

# **Lender Control Over the Asset Sale Process & How Courts Respond**

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## I. Introduction: Current Illustrative Examples of Lender Control Over the Sale Process

In recent years there has been a trend toward secured lenders, through the vehicle of the DIP order, insisting upon greater control over timing of the reorganization of Debtors, the liquidation of assets, and/or the sale of the Debtors as a going concern or of the rest of their assets. This trend is likely due to the heightened pressures and constraints lenders and borrowers are facing in today's credit market. Specifically, as the problem worsens, with widespread lack of liquidity and erosion of asset values, there seems to be greater pressure placed upon lenders to seek further control over the disposition of assets in chapter 11 cases. As a result, it is becoming increasingly more common to see cases in which lenders seek to dominate the chapter 11 environment and process at the onset of the cases by way of the DIP order. Three recent examples include Gemini Cargo Logistics, Inc., et al. ("Gemini") (Southern District of Florida, Case No. 08-18173), Whitehall Jewelers Holdings, Inc. ("Whitehall") (District of Delaware, Case No. 08-11261), and Steve & Barry's Manhattan LLC, et al. ("S&B") (Southern District of New York, Case No. 08-12579).

### 1. Florida

Gemini filed a voluntary petition for chapter 11 protection in the Southern District of Florida on June 18, 2008. On the petition date, together with their several other first day motions, the Debtors filed an emergency motion (the "DIP Motion") requesting authorization to obtain secured post-petition financing (the "DIP Facility"). Pursuant to the terms of the order granting the DIP Motion on an interim basis, which was entered on June 20, 2008 (the "Interim DIP Order"), an excerpt of which is annexed as Attachment "1," the DIP Facility would terminate (each a "Termination Date"):

- if the court did not enter an order establishing auction procedures, acceptable to the DIP lender, for the Asset Sale (defined below) by June 27, 2008;
- if the Debtors did not enter into an agreement for the sale of substantially all of their assets, on terms and conditions acceptable to the DIP lender (the "Asset Sale"), by August 8, 2008;
- if the court did not enter an order approving the Asset Sale in a form reasonably acceptable to the DIP lender by August 13, 2008; and
- if the Asset Sale acceptable to the DIP lender did not closed by August 15, 2008.

Pursuant to the Interim DIP Order, upon the occurrence of a Termination Date, and without application to the court, the DIP lender was granted leave to, among other things, terminate the DIP Facility, accelerate all indebtedness, and revoke the Debtors' right to use cash collateral. In addition, the DIP lender may move to terminate the automatic stay for the purpose of allowing the DIP lender to exercise all of its rights and remedies under the DIP Facility and the Interim DIP Order. A hearing on the motion to terminate the automatic stay must be held within three (3) days after service of such motion and the only issue to be considered at the hearing is whether a Termination Date has occurred.

## 2. Delaware

Whitehall filed a voluntary petition for chapter 11 protection in the District of Delaware on June 23, 2008. On the petition date, the Debtors filed a motion seeking authorization to obtain post-petition secured financing (the “DIP Motion”) pursuant to a DIP credit agreement (the “DIP Credit Agreement”). On June 24, 2008, the court entered an order granting the DIP Motion on an interim basis (the “Interim DIP Order”), an excerpt of which is annexed as Attachment “2.” Pursuant to the terms of the Interim DIP Order, an event of default under the DIP Credit Agreement (an “Event of Default”) will occur (i) if the court failed to enter an order approving bidding procedures on or before July 10, 2008 (or such later date agreed to in writing by the DIP agent), in form and substance acceptable to the DIP agent, or (ii) if the court failed to enter a sale order, in form and substance acceptable to the DIP agent on or before August 4, 2008 (or such later date agreed to in writing by the DIP agent).

Pursuant to the Interim DIP Order, upon the occurrence of an Event of Default, in addition to other customary remedies, any automatic stay otherwise applicable to the DIP lenders will be modified so that after the occurrence and continuance of an Event of Default and at any time thereafter upon five (5) business days prior written notice of such occurrence, in each case given to the Debtors, counsel for any official committee, and the U.S. Trustee, the DIP lenders will be entitled to exercise their rights and remedies in accordance with the DIP Credit Agreement. Immediately following giving of notice of the occurrence of an Event of Default: (i) the Debtors must continue to deliver and cause the delivery of the proceeds of collateral to the DIP agent; (ii) the DIP agent will continue to apply such proceeds in accordance with the provisions of the Interim Order and the DIP Credit Agreement; (iii) the Debtors will have no right to use any of such proceeds nor any other cash collateral, other than towards the satisfaction of the DIP Credit Agreement; and (iv) the DIP lenders’ obligation to provide any loan or advance will be suspended.

## 3. New York

S&B filed a voluntary petition for chapter 11 protection in the Southern District of New York on July 9, 2008. On the petition date, together with their other first day motions, the Debtors filed a motion requesting authorization to use cash collateral (the “Cash Collateral Motion”). On July 11, 2008, the court entered an interim order granting the Cash Collateral Motion (the “Interim Order”), an excerpt of which is annexed as Attachment “3.” Pursuant to the Interim Order, the Debtors’ failure to perform the following “sale trigger events” by their respective dates would constitute an event of default (an “Event of Default”):

- On or before July 24, 2008, unless the pre-petition revolver agent and the Debtors agree otherwise, the Debtors, after consultation with the creditors’ committee and the pre-petition revolver agent, must have accepted a stalking

horse bid from a stalking horse bidder that is reasonably acceptable to pre-petition revolver agent.

- On or before July 29, 2008, the court must have approved and entered a sale procedures order with respect to a going concern sale or full chain liquidation, in form and substance satisfactory to the pre-petition revolver agent.
- On or before August 12, 2008, the Debtors must complete the auction for a going concern sale or full chain liquidation.
- On or before August 14, 2008, the Debtors must receive the approval of the court for a going concern sale or full chain liquidation, and the order approving such a going concern sale or full chain liquidation must be in form and substance satisfactory to the pre-petition revolver agent.
- On or before August 15, 2008, the Debtors must have executed all of the agency documents, to the extent applicable, or purchase agreements and all other relevant documents in connection with a going concern sale or full chain liquidation.
- On or before August 15, 2008, to the extent applicable, the going concern sale shall have been consummated, or the full chain liquidation shall have commenced.

Pursuant to the Interim DIP Order, upon the occurrence of an Event of Default, the lenders may declare a termination, reduction or restriction of the ability of the Debtors to use any cash collateral, and any automatic stay otherwise applicable will be modified so that five (5) business days after giving notice of such a termination, the lenders will be entitled to exercise their rights and remedies to satisfy any obligation under the Interim Order.

## II. How Courts Are Dealing With This Dilemma

1. In response to the tension between a debtor's need for access to funds at the beginning of a case and the need to provide post-petition lenders with an appropriate level of protection, courts try to take a measured approach, realizing there is limited cash available and too much push-back may cause liquidation or conversion to chapter 7.

2. Some of the problems with entry of cash collateral and debtor-in-possession financing orders at the very outset of a case include:

- the lack of an official committee of unsecured creditors (or other committees as may be appropriate) to act as a check on overbearing lender restrictions;
- the overall minimal amount of notice to creditors of the filing and hearing on first day motions; and
- the fact that first day motions dictate the direction of a case.

3. In re The Colad Group, Inc.: Judge Bucki offered four principles as guidance for considering first day motions. As Judge Bucki explained:

First, the requested relief should be limited to that which is minimally necessary to maintain the existence of the debtor, until such time as the debtor can effect appropriate notice to creditors and parties in interest. In particular, a first day order should avoid substantive rulings that irrevocably determine the rights of parties.

Second, first day orders must maintain a level of clarity and simplicity sufficient to allow reasonable confidence that an order will effect no unanticipated or untoward consequences.

Third, first day orders are not a device to change the procedural and substantive rights that the Bankruptcy Code and Rules have established. In particular, first day orders should provide no substitute for the procedural and substantive protections of the plan confirmation process.

Fourth, no first day order should violate or disregard the substantive rights of parties, in ways not expressly authorized by the Bankruptcy Code.

In re The Colad Group, Inc., 324 B.R. 208, 213 (Bankr. W.D.N.Y. 2005).

4. Whitehall: the debtors, as part of their motion for approval of proposed procedures for the auction of substantially all of the assets of the estate, or for the right to conduct liquidation sales of the debtors' inventory, proposed an auction be held on July 16, 2008 (just over 20 days after the petition date), that the hearing to approve the winning auction bid be held July 18, 2008, and, assuming the proposed liquidator was the successful bidder, to begin the store closing sales on July 19, 2008. The court rejected the truncated timeframe and entered an order scheduling the auction for July 31, 2008, and tentatively scheduling the hearing on approval of the sale for August 8, 2008.

- The court rejected the truncated timeframe for a number of reasons. In particular, the debtors seek to include \$63 million (at cost) of consigned jewelry inventory in the proposed asset sale. Vendors of goods consigned to the debtors opposed the inclusion of their inventory in the auction. The court recognized that consideration and resolution of the issues surrounding the consigned inventory required more time than was available under the debtors' proposed timeframe. By slowing down the process leading to a sale of assets, the court allowed the various parties time to develop the facts necessary for consideration of the request to sell the consigned inventory outside of the ordinary course of business.

5. Steve & Barry's: another recent example of a court's response to first day requests that would have resulted in an extremely fast sale of assets. Notably, the expedited timeframes proposed by the debtors conceivably could have made the sale of the debtor as a going concern, or the initiation of a liquidation process, begin before the

various creditor constituencies had a meaningful opportunity to be heard and voice concerns.

- Judge Gropper encouraged the parties to modify the terms of the proposed cash collateral order. The interim cash collateral order was modified as follows:
  - (i) the adequate protection liens and superpriority claims granted to the pre-petition lenders are only for diminution in value;
  - (ii) the adequate protection liens attached only to the proceeds of leases and not to the leases themselves;
  - (iii) the adequate protection liens did not prime any valid, prior, non-avoidable and enforceable liens;
  - (iv) the pre-petition agents and lenders were required to provide detailed statements of their fees to the debtors, the United States Trustee and the committee;
  - (v) the termination of the automatic stay after an event of default was automatic after expiration of the applicable remedies period, absent a court order otherwise;
  - (vi) the sentence restricting the Debtors to seeking an emergency hearing for the sole purpose of contesting an event of default was deleted; and
  - (vii) by the addition of language to the effect that if the pre-petition liens were successfully challenged, the payments to the lenders could be reversed and if the lenders were found to not have been oversecured, the fees and interest paid would be applied to principal.
  
- The Interim Cash Collateral Order, excerpts of which are annexed as Attachment “3,” was entered on July 11, 2008, and the hearing on the proposed Final Cash Collateral Order was scheduled for July 29, 2008. The Interim Order established certain deadlines that were approximately two weeks later than the deadlines proposed by the Debtors. In particular, the debtors had proposed July 29, 2008 as the deadline to complete the auction; the Interim Order established August 12, 2008 as the auction deadline.
  
- In the course of the hearing, Judge Gropper commented that the participation of a creditors’ committee would be essential and noted that the better way to proceed was for the Debtors to convince the committee that an expedited process was necessary. By slowing down the process leading up to an auction and the closing of any sale transaction, the court ensured that a creditors’ committee would be formed and have an opportunity to take a position before any asset sale could occur.
  
- The situation in S&B illustrates the tension between the practical concerns of minimizing the financial burden of continuing a debtor’s operations and the need to ensure sufficient time to evaluate and select the course of action that will maximize the value of the estate.

6. Local rules are an opportunity for courts to set some guidelines in the hope that the parties in interest will have a chance to review these provisions.

➤ Delaware Local Rules

- Rule 4001-2: requires financing motions to identify whether certain provisions are included in the proposed order or underlying agreement and to justify the inclusion of such provisions. Such provisions include:
  - Provisions that grant cross-collateralization protection (other than replacement liens or other adequate protection) to the pre-petition secured creditors;
  - Provisions or findings of fact that bind the estate or other parties in interest with respect to the validity, perfection or amount of the secured creditor's pre-petition lien or the waiver of claims against the secured creditor without first giving parties in interest at least seventy-five (75) days from the entry of the order and the creditors' committee, if formed, at least sixty (60) days from the date of its formation to investigate such matters;
  - Provisions that seek to waive, without notice, whatever rights the estate may have under 11 U.S.C. § 506(c);
  - Provisions that immediately grant to the pre-petition secured creditor liens on the debtor's claims and causes of action arising under 11 U.S.C. §§ 544, 545, 547, 548 and 549;
  - Provisions that deem pre-petition secured debt to be post-petition debt or that use post-petition loans from a pre-petition secured creditor to pay part or all of that secured creditor's pre-petition debt, other than as provided in 11 U.S.C. § 552(b);
  - Provisions that provide disparate treatment for the professionals retained by a creditors' committee from those professionals retained by the debtor with respect to a professional fee carve-out; and
  - Provisions that prime any secured lien without the consent of that lienor.
- A copy of Delaware's Local Rule 4001-2 is annexed as Attachment "4."

➤ Southern District of New York General Order No. M-274

- Establishes guidelines for financing requests which require disclosure of extraordinary provisions such as those listed in the Delaware Local Rule.
- A copy of General Order No. M-274 is annexed as Attachment "5."

➤ Southern District of New York General Order No. M-331

- Establishes guidelines for conduct of sales pursuant to Code section 363(b), and for applications to approve such sales. This General Order requires disclosure of, among other items, the following extraordinary provisions and issues (this is only a partial list):
  - provisions for sales to insiders and the measures taken to ensure fairness in the sale process and proposed transaction;
  - whether the proposed buyer has discussed or entered into any agreements with management or key employees regarding compensation or future employment, the material terms of any such agreements, and what measures have been taken to ensure the fairness of the sale and the proposed transaction in the light of any such agreements;
  - if no auction is contemplated, the debtor has agreed to a limited no-shop or no-solicitation provision, or the debtor has otherwise not sought or is not actively seeking higher or better offers, the sale motion must so state and explain why such sale is likely to maximize the sale price;
  - if the proposed transaction includes deadlines for the closing or court approval of the sale procedures order or the sale order that have the effect of limiting notice below certain thresholds, the sale motion must provide an explanation;
  - if any qualified bidder, including a stalking horse, is excused from submitting a good faith deposit, the sale motion must provide an explanation;
  - if a debtor is entering into any interim agreements or arrangements with the proposed purchaser, such as interim management arrangements, the sale motion must disclose the terms of such agreements;
  - if a debtor proposes to release sale proceeds on or after the closing without further court order, or to provide for a definitive allocation of sale proceeds between or among various sellers or collateral, the sale motion must describe the intended disposition of such amounts and the rationale therefore.
- A copy of General Order No. M-331 is annexed as Attachment “6.”