) sub rosa plan is the use of an asset sale under 11 U.S.C. § 363 to circumvent plan process or impose plan terms without complying with requirements for confirmation. *See, e.g., In re Continental Airlines, Inc.*, 780 F.2d 1223, 1226 (5th Cir. 1986); *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983); *see also In re Cajun Electric*, 119 F.3d 349 (5th Cir. 1997) (settlement contended to be sub rosa plan).

3) courts have approved complex sales concerning substantially all of a debtor’s assets prior to plan confirmation by finding that creditor voting and distribution rights are not affected by sale. *See, e.g., In re TWA, Inc.*, 2001 Bankr. Lexis 980 (Bankr. D. Del. 2001).

MICHIGAN PRACTICE NOTE: The Sixth Circuit Court of Appeals has held that a trustee or debtor in possession may sell all or substantially all of its assets in a Chapter 11 case only when a sound business purpose justifies such sale. *Stephens Industries, Inc. v. McClung*, 789 F.2d 386 (6th Cir. 1986) (adopting *Lionel* and finding sound business judgment because debtor could not financially continue to operate, which would have resulted in loss of licenses).

d. Exclusivity

1) Pre-BAPCPA

a) Debtor granted the exclusive right to file a plan of reorganization for first 120 days, and sixty days thereafter to gain approval of such plan. 11 U.S.C. § 1121(b) and (c).

b) Bankruptcy court had discretion to continue to grant extensions of the exclusivity periods for an undetermined amount of time if the debtor could demonstrate cause. 11 U.S.C. § 1121(d)(1).

2) BAPCPA

a) Exclusivity period may not be extended beyond eighteen (18) months after the order for relief has been entered. 11 U.S.C. § 1121(d)(2)(A).

b) Exclusivity to gain approval of a plan cannot be extended past twenty (20) months after the order for relief has been entered.

c) Bankruptcy court can grant to the debtor the exclusive right to file a plan for, at most, eighteen (18) months and, at most, an additional two (2) months to gain approval of such plan. 11 U.S.C. § 1121(d)(2)(A) and (B).

e. Notice

1) A hearing on a disclosure statement is scheduled upon twenty-five (25) days written notice to all parties in interest. Fed. R. Bankr. P. 2002(b) and 3017(a).

2) After approval of the disclosure statement, the plan proponent must mail to all parties in interest the plan, disclosure statement, and ballot, among other things. Fed. R. Bankr. P. 2002(b) and 3017(d).

MICHIGAN PRACTICE NOTE: The Bankruptcy Court for the Eastern District of Michigan has adopted local rules concerning plans and disclosure statements. *See* L.B.R. 3016-1 – 3018-1 (Bankr. E.D. Mich.);

f. Claims Purchasing

1) Permitted in bankruptcy pursuant to Fed. R. Bankr. P. 3001(e), which provides fairly simple notice and filing procedures.

2) Claims purchasers interested in a specific asset can purchase a secured claim and then seek to foreclose if the purchaser is successful in obtaining relief from the automatic stay.

3) Alternatively, the claims purchaser may attempt to credit bid at a sale pursuant to 11 U.S.C. § 363.

4) Claim purchaser, in some situations, can control the reorganization process through its plan voting rights.

a) Purchaser may attempt to purchase enough claims to block proposed plan, and thus use its voting rights as leverage to negotiate more favorable terms or, if unacceptable, deny confirmation.

b) The purchaser may attempt to propose its own plan after the expiration of the exclusivity period.

5) Purchasers often do so where they believe that a plan will offer equity as opposed to a cash payout. By purchasing claims, the purchaser can put itself in position to have a controlling stake in the reorganized company's equity. *See In re Kmart Corp.*, Case No. 02-02474 (Bankr. N.D. Ill.).

MICHIGAN PRACTICE NOTE: A party who purchases a claim has standing as a creditor in the bankruptcy case, even if the claim is purchased post-petition. *In re Embrace Systems Corp.*, 178 B.R. 112 (Bankr. W.D. Mich. 1995).

B. Second Tier Lienholders/Claims Traders³

1. Characteristics
 - a. Typically non-bank lenders such as a hedge fund or private equity firm.
 - b. Seek to employ a “loan to own” strategy.
2. Perspective of Borrower
 - a. Advantages
 - 1) obtain better pricing on second lien financing than mezzanine financing;
 - 2) no prepayment penalties;
 - 3) lending is based on collateral value, present and future cash flows, and enterprise value without requiring stock options and warrants; and
 - 4) no capturing of excess cash flow.
 - b. Disadvantages
 - 1) restrictive cap on how much additional debt can be obtained from senior secured lender;
 - 2) difficulty in obtaining any unsecured financing;
 - 3) additional transaction costs, including negotiation of intercreditor agreements that are highly negotiated.
3. Perspective of Senior Lender
 - a. Advantages
 - 1) portion of debt may be prepaid from proceeds of subordinated secured lender;
 - 2) protects borrower from insolvency or liquidation by providing additional liquidity; and
 - 3) waivers obtained through the intercreditor agreement.
 - b. Disadvantages
 - 1) limitation and restrictions on disposition of collateral where borrower is distressed or in bankruptcy;
 - 2) interference by subordinated lender with terms of workout;
 - 3) potential competing plan in bankruptcy and intense DIP financing and cash collateral negotiations; and
 - 4) potential priming through debtor in possession financing.
4. Perspective of Second Lien Lender
 - a. Advantages

³ Peter M. Gilhuly, *et al.*, *Changing Roles in Commercial Cases: The Impact of Hedge Funds and Private Equity Funds on the Restructuring Landscape*, Am. Bankr. Inst. Annual Spring Meeting (Am. Bankr. Inst. 2007); Linda V. Donhauser, *et al.*, *The Advent of Second Lien Lending and the Swing of the Pendulum Under BAPCPA*, American Bankruptcy Institute Mid-Atlantic Bankruptcy Workshop (Am. Bankr. Inst. 2006).

- 1) priority over unsecured creditors;
 - 2) post-petition interest if second lien lender is oversecured;
 - 3) adequate protection rights in bankruptcy (so long as adequate protection is not waived as part of intercreditor agreement); and
 - 4) more leverage in plan negotiations.
- b. Disadvantages
- 1) waivers in the intercreditor agreement;
 - 2) susceptible to interests of senior lender; and
 - 3) different strategy for exit from bankruptcy than senior lender.
5. Provisions in Intercreditor Agreement Relating to Bankruptcy
- a. waiver of right to oppose adequate protection for senior secured lender and right of subordinate lender to request adequate protection;
 - b. advance consent to use of cash collateral;
 - c. advance consent to debtor in possession financing and a waiver of the subordinate lender to object to such financing with priming liens if senior lender consents;
 - d. waiver of right to object to a sale of collateral if senior lender consents;
 - e. waiver of right to file relief from the automatic stay; and
 - f. waiver of ability to vote on plan of reorganization. *Compare In re 203 N. LaSalle Street P'ship*, 246 B.R. 325 (Bankr. N.D. Ill. 2000) (subordination agreement cannot override right to vote on plan) *with In re Curtis Center Limited P'ship*, 192 B.R. 648 (Bankr. E.D. Pa. 1996) (court enforced subordination agreement's grant to senior lender of right to vote claims of junior lender).