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**Section 363(n) and the Issue of Collusion in Asset Sales**

Section 363(n) of the Bankruptcy Code provides:

The trustee may avoid a sale under this section if the sale price was controlled by an agreement among potential bidders at such sale, or may recover from a party to such agreement any amount by which the value of the property sold exceeds the price at which such sale was consummated, and may recover any costs, attorneys' fees, or expenses incurred in avoiding such sale or recovering such amount. In addition to any recovery under the preceding sentence, the court may grant judgment for punitive damages in favor of the estate and against any such party that entered into such an agreement in willful disregard of this subsection.

11 U.S.C. § 363(n).

- I. The Requisite Elements For a Finding of Liability**
  - A. Must the agreement among potential bidders be written?
  - B. Who qualifies as a “potential bidder”?
  - C. What if the agreement merely “affects” rather than “controls” the price of the sale?
- II. How Thin is the Line Between Collusion and Collaboration?**
- III. How to Structure Joint Bids**
- IV. The Penalties for Violating Section 363(n)**
- V. The Interaction Between Sections 363(n) and 363(m)**
- VI. How Section 363(n) Affects the Finality of Sale Orders**
- VII. The Leading Cases on Section 363(n)** – Below please find a summary of the following leading cases on Section 363(n):
  - A. *Lone Star Indus. v Compania Naviera Perez Companc (In re New York Trap Rock Corp.)*, 42 F.3d 747 (2d Cir. 1994) (“*Lone Star*”)
  - B. *Blydenburgh Props., Inc. v. Colony Hill Assocs. (In re Colony Hill Assocs.)*, 111 F.3d 269 (2d Cir. 1997) (“*Colony Hill*”)
  - C. *In re Edwards*, 228 B.R. 552 (Bankr. E.D. Pa. 1998) (“*Edwards*”)
  - D. *Trenco Food Corp. v. Delprete (In re Clinton Street Food Corp.)*, 254 B.R. 523 (Bankr. S.D.N.Y. 2000) (“*Clinton Street*”)
- VIII. Attachments** – Attached hereto is a helpful article and presentation discussing Section 363(n):
  - A. Jason Binford, *Collusion Confusion: Where Do Courts Draw the Lines in Applying Bankruptcy Code Section 363(n)?*, 24 BANK. DEV. J. 41 (2008)
  - B. Laura Davis Jones, Hon. Kevin Gross, Scott L. Hazan, Jeffrey S. Sabin and Hon. Brendan Linehan Shannon, *Delaware Views from the Bench and Bar: Section 363 Sales*, ABI CONFERENCE (November 3, 2008)

**LONE STAR**

In *Lone Star Indus. v Compania Naviera Perez Companc (In re New York Trap Rock Corp.)*, 42 F.3d 747 (2d Cir. 1994), the Second Circuit stated two rules regarding § 363(n):

1. § 363(n) prohibits agreements among potential bidders that are intended to *control* a sale price, not those agreements that have the unintended consequence of *influencing* or *affecting* a sale price.
2. § 363(n) prohibits potential bidders from formulating agreements whereby one bidder agrees to drop out of the bidding in order to control a sale price by reducing or eliminating competitive bidding.

The Sale

In *Lone Star*, the Chapter 11 debtor, Lone Star Industries, Inc. (“Lone Star”) sought to sell its wholly-owned subsidiary, CACP, which owned a 50% interest in another company, CSM. 42 F.3d at 749. CACP was involved in a joint venture with Perez, which owned the other half interest in CSM. *Id.*

In 1992, Lone Star began marketing efforts toward the sale of CACP, offering CACP’s stock (including its 50% share of CSM) for \$55 million. *Id.* at 750. Initially, there were six interested buyers including Perez. *Id.* However, Perez was the only party to actually submit a bid. *Id.* Thus, in May 1992, Lone Star entered into a stock purchase agreement with Perez, whereby Perez agreed to pay \$36 million in cash for CACP so long as: (1) Perez was a “good faith purchaser;” (2) the Bankruptcy Court approved the transaction; and (3) no other entity outbid Perez by at least \$1 million. *Id.* In June 1992, the Bankruptcy Court entered an Order governing the bidding procedures. *Id.* Pursuant to the Order, each bidder was required to submit a written bid at least three days prior to the sale, overbid the current highest bidder by at least \$1 million, and prove financial capability to consummate the sale. *Id.* Under the Order, bidders were not required to disclose any relationships among other potential bidders. *Id.* The hearing to approve the sale was scheduled for August 1992 and notice of the sale was published in three newspapers. *Id.*

In July 1992, two additional buyers placed bids. *Id.* First, Petroquimica, which was one of the original six prospective buyers, submitted a bid for \$37 million, contingent on financing and due diligence. *Id.* Several days later, another company, Loma Negra, submitted an unconditional bid for \$38 million. *Id.* Approximately one week before the date of sale, with its \$38 million bid still on the table, Loma Negra signed a “secret” agreement to purchase Perez’s 50% interest in CSM for \$55 million. *Id.* This agreement was made without disclosure to Lone Star or the Bankruptcy Court. *Id.*

The day before the sale, Petroquimica withdrew its bid, leaving only Perez and Loma Negra as bidders. *Id.* However, Perez did not appear at the hearing, nor did it submit an additional bid. *Id.* The Court authorized the sale of CACP to Loma Negra for \$38 million. *Id.*

Procedural History

Several months after the sale, Lone Star commenced an adversary proceeding against Perez and Loma Negra alleging that they had, *inter alia*, violated § 363(n) “by entering into a secret agreement to control the price of the bankruptcy sale of the CACP stock.” *Id.* at 750-51. The defendants moved to dismiss Lone Star’s complaint under Fed. R. Civ. P. 12(b)(6) for failure to state a claim, and Lone Star cross-moved for partial summary judgment, arguing that the agreement between Perez and Loma Negra “had the effect of controlling the sale price of CACP, and therefore violated § 363(n) as a matter of law.” *Id.* at 751.

The Bankruptcy Court dismissed Lone Star’s claim, reasoning that § 363(n) provided a remedy for debtors where potential bidders colluded to fix the sale price of the *debtor’s* property, not a *non-debtor’s*

property. *Id.* Furthermore, the Bankruptcy Court reasoned that there is no liability under § 363(n) where the “price of the debtor’s property is merely *affected*, and not *controlled*, by an agreement concerning non-debtor property.” *Id.* (emphasis added).

On appeal in *Lone Star Indus. v Compania Naviera Perez Companc (In re New York Trap Rock Corp.)*, 160 B.R. 876 (S.D.N.Y. 1993), the District Court affirmed the Bankruptcy Court’s dismissal, reasoning that Lone Star’s § 363(n) claim “merely protested its lack of bargaining power vis-à-vis Perez during the sales of their respective halves of CSM.” 42 F.3d at 751. Furthermore, the District Court held that even though Lone Star was not able to receive a control premium, that fact alone did not entitle it to seek recovery under § 363(n) without evidence that Perez and Loma Negra colluded to control the price received by Lone Star. *Id.*

### The Second Circuit Decision

On appeal to the Second Circuit, Lone Star argued that the Bankruptcy Court erred when it dismissed Lone Star’s motion for summary judgment because the agreement between Perez and Loma Negra *affected the price* of Lone Star’s half, in violation of § 363(n). *Id.* at 751-52. According to Lone Star, Loma Negra effectively eliminated Perez’s incentive to bid for Lone Star’s half of CSM by purchasing Perez’s half interest in CSM, and, as a result, Loma Negra had no bidding opposition. *Id.* at 752. Lone Star further alleged that this lack of opposition caused Lone Star’s half of CSM to sell for less than it would have if Loma Negra and Perez had been competitors, and thus the agreement between Perez and Loma Negra, which affected the price of Lone Star’s half, was in violation of § 363(n). *Id.*

The Second Circuit disagreed with Lone Star’s characterization of , holding that § 363(n) prohibits agreements among potential bidders that “control” the sale price, not agreements that “affect” the sale price. *Id.* The Court carefully explained that the term “control” implies the actual intention or objective to influence price and that this interpretation comports with Congress’s legislative intent. *Id.* (“§ 363(n) is directed at *collusive* bidding”). The Court further noted that it is “most unlikely that Congress would have intended to prohibit all agreements that *affect* a sale price.” *Id.* The Court finally held that § 363(n)’s prohibition of agreements among potential bidders that control price “does not implicate agreements that merely ‘affect’ the sale price.” *Id.* Furthermore, the Court clarified that “[t]he influence on the sale price must be an intended objection of the agreement, and not merely an unintended consequence. . .” *Id.*

However, the Court mentioned that to the extent Loma Negra’s purchase of Perez’s share of CSM for \$55 million was to induce Perez to drop out of the bidding, it would “come close to the classic collusive bidding,” prohibited by the statute. *Id.* at 753. According to Lone Star, Perez and Loma Negra both understood that Lone Star’s share of CSM stock was worth more than \$38 million, so if Perez dropped out and Loma Negra maintained its bid for \$38 million unopposed, when the sale was consummated, Perez and Loma Negra would share the profit between them – the profit that should have been Lone Star’s. *Id.* Pursuant to these allegations, the Court held that “[t]o the extent Lone Star’s complaint alleges that it was a term of the Loma-Negra-Perez agreement (whether written or unwritten) that Perez would drop out of the bidding for Lone Star’s half of CSM, the complaint alleges a prohibited voidable transaction under § 363(n). *Id.* Thus, the Court held that Lone Star had pleaded a viable theory and that Lone Star’s motion for summary judgment was improperly dismissed. *Id.*

### **COLONY HILL**

In *Blydenburgh Props., Inc. v. Colony Hill Assocs. (In re Colony Hill Assocs.)*, 111 F.3d 269 (2d Cir. 1997), the Second Circuit addressed the issue of whether an unsuccessful bidder has standing to bring a § 363(n) claim. The Court held that:

1. An unsuccessful bidder may have standing under § 363(n) to challenge the “intrinsic fairness” of a court-approved sale.

#### The Facts

In *Colony Hill*, the debtor, Colony Hill Associates (“Colony Hill”) operated as a Chapter 11 debtor-in-possession from February 1991 through July 25, 1996, when its reorganization plan (the “Plan”) was confirmed. *Id.* at 271. Colony Hill’s primary assets included a golf course and some residential property (collectively, the “Property”). *Id.* In June 1996, the Bankruptcy Court approved the notice and bidding procedures associated with the sale of the Property. *Id.* In the notice, Colony Hill stated that it was prepared to sell the Property to “G&W” for \$7.5 million, “subject to higher and better offers.” *Id.* Furthermore, all bidders were required to submit initial bids in writing ten days before the sale hearing. *Id.* For an initial bid to be deemed “qualified,” certain conditions had to be satisfied. *Id.*

As of the bid deadline, Colony had received only one qualified bid – from Holiday for \$8.1 million. *Id.* However, the day before the auction, a party to the action, Kabro filed an “emergency request” to submit a bid of \$10 million, even though the deadline for initial bid submissions had passed. *Id.*

At the hearing the following day, Holiday opposed Kabro’s motion to submit its bid, arguing that Kabro’s bid should be disqualified because it failed to comply with the bidding procedures, but two secured creditors and G&W supported Kabro’s participation in the auction. *Id.* at 272. However, after Holiday increased its bid to \$9.6 million and included more favorable conditions, the main secured creditor opposed Kabro’s bid and then the Bankruptcy Court approved the sale of the Property to Holiday. *Id.*

#### The Second Circuit Decision

Kabro moved for a stay of the sale pending appeal, which was denied. However, Kabro appealed again, seeking that the Second Circuit set aside approval of the sale, arguing *inter alia*, that the sale resulted from collusive bidding between Holiday and the creditors, as prohibited by § 363(n). *Id.* Despite the allegations of collusion, the Court mainly addressed the issue of whether Holiday was a good faith purchaser under § 363(m), and, as a corollary issue, whether an unsuccessful bidder such as Kabro has standing to appeal a sale order. *Id.*

In analyzing the standing issue, the Second Circuit first noted that standing to appeal an order of the Bankruptcy Court is derived from former section 39(c) of the Bankruptcy Act of 1898, which confers standing only to “aggrieved” persons, or those who are “directly and adversely affected pecuniarily” by the court order at issue. *Id.* at 273. The Court noted that under this standard, an unsuccessful bidder, such as Kabro, lacks standing to challenge the approval of a sales transaction because its only pecuniary loss “is the speculative profit it might have made had it succeeded in purchasing property at an auction.” *Id.*

The Court stated, however, that the rule of denying unsuccessful bidders standing is not absolute. *Id.* Then, in reliance on other cases holding that a party has standing to challenge the *fairness* of a bankruptcy proceeding, the Court held that Kabro had standing to challenge the sale for three reasons. *Id.* at 274. First, Kabro was not a party “wholly unknown” to the debtor and creditors, appearing a sale hearing to challenge a consummated sale. *Id.* Second, Kabro was challenging the “intrinsic fairness” of the sale hearing rather than “merely complaining that the bankruptcy court abused its discretion by excluding its bid.” *Id.* Third, an unsuccessful bidder may be “the only party with an interest in exposing” collusion. *Id.* Accordingly, the

Court held that Kabro had standing to challenge the Bankruptcy Court's approval of the sale "to the extent it alleges that Holiday's actions destroyed the 'intrinsic fairness' of the sales transaction so that it was not a good faith purchaser." *Id.*

### ***EDWARDS***

In *In re Edwards*, 228 B.R. 552 (Bankr. E.D. Pa. 1998), the Bankruptcy Court for the Eastern District of Pennsylvania addressed the issue of how to draw the line between impermissible collusion and permissible collaboration. The Court held that:

1. Potential bidders may permissibly collaborate on a bid if they can demonstrate that their motivations for collaboration were innocent, such as working together to reach a favorable settlement.

#### The Facts

In *Edwards*, Chapter 7 debtor Edwards owned one third of the stock in a corporation, Pilot. *Id.* at 554. Edwards' Pilot stock, as well as his one-third interest in a partnership, were his estate's only significant assets (the "Equity Interests"). *Id.* The Trustee determined that other Pilot shareholders would likely be the only interested purchasers and thus, initially sought to sell the Equity Interests to Phillips, the CEO of Pilot, for \$3.4 million. *Id.* at 554-55. Along with Phillips' initial bid of \$3.4 million, Phillips (together with Pilot and an individual Drescher, collectively the "Phillips Group") agreed to waive its multi-million dollar claims against Edwards' estate and the Trustee agreed to waive the debtor's claims against Pilot and Phillips. *Id.* at 555.

In a subsequent hearing on the sale, the Trustee's expert valued the Equity Interests at \$2.745 million, premised on the sale of a minority equity interest. *Id.* However, an individual named Wyatt emerged, alleging that he held a 45% interest in Pilot through the exercise of certain stock options. Until the ownership issue was resolved, Wyatt argued, he would not be able to frame a bid. *Id.* Wyatt eventually bid \$3.6 million (\$200,000 greater than the Phillips' bid); however, Wyatt's bid did not address the claims issues, which the Trustee would have to resolve were she to accept Wyatt's bid. *Id.* at 556. As a result, Wyatt later increased his bid to \$5 million in cash, supplemented by a bond of up to \$3 million to secure payment of the Pilot Group claims when liquidated. *Id.* at 558.

On the date of an interim hearing, a "new" bidder emerged – Pilot franchisees and employees who had collaborated with Philips – to set forth a bid of \$5.1 million, complete with the mutual claims settlement. *Id.* Then, at the next and final hearing, yet another bid was placed: Wyatt and Phillips joined together to bid \$5.2 million plus the claims settlement (the "Wyatt-Phillips Bid"). *Id.* Although there was no physical evidence or testimony regarding the new bid, there was evidence of a global settlement agreement between Wyatt, Phillips, and Pilot, which settled all disputes between the parties. *Id.* at 559.

The Trustee accepted the Wyatt-Phillips Bid, but the debtor objected, arguing that the bid was the result of impermissible collusion between Wyatt and Phillips, in violation of § 363(n). *Id.* at 560.

#### The Court's Decision

In analyzing the debtor's allegations, the Court examined whether the sale was made in good faith, a determination which turned on the motivations of the parties and whether they sought to control the sale price. *Id.* at 563. The Court held that although Wyatt and Phillips undoubtedly collaborated on the bid, their motivation was not to control price, but rather to reach a global resolution of all outstanding claims. *Id.* 564-65. Accordingly, the Court found that the Wyatt-Phillips Bid was the result of permissible collaboration rather than unlawful collusion. *Id.* at 566.

***CLINTON STREET***

In *Trenco Food Corp. v. Delprete (In re Clinton Street Food Corp.)*, 254 B.R. 523 (S.D.N.Y. 2000), the Bankruptcy Court for the Southern District of New York addressed the issue of whether a claim brought under § 363(n) three years after a sale was consummated was time-barred. The Court held:

1. Although § 363(n) does not provide for a limitations period, the one-year limitations period in Fed. R. Civ. P. 60(b)(3) may govern claims brought under § 363(n).

**The Facts**

In *Clinton Street*, the chapter 7 Trustee entered into a written agreement to sell certain debtor assets to defendant Fuertes for \$300,000, subject to higher and better offers. *Id.* at 527. At the sale hearing approximately one year later, the Trustee sought approval of the sale to Fuertes without knowledge that a competitor of the debtor, Maui (also a defendant), had agreed to pay three parties, including Fuertes, not to bid. *Id.* The scheme was not only concealed from the Trustee, but was also not disclosed to the Bankruptcy Court, even though the judge specifically asked each defendant “whether they were aware of the existence of any agreement to control the sale price.” *Id.* Thus, Maui was the sole bidder at \$320,000. *Id.* Maui’s bid was accepted although the assets were worth at least \$2 million. *Id.*

Almost five years after the Sale Order to Maui was entered, the Trustee brought an adversary proceeding against the defendants alleging a violation of § 363(n) as well as various causes of action sounding in fraud. *Id.* at 528-29.

**The Court’s Decision**

The Court dismissed the § 363(n) claim as time-barred pursuant to the one-year statute of limitations provided for in Fed. R. Civ. P. 60(b)(3). *Id.* at 529. The Trustee moved for reconsideration, which was granted. Nonetheless, the Court upheld the original ruling and further concluded that the Trustee’s claims for money damages under § 363(n) were also time-barred. *Id.* at 529-30.

Upon another motion for reconsideration, the Court noted that an order approving the sale of assets is a final order for *res judicata* purposes. *Id.* at 530. The Court stated that this rule “promotes the important public policy favoring the finality of orders transferring ownership of bankruptcy estate assets.” *Id.* at 530-31. The Court then noted that § 363(n), although a statutory exception to the rule of finality in bankruptcy sale orders, does not provide for a limitations period for asserting a claim after a sale order has been entered. *Id.* at 531. Accordingly, the Court stated that because the court in the prior decision had held that § 363(n) was governed by the one-year limitations period of Rule 60(b)(3), that ruling was now “law of the case” and would not be revisited. *Id.*