

ASSET SALE ISSUES

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The last year has been a remarkable one for section 363 sales. Behemoth companies like Lehman Brothers Holdings Inc., Chrysler LLC and General Motors Corporation filed chapter 11 petitions and consummated rapid section 363 sales of substantially all of their assets. The latter two involved sale transactions in which the federal government was intimately involved. These and other sale transactions involved weighty legal issues such as (a) who has the authority to consent to these sales when fewer than all secured lenders approve of the sale and (b) whether section 363 sales can be effected free and clear of successor liability claims. In addition, in the middle of 2008, the Bankruptcy Appellate Panel for the Ninth Circuit issued its decision in the *Clear Channel* case, where it ruled that section 363(f) of the Bankruptcy Code does not permit the sale of assets to a secured lender pursuant to a credit bid free and clear of a valid, non-consenting junior lien, where the purchase price was less than the amount of the total debt secured by those assets. These materials discuss the Lehman, Chrysler and GM sales, the *Clear Channel* decision, as well as the legal issues courts addressed in each of these cases. These materials also address other issues that were raised recently in the section 363 sale context.

I. SIGNIFICANT RECENT SECTION 363 SALES

A. LEHMAN: *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y. 2008)

On September 15, 2008, Lehman Brothers Holdings Inc. and certain affiliates (“Lehman”) filed for protection under chapter 11 of the U.S. Bankruptcy Code. One week later, on September 22, Lehman sold substantially all of Lehman’s North American broker-dealer assets to Barclays PLC (“Barclays”) pursuant to section 363 of the Bankruptcy Code. Lehman’s bankruptcy filing and the resulting section 363 sale were remarkable for their swiftness and the exigencies driving the sale.

By early September 2008 it was clear that Lehman, like many Wall Street institutions, was facing unprecedented challenges that could lead to collapse absent outside assistance. In an attempt to salvage the company and avoid bankruptcy, Lehman had sought out a variety of strategic alternatives, including potential partners and buyers. As such efforts faltered, Lehman sought direct government assistance. Over the weekend of September 13 and 14, 2009, the Federal Reserve called meetings with top bankers and officials from the United States Treasury (the “Treasury”), the Federal Reserve and the Securities and Exchange Commission. In the meetings, government officials announced there would be no public bailout of Lehman. See Andrew Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold*, N.Y. TIMES, Sept. 15, 2008. Lehman subsequently spent the rest of the weekend trying to find a last-minute buyer, focusing on Bank of America and Barclays. Both banks ultimately chose not to purchase Lehman outside of chapter 11.

Two days after its bankruptcy filing, on September 17, 2008, Lehman filed a motion to approve a section 363 sale of its North American broker dealer Lehman Brothers Inc., its Manhattan office tower and two data centers to stalking-horse bidder Barclays. After a marathon sale hearing, the bankruptcy court approved the sale on September 19, 2008 free and clear of all liens, claims, encumbrances, obligations, liabilities and contractual commitments and rights. *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 19, 2008). At that

point, Lehman had been in bankruptcy for only five days. The sale closed on September 22, 2008. In the sale, Barclays paid roughly \$1.7 billion in cash and assumed approximately \$45.5 billion in liabilities. The cash payment was roughly equivalent to the value of the office tower that was sold as part of the deal.

In requesting the sale on an expedited basis, Lehman relied on a “melting ice-cube” theory to justify the swiftness of the sale and the sale process. At the sale hearing, Judge James Peck observed that “[t]here is no better or alternative transaction for these assets” and “the consequences of not approving a transaction could prove to be truly disastrous.” Transcript of Record at 250, Sept. 16, 2008. Indeed, the week prior to the bankruptcy court’s approval of the sale, the value of the assets to be transferred to Barclays declined from roughly \$70 billion to \$50 billion.

In light of the unique circumstances surrounding the Lehman bankruptcy, Judge Peck indicated his belief that the section 363 sale would not set a precedent in almost any other bankruptcy cases, by noting at the sale hearing “it’s hard for me to imagine a similar emergency.” *Id.* at 251-52. Acknowledging that the process and speed of the sale was “unheard of,” Judge Peck stated that such steps were required out of necessity and did not reflect a general trend of circumventing rules designed to slow down the process, such as Bankruptcy Rule 6003. *Id.* at 250. Judge Peck also observed that the transaction was “an extraordinary example of the flexibility that bankruptcy affords under circumstances such as this.” *Id.* at 252. Unbeknownst to anyone at that time, Chrysler and GM would undergo similarly quick section 363 sales less than a year later.

While time was of the essence in completing the sale of Lehman’s assets to Barclays, the breakneck speed in which the transaction was negotiated and consummated may have led to mistakes that benefited Barclays at the expense of Lehman. On or about May 18, 2009, Lehman filed a motion under Federal Rule of Bankruptcy Procedure 2004 seeking discovery from Barclays, alleging that Barclays bought the assets for less than adequate consideration. In its Bankruptcy Rule 2004 motion, Lehman stated that it had become aware of apparent material discrepancies relating to the liabilities Barclays was to assume and the benefits Lehman was to receive under this and related transactions. Those apparent discrepancies concern, *inter alia*, Barclays’ obligation to pay employee bonuses and certain contract cure amounts as well as certain asset transfers related to repurchase transactions conducted during the week the sale transaction was negotiated.² Lehman believed that these discrepancies may have resulted in a windfall to Barclays at the expense of Lehman, in an amount that could reach into the billions of dollars.

² Lehman sought permission to investigate three issues - first, whether Barclays paid the promised \$2 billion in bonuses to former Lehman employees who now work for Barclays; second, whether Barclays gained \$5 billion through an undisclosed “discount” in a \$50 billion repurchase tied to the sale; and, third, the circumstances surrounding the \$1.5 billion Barclays was to pay to get out of certain contracts. The bankruptcy court ruled that Lehman may investigate these issues. See The Associated Press, *Judge Approves Inquiry Into Barclays Deal to Buy Lehman Unit*, N.Y. TIMES, June 25, 2009.

B. **CHRYSLER:** *In re Chrysler LLC*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009)

On April 30, 2009, Chrysler LLC and certain affiliates filed for protection under chapter 11 of the U.S. Bankruptcy Code. As of its petition date, Chrysler owed \$6.9 billion under a senior secured first lien credit agreement, \$2 billion under a second lien credit agreement, more than \$4 billion under subordinated loans from the U.S. government, and \$5.34 billion in outstanding debt to trade creditors.

Chrysler's bankruptcy filing concluded months of intense restructuring negotiations between the company and various stakeholders. In late 2008, Chrysler faced a severe liquidity crisis caused by declining sales and the general economic downturn. Along with other automakers, Chrysler sought assistance from the United States government. The government responded with a \$4 billion loan that required Chrysler to articulate a long term viability plan that would be satisfactory to the government.

In February 2009, Chrysler presented three viability plans to the Treasury, all of which required additional government funding. The President's Auto Task Force was created to evaluate the viability plans. On March 30, 2009 the Auto Task Force announced that it would only fund a strategic partnership and that it would not fund a standalone reorganization plan. The Treasury agreed to provide one month of working capital for Chrysler to secure such a partnership. The availability of the additional funding was conditioned on a series of government-imposed requirements and benchmarks. Chrysler spent April 2009 negotiating further concessions from stakeholders and key constituencies. The result of these negotiations was a Master Transaction Agreement ("MTA") dated as of April 30, 2009.

The purchase price for substantially all of Chrysler's assets was set at \$2 billion in cash, with the U.S. and Canadian governments funding the sale. Also contemplated in the MTA were a series of deals with key Chrysler constituencies and stakeholders. In exchange for debtor-in-possession financing and a \$6 billion senior secured facility, the U.S. and Canadian governments received, respectively, 8% and 2% equity interests in the entity that would purchase Chrysler's assets ("New Chrysler"); in exchange for key concessions regarding retiree benefits and a newly negotiated collective bargaining agreement, the UAW retiree fund received a 55% equity stake in New Chrysler; and, in exchange for new vehicle platforms, technology, and distribution networks, Fiat received 20% of New Chrysler's equity and the right to acquire an additional 31% of the equity once New Chrysler's debts to the U.S. and Canadian governments are paid in full. Because Chrysler was not able to secure approval of the MTA from all of its senior secured lenders, Chrysler filed a bankruptcy petition and sought an expedited sale of its assets to New Chrysler under section 363 of the Bankruptcy Code.

A litany of objections to the sale were filed, the most notable of which included a small group of senior secured lenders comprised of Indiana state pension funds (the "Indiana Funds"). Counterparties under dealership agreements that Chrysler sought to reject, various state attorneys general, and various pre-petition tort claimants also filed objections. The Indiana Funds argued that as first priority lien holders, they had to be paid in full before junior creditors (such as the UAW) could receive any value on account of their pre-petition claims. The Indiana Funds also argued that the proposed sale was a *sub rosa* plan (*i.e.*, an end-run around the chapter 11 plan

confirmation requirements). The Indiana Funds asserted that, essentially, the proposed section 363 sale was really a plan of reorganization because it reorganized the financial affairs of the Debtors and dictated the treatment of substantially all of Debtors' creditors. Because of the continuity between "old" and "new" Chrysler, and because virtually every significant creditor of "old" Chrysler was receiving value under the sale transaction, the Indiana Funds argued that the sale was simply a veiled plan of reorganization.

In approving the sale over these and other objections, the bankruptcy court first found that the asset sale was an appropriate exercise of the debtors' business judgment under the standards articulated in *In re Lionel Corp.*, 722 F.2d 1063, 1066 (2d Cir. 1983). The court held that the sale was the only currently viable option available to Chrysler other than immediate liquidation, and that the "the whole [new] enterprise may be worth more than the sum of its parts because of the synergies between Chrysler...and Fiat." *In re Chrysler LLC*, 405 B.R. 84, 96 (Bankr. S.D.N.Y. 2009). Moreover, the court found that the value of Chrysler was rapidly deteriorating and that an immediate sale was necessary to preserve going concern value. *Id.* at 96-97.

In rejecting the assertion that the sale was an impermissible *sub rosa* plan, the court relied heavily on the distinction between "new value" contributions to New Chrysler and the \$2 billion in cash the Old Chrysler estate received as proceeds from the sale (and directly paid to Chrysler's pre-petition secured lenders). By distinguishing between the \$2 billion in cash being paid to the estate (which the court found was above Chrysler's liquidation value) and distributions of New Chrysler equity to Old Chrysler stakeholders (which the court found was new consideration for new value), the court concluded that "not one penny of value of the Debtors' assets is going to anyone other than the First-Lien Lenders." *Id.* at 97. Prepetition creditors receiving equity in New Chrysler "receive such interest on account of value that each provides to New Chrysler in its efforts to compete in the auto industry." *Id.* at 92. As such, the equity distributions were "neither a diversion of value from Debtors' assets nor an allocation of the proceeds from the sale of the Debtors' assets." *Id.* at 99.

The Indiana Pensioners also argued that they had not consented to the sale and that therefore section 363(f)(2) of the Bankruptcy Code (which permits the sale of property free and clear of interests with the consent of the holder of the affected interests) could not be used to justify the sale free of their liens on the Chrysler assets. Chrysler argued that the collateral trustee, Wilmington Trust Company, had consented to the sale and Wilmington Trust Company's consent was sufficient for purposes of section 363(f)(2) of the Bankruptcy Code. The court examined the relevant loan documents and determined that the right to consent to the sale is a "Collateral Enforcement Action" as defined in the loan documents and that Collateral Trustee had the exclusive right to take such action. *Id.* at 102. Furthermore, the Collateral Trustee was acting at the direction of the Administrative Agent, who had been properly authorized to make that determination upon the consent of 92.5% of the secured lenders. *Id.* The Indiana Pensioners asserted that the section 363 sale was a "release of collateral," which must be authorized by every lender. The court rejected this argument and interpreted the unanimous consent requirement in the credit agreement to only apply to those actions that required the amendment or modification of the loan documents, and that the unanimous consent requirement did not

apply to “collective action to enforce rights as authorized under the agreed-upon specific provisions of the parties’ loan agreements.” *Id.* at 102-03.

The court briefly addressed and rejected objections based on the government’s unique role in the sale process as well as alleged bad faith by the government, Chrysler, and the purchaser. *Id.* at 104-11. The court also found that “because of the overriding concern of the U.S. and Canadian governments to protect the public interest, the terms of the Fiat Transaction present an opportunity that the marketplace alone could not offer.” *Id.* at 96.

The *Chrysler* sale order bars all claims “known or unknown as of the closing.” The court rejected objections by tort claimants who had argued that the sale could not extinguish successor liability claims they may have against New Chrysler. Following *In re Trans World Airlines, Inc.*, 322 F.3d 282 (3rd Cir. 2003), the court held that “such tort claims are interests in property such that they are extinguished by a free and clear sale under section 363(f)(5) and are therefore extinguished by the Sale Transaction.” *Chrysler*, 405 B.R. at 111. The court noted that that the general notice provided in the bankruptcy case was sufficient to meet the requirements of *Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306 (1950). See *Chrysler*, 405 B.R. at 111. The enforceability of the *Chrysler* sale order’s limit on liability of the purchaser for future tort claims has not been tested and may turn on applicable state law.

An expedited appeal of the sale order was certified by the bankruptcy court and accepted by the Second Circuit. In less than a week, the Second Circuit was briefed and heard oral arguments. The sale order was affirmed, with the Second Circuit issuing a brief order affirming the sale order for “substantially the reasons” stated by the bankruptcy court. A temporary stay was then issued by the United States Supreme Court, which ultimately declined *certiorari* and lifted its stay. The sale closed on June 10, 2009.

C. **GM:** *In re General Motors Corp.*, No. 09-50026, 2009 Bankr. LEXIS 1687 (Bankr. S.D.N.Y. July 5, 2009)

On June 1, 2009 General Motors Corporation (“GM”) and certain of its affiliates filed for protection under chapter 11 of the U.S. Bankruptcy Code. Upon commencing its chapter 11 case, GM filed a motion pursuant to section 363 of the Bankruptcy Code to sell substantially all of its assets to a newly-formed purchaser sponsored by the Treasury. Barely more than a month later, on July 5, 2009, the bankruptcy court approved the sale.

For over 100 years, GM had been a major component of the United States manufacturing and industrial base. Like many companies, and virtually all other automotive manufacturers, GM suffered financial turmoil as a result of the recent economic downturn. By the fall of 2008, GM was in the midst of a severe liquidity crisis and seeking financial assistance from the U.S. Government. In late December 2008, the Treasury and GM entered into a loan agreement that provided GM up to \$13.4 billion in financing on a senior secured basis. The loan was contingent on GM developing a business plan that would fundamentally transform the company into a viable and profitable manufacturer. The Treasury and GM subsequently entered into additional credit agreements in April and May 2009 that provided for a further \$6 billion. The funds advanced to GM under these facilities, as of the petition date, totaled approximately \$19.4 billion.

The Treasury conditioned its loans (which subsequently included funds from the Canadian government) on GM restructuring its capital structure and operations in compliance with certain benchmarks. In an effort to promote such a restructuring, the Treasury continued to lend GM money through its bankruptcy petition date. Thereafter, the Treasury agreed to provide GM up to \$33.3 billion in DIP financing. However, the DIP facility was to expire on July 10, 2009 if a section 363 sale transaction was not approved by that date. No other entity was willing to lend to GM or purchase GM. See *In re General Motors Corp.*, No. 09-50026, 2009 Bankr. LEXIS 1687 at *26-27 (Bankr. S.D.N.Y. July 5, 2009).

In light of a steep decline in GM's sales and the potential for further erosion of value if the company lingered in bankruptcy, GM asserted that an immediate section 363 sale was necessary to preserve the value of its assets. GM proposed transferring most of its assets to Vehicle Acquisition Holdings LLC ("New GM"). The transaction was structured so that New GM, as an assignee of the Treasury's rights and claims under the pre-petition secured loans and DIP loan, would credit bid substantially all of GM's indebtedness under those facilities in the sale. *In re General Motors Corp.*, 2009 Bankr. LEXIS 1687 at *30, 134. New GM would also assume various estate liabilities and contribute 10% of its common equity (plus warrants) to the estate. The total value of the sale consideration and assumed liabilities was estimated to be approximately \$45 billion. *Id.* at *30.

In approving the sale, the bankruptcy court found that GM's decision to enter into the sale was an appropriate exercise of its business judgment. *Id.* at *39. In analyzing the sale motion, the bankruptcy court applied the business judgment factors articulated in *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983). Those factors are:

- (a) the proportionate value of the asset to the estate as a whole;
- (b) the elapsed time since the bankruptcy filing;
- (c) the likelihood that a plan of reorganization will be proposed and confirmed in the near future;
- (d) the effect of the proposed disposition on future plans of reorganization;
- (e) the proceeds to be obtained from the disposition vis-à-vis any appraisals of the property;
- (f) which of the alternatives of use, sale or lease the proposal envisions;
and
- (g) "most importantly perhaps," whether the asset is increasing or decreasing in value.

Id. at *52-53 (citing *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983)). The court also "suggested" additional factors that "may" be relevant:

(h) whether the estate has the liquidity to survive until confirmation of a plan;

(i) whether the sale opportunity would still exist at the time of plan confirmation;

(j) If the sale opportunity would not still exist at the time of plan confirmation, how likely it is that there will be a satisfactory alternative sale opportunity or a stand-alone plan alternative that is equally desirable (or better) for creditors; and

(k) whether there is a material risk that by deferring the sale, “the patient will die on the operating table.”

Id. at *53.

In finding that GM exercised valid business judgment in approving the sale to New GM, the court found that “GM, with no liquidity of its own and the need to quickly address consumer and fleet owner doubt, does not have the luxury of selling its business under a plan.” *Id.* at *56. The court further emphasized that liquidation was the only alternative to the proposed section 363 sale. *Id.* at *57.

Like in *Chrysler*, various parties challenged the proposed sale as a *sub rosa* plan. The court characterized the *sub rosa* analysis under *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983) as whether the sale “establish[es] the terms of the plan” by dictating such terms, restraining parties from exercising their confirmation rights, restricting creditors’ rights to vote on a plan, or allocating distributions of sale proceeds among different classes of creditors. *In re General Motors Corp.* at *67-68. The court found that no such factors were present and that, instead, the sale “merely brings in value.” *Id.* at *68-69. The court stated that the objectors wrongly focused on the purchaser’s intentions and actions, when the focus should have been instead on debtors’ estates and their interests. The court found substantial support for its decision on the *sub rosa* issue in the *Chrysler* opinion, which was handed down less than a month earlier. The court held that similar objections had been “squarely raised” and rejected in *Chrysler*, and that the Second Circuit affirmed the *Chrysler* decision (and adopted the bankruptcy court’s analysis) on appeal. *Id.* at *72. The court stated that the *Chrysler* decision was “directly on point and conclusive” in part because the “transaction was structured in a fashion very similar to that here, with a combination of sale proceeds to be provided to the seller, assignments of contracts with suppliers, taking on seller employees, and contribution to a VEBA.” *Id.*

Turning to what the *GM* bankruptcy court characterized as “the most debatable” of the issues presented, the court extensively analyzed successor liability and the effect of a sale pursuant to section 363(f) on tort liability claims. *Id.* at *82. GM originally proposed that the sale be approved free and clear of “rights or claims based on any successor or transferee liability.” Prior to the sale hearing, however, New GM consented to an explicit assumption of warranty claims and product liability claims arising *after* the sale. However, New GM would not assume liability for injuries occurring *before* the sale. *In re General Motors Corp.* at *81.

Several parties argued that a bankruptcy court may not approve a sale free and clear of tort liability claims under section 363(f) of the Bankruptcy Code. Acknowledging a split in the case law from other circuits, the bankruptcy court held that the *Chrysler* opinion and its affirmance by the Second Circuit is binding on it. As such, the court followed *Chrysler* and held that the sale free and clear of “any interest in such property” would extinguish tort claimants not otherwise provided for in the order.

Both the *Chrysler* and *GM* courts addressed the role of U.S. government officials in the sale process. See *Chrysler*, 405 B.R. at 104-08; *In re General Motors Corp.* at *15-29. Both courts concluded that government involvement, in and of itself, was not an impediment to approving the sales. See *Chrysler*, 405 B.R. at 104; *In re General Motors Corp.* at *74-79. Moreover, both courts found that government control over the process was appropriate in light of the government’s role as “lender of last resort” to GM and Chrysler. See *Chrysler*, 405 B.R. at 105; see also *In re General Motors Corp.* at *18. Nevertheless, it remains to be seen whether *private* lending parties could impose the incredibly fast-paced time frames seen in *Chrysler* and *GM* on future courts, especially if the party seeking bankruptcy protection does not have such a high political and public profile.

II. NINTH CIRCUIT BAP DECISION IN CLEAR CHANNEL

In *Clear Channel Outdoor Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (B.A.P. 9th Cir. 2008), the Bankruptcy Appellate Panel for the Ninth Circuit (the “BAP”) held that section 363(f) of the Bankruptcy Code does not permit a senior secured creditor to credit bid for assets free and clear of a valid, non-consenting junior lien, where the purchase price was less than the amount of the debt that was secured by those assets. In so holding, the BAP also concluded that the good faith protection of section 363(m) of the Bankruptcy Code does not apply to the lien-stripping provisions of section 363(f) of the Bankruptcy Code and that, therefore, review of the lien-stripping was not moot and could be reviewed on appeal.

PW, LLC (“PW”) owned large parcels of real estate in southern California. The real estate property was encumbered by a senior secured claim of more than \$40 million held by DB Burbank, LLC (“DB”) and a \$2.5 million junior lien held by Clear Channel Outdoor, Inc. (“CCO”). PW filed a voluntary chapter 11 petition in November 2006. The chapter 11 trustee quickly marketed the real estate property for sale pursuant to section 363 of the Bankruptcy Code because it was a “single asset real estate” case and section 362(d)(3) thus would have permitted the secured creditor to obtain relief from the automatic stay on an expedited time frame to foreclose on the assets.³

DB and the chapter 11 trustee negotiated a stalking horse bid, whereby DB would purchase substantially all of the debtor’s assets via a \$41.4 million credit bid that was intended to wipe out any junior lienholders. CCO argued that the sale could not be consummated free and

³ Section 362(d)(3) of the Bankruptcy Code provides that the court shall grant relief from the automatic stay on an action by a lienholder against single asset real estate unless the debtor (i) makes monthly interest payments to the lienholder, or (ii) submits a plan of reorganization, within 90 days after the lienholder’s entry for relief or 30 days after the court determines the debtor is subject to this code provision (whichever is later).

clear of its liens under section 363(f) of the Bankruptcy Code because it could not be “compelled ... to accept a money satisfaction” of its interest. Over CCO’s objection, the bankruptcy court entered an order authorizing the sale free and clear of the junior lien pursuant to section 363(f)(5). *Clear Channel*, 391 B.R. at 31-32. There were no qualified overbidders, and on May 31, 2007, the bankruptcy court approved the sale to DB, finding that DB was a purchaser in good faith. *Id.* at 32. Both the bankruptcy court and a motions panel for the BAP declined to stay the sale order pending appeal. Because the sale was done pursuant to a credit bid, there were no available proceeds to which CCO’s liens could attach.

CCO filed a timely appeal challenging the sale order. While CCO’s appeal was pending, DB and the trustee closed the sale and subsequently moved to dismiss CCO’s appeal as moot under section 363(m) of the Bankruptcy Code. On appeal, the BAP considered two central issues: whether CCO’s appeal of the sale was moot, and whether outside a plan of reorganization, section 363(f) of the Bankruptcy Code permits a secured creditor to credit bid its debt and purchase estate property free and clear of valid, non-consenting junior liens. *Id.* at 29.

A. Mootness on appeal

Turning first to mootness, the BAP found constitutional mootness inapplicable because (while potentially difficult or inequitable) it was still possible to fashion some relief on appeal. Therefore, a live case and controversy remained. *Id.* at 33. With regard to equitable mootness, the BAP distinguished between the sale itself, which was equitably moot because it was too difficult to unwind, and the stripping of CCO’s liens, which was not equitably moot since “reattaching Clear Channel’s lien to PW’s former property is not theoretically or practically difficult.” *Id.* at 34. Finally, in analyzing “statutory mootness” under the Bankruptcy Code, the BAP found that because section 363(m) references only sections 363(b) and (c), but not section 363(f), “free and clear” determinations under section 363(f) could be reviewed on appeal. *Id.* at 35. The BAP thus considered the appeal only with regard to the lien stripping of the junior secured creditor.

In a recent decision, the Bankruptcy Appellate Panel for the Sixth Circuit declined to adopt *Clear Channel*’s interpretation of section 363(m). See *Official Committees of Unsecured Creditors v. Anderson Senior Living Property, LLC (In re Nashville Senior Living, LLC)*, 2009 WL 1617860, at * 7 (B.A.P. 6th Cir. June 11, 2009). The court rejected an argument that section 363(m) good faith protections should not apply to aspects of a sale authorized pursuant to section 363(h).⁴ See *id.*, at *3. Citing *Clear Channel*, the non-debtor co-tenants argued that appeal was not moot because section 363(m) is directed only to sales under sections 363(b) or (c). Rejecting this argument, the court stated that “*Clear Channel* appears to be an aberration in well-settled bankruptcy jurisprudence applying § 363(m) to the ‘free and clear’ aspect of a sale under § 363(f),” and noted that “*Clear Channel* cited no case law for its conclusion and the overwhelming weight of authority disagrees with its holding that the § 363(m) stay does not apply to the ‘free and clear’ aspect of a sale under § 363(f).” *Id.* at *7. The court held that “although § 363(m) does not explicitly refer to a sale authorized under subsection (h), it

⁴ Section 363(h) of the Bankruptcy Code codifies the common law right of a tenant in common to seek partition by sale in certain limited circumstances

nevertheless applies because the authority for such a sale is derived from subsection (b),” and to hold otherwise would be “contrary to long-standing and well-established principle that the protection of § 363(m) is necessary to promote the finality of bankruptcy sales and would jeopardize the finality of any sale in which a non-debtor co-owner’s interest is involved.” *Id.*

Other jurisdictions will surely be forced to address *Clear Channel*’s limited reading of 363(m). If adopted, *Clear Channel*’s holding that lien-stripping determinations can be reversed on appeal puts at risk the advantage of finality on which section parties to section 363 sales have previously been able to rely. Purchasers could potentially refrain from closing until all appeals have been fully exhausted. Purchasers could also seek new protections in asset purchase agreements to guard against the possibility that the purchased assets might be deemed encumbered by other liens. However, it should be noted that the BAP did not distinguish between sales in which a secured creditor acquires the debtor’s assets through a credit bid, and those in which a third party bidder purchases the estate’s assets for cash and subsequently acts in reliance on the finality of the sale order.

B. *Clear Channel* and the scope of “free and clear” sales under section 363(f) of the Bankruptcy Code

Turning to the substantive issue of whether the stripping of CCO’s lien was permissible, the BAP analyzed whether the sale of PW’s assets satisfied either the requirements of sections 363(f)(3) or 363(f)(5) of the Bankruptcy Code.

1. *Clear Channel*’s definition of “value” as used in section 363(f)(3)

Courts are split on the correct interpretation of “value” as used in section 363(f)(3). Section 363(f)(3) of the Bankruptcy Code provides:

The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than estate, only if . . . 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.

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

The split centers around whether “value” means (a) the value of a lienholder’s secured claim as the term is used in section 506(a) or (b) the face value of all claims with a lien on the assets to be sold. Courts generally follow one of two basic approaches to this question. The first approach, the “Economic Value Test,” finds section 363(f)(3) of the Bankruptcy Code to be satisfied when the sale price exceeds the actual economic value of the asset, or the fair market value of the assets, consistent with how the term “value” is used in section 506(a) of the Bankruptcy Code. *See, e.g., In re Canonigo*, 276 B.R. 257, 260 (Bankr. N.D. Cal. 2002) (stating that “a majority of the courts that have confronted the issue have adopted the ‘economic value of the lien’ approach”); *In re Collins*, 180 B.R. 447, 451 (Bankr. E.D. Va. 1995) (approving an asset sale at a price that was less than the face amount of the debt that the assets secured).

The BAP in *Clear Channel* rejected the Economic Value Test and instead adopted the “Face Value Test,” which authorizes a sale free and clear of liens under section 363(f)(3) of the Bankruptcy Code only if the sale price exceeds the aggregate face amount of all liens held against the property, as opposed to the economic value of the underlying collateral. *See, e.g., Criimi Mae Services Ltd. v. WDH Howell, LLC (In re WDH Howell, LLC)*, 298 B.R. 527, 531-34 (D.N.J. 2003) (finding the “value” of all liens in section 363(f)(3) of the Bankruptcy Code to mean their face amount, not economic value because sale price is by definition equal to, not greater than, fair market value); *In re Canonigo*, 276 B.R. 257, 265 (Bankr. N.D. Cal. 2002) (holding that “value” in section 363(f)(3) refers not to economic value of property supporting liens, but to the full face amount of claims that these liens secure). In adopting the Face Value Test, the court in *Clear Channel* stated that interpreting “value” to be predicated on economic value runs contrary to the language of section 363(f)(3): “[i]n any case in which the value of the property being sold is less than the total amount of claims held by secured creditors, the total of all allowed secured claims will *equal*, not *exceed*, the sales price, and the statute requires the price to be ‘greater than’ the ‘value of all liens.’” *Clear Channel*, 391 B.R. at 40.

The reasoning in *Clear Channel* and the other courts that have adopted the “Face Value Test” – that “value” means the face value of liens – implies that section 363(f)(3) of the Bankruptcy Code will apply only when the debtor retains equity in the property to be sold. This interpretation may have a significant impact on the 363 sale process by calling into question whether the lien-stripping advantages of section 363(f) can be realized in sales of over-encumbered property.

2. *Clear Channel’s* interpretation of section 363(f)(5) and senior lender credit bidding

Pursuant to section 363(f)(5), assets may be sold free and clear of interests if the holder of such interest “could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.” The bankruptcy court in *Clear Channel* determined that because money payment can satisfy liens and a chapter 11 plan providing for such money payment can be crammed down on lienholders, the requirements of section 363(f)(5) of the Bankruptcy Code were met. The BAP rejected this reasoning as impermissibly broad because it would render subsection (f)(3) superfluous; the provisions of subsection (f)(3) would never need to be used, because all liens would be subject to subsection (f)(5), “regardless of the relationship between the value of a creditor’s collateral and the amount of its claim.” *Id.* at 44. Instead, the BAP ruled that section 363(f)(5) only permits a sale free and clear of junior liens if a legal or equitable proceeding exists that could force the junior lienholder to accept a money judgment in satisfaction of its lien. *Id.* at 45-46.

The BAP further held that cramdown could not meet the requirement of a “legal or equitable proceeding” because such reasoning would be circular and would “undercut[] the required showing of a separate proceeding.” *Id.* at 46. The court did not, however, identify what type of non-bankruptcy proceeding would fulfill the requirements of section 365(f)(5) of the Bankruptcy Code. Because of the lack of specific findings by the bankruptcy court, the BAP remanded the case for determination of whether a qualifying proceeding exists under non-

bankruptcy law that would enable the stripping of CCO's lien under 363(f)(5) of the Bankruptcy Code.

Some commentators have suggested that the *Clear Channel* decision was a result of the BAP's dissatisfaction with the record on appeal. See Frank A. Oswald and Andy Winchell, *Missing the Forest for the Trees in § 363: How the Ninth Circuit's Bankruptcy Appellate Panel Neglected the Big Picture in the Clear Channel Decision*, Norton Bankr. L. Adviser, April 2009, at 2. The opinion makes references to the lack of finding by the bankruptcy court of a specific non-bankruptcy mechanism that would satisfy section 363(f)(5). See *Clear Channel*, 391 B.R. at 46 ("Neither the Trustee nor DB has directed us to any such [legal or equitable] proceeding under non-bankruptcy law, and the bankruptcy court made no such finding."). The appellees relied heavily on section 1129(b)'s "cramdown" provision as a proceeding that satisfies section 363(f)(5). But, the BAP rejected that theory. The BAP did not consider whether foreclosure proceedings under state law would qualify under section 363(f)(5). Commentators have therefore suggested that the *Clear Channel* decision might have been decided differently if appellees had provided the BAP with more robust briefing on state foreclosure laws. At least one post- *Clear Channel* court has found state law foreclosure sufficient for 363(f)(5) purposes. See *In re Jolan, Inc.*, 403 B.R. 866, 867 (Bankr. W.D. Wash. 2009) (discussed *infra*).

Nevertheless, some courts had previously criticized credit bidding by senior secured creditors as being unfair to junior lienholders and likely to dissuade other outside bidders. See, e.g., *In re Antaeus Technical Services*, 345 B.R. 556, 564 (Bankr. W.D. Va. 2005) (noting that section 363(k)'s allowance for credit bidding "cannot alter the economic realities that an auction sale in which one bidder is an existing lender who does not have to put up new money, but can rely upon money previously advanced and which the lender has no other actual way to recover, is not a sale in which the bidders are on a level playing field"); *In re Moonraker Assocs. Ltd.*, 200 B.R. 950, 955 (Bankr. N.D. Ga. 1996) (noting that credit bidding can result in a distortion of value because a "dominant creditor could submit a bid over and above a 'reasonable' assessment of the value it actually perceives," and that "[s]uch a bid could effectively displace all other bids and any benefit to be achieved through such competitive bidding . . . would be virtually nonexistent"). While section 363(k) recognizes a lienholder's right to credit bid the value of its claim, it also provides bankruptcy courts the authority to disallow credit bidding "for cause." See *In re Theroux*, 169 B.R. 498, 499 (Bankr. D.R.I. 1994) (disallowing credit bidding where intended sale price was only a fraction of fair market value and "clearly inadequate"). Although "cause" is not a defined term in the Bankruptcy Code, "it is intended to be a flexible concept enabling a court to fashion an appropriate remedy on a case-by-case basis." *In re NJ Affordable Homes Corp.*, No. 05-60442 (DHS), 2006 WL 2128624, at * 16 (Bankr. D.N.J. June 29, 2006).

In interpreting *Clear Channel*, other courts have limited the holding to the specific issues and arguments that were presented to the BAP on appeal. In *In re Jolan, Inc.*, 403 B.R. 866, 867 (Bankr. W.D. Wash. 2009), the court stated that *Clear Channel* "does not preclude a § 363(b) sale free and clear for an amount less than enough to satisfy all liens." The *Jolan* court found that subsection 363(f)(5) is the only subsection of section 363(f) that might permit the asset in question to be sold free and clear of junior liens if the proceeds do not cover the senior secured debt. *Id.* at 869. However, the court found there were legal and equitable proceedings available under the state of Washington's Uniform Commercial Code that could satisfy the requirements

of section 363(f)(5) of the Bankruptcy Code:

But there are legal and equitable proceedings in Washington in which a junior lienholder could be compelled to accept a money satisfaction: a senior secured party's disposition of collateral after under [sic] the default remedies provided in part VI of Article 9, Secured Transactions, of Washington's Uniform Commercial Code, RCW 62A.9A. . . . And a receiver may sell free and clear of liens under RCW 7.60.260, with the liens attaching to the proceeds. Since a receivership can be commenced by parties having interests in less than all of a debtor's property, and the receivership estate may be an entire business with numerous properties, RCW 7.60.025, the receiver may sell free and clear of even the interests of first lienholders.

Id. The court accordingly found that because there are proceedings by which lienholders may be compelled to accept money satisfaction, section 363(f)(5) permits a sale free and clear of liens, with the liens attaching to the proceeds, notwithstanding that those proceeds may be insufficient to pay all liens. *Id.* at 870.

III. RECENT SIGNIFICANT ISSUES IN SECTION 363 SALES

A. Syndicate lender holdouts: Who can consent to a sale or credit bid?

There has been significant recent litigation on the issue of what qualifies as "consent" under section 363(f)(2) of the Bankruptcy Code when the lien is held by a collateral agent on behalf of a syndicated lender group. The *Chrysler* court followed *In re GWLS Holdings, Inc.*, No. 08-12430, 2009 Bankr. LEXIS 378, at *3 (Bankr. D. Del. Feb. 23, 2009) ("Greatwide"), holding that, if provided for under applicable loan documents, an authorized syndicate representative (such as a collateral agent) has the authority to consent to "collateral enforcement actions," even if the lenders do not unanimously consent to such action.

Greatwide Logistics Services, Inc.'s ("GLSI") prepetition debt structure consisted of two tiers – a \$337 million First Lien Credit Agreement and a \$117 million Second Lien Credit Agreement. GLSI entered into collateral agreements with the first lien and second lien collateral agents, respectively. The first lien agent and the second lien agent also executed an intercreditor agreement. As of the petition date, approximately \$366 million of first lien debt and \$117 million of second lien debt were outstanding. *Id.* at *2-3.

In *Greatwide*, the first lien lenders proposed to credit bid in a sale of substantially all of the debtors' assets. All of the first lien lenders, except Grace Bay, consented to the credit bid. Grace Bay objected to the Debtors' motion to authorize the sale free and clear of liens, claims, encumbrances, and other interests on the grounds that unanimous consent was required. *Id.* at *4. The court rejected this objection and approved the sale.

Grace Bay asserted two primary arguments. First, that the credit agreement required unanimous written consent of first lien lenders for any modification of the agreement, including

the waiver and release of the first lien lenders' lien on the collateral, and that the release of collateral was necessary for the sale of debtors' assets. *Id.* at *12-13. Second, Grace Bay cited the provisions of the intercreditor agreement providing that “[s]o long as the Discharge of the First Lien Obligations has not occurred . . . the First Lien Collateral Agent *and* the First Lien Secured Parties shall have the exclusive right to enforce rights, exercise remedies (including setoff and the right to credit bid debt) and make determinations regarding the release, disposition, or restrictions with respect to the Collateral” *Id.* at *5-6.

The first lien agent and debtors argued, and the court agreed, that because the “required lenders” approved the credit bid, the collateral agent was permitted to authorize the credit bid without Grace Bay’s consent. The credit agreement appointed the collateral agent to act on the behalf of the lenders and the collateral agreement stipulated that, in the event of default, the “Collateral Agent . . . may exercise . . . all rights and remedies of a secured party” *Id.* at *7. In such circumstances, the collateral agreement vested the collateral agent with the power to “sell, lease, license, sublicense, assign, give option or options to purchase, or otherwise dispose of and deliver the Collateral or any part thereof.” *Id.* Therefore, the court found that the collateral agent’s actions that were taken with only the consent of “required lenders” were proper under the loan documents and thus sufficient to bind all lenders.

Grace Bay argued that the loan documents required unanimous lender approval of waivers, amendments, supplements or modifications of the loan. The court rejected this argument by noting that the all lender requirement for waivers, amendments, supplements or modifications must be read in harmony with the provisions allowing the collateral agent to dispose of collateral after an event of default. *Id.* at *12. Reading the two provisions together led the court to find that the credit bid was not a waiver, amendment, supplement or modification of the credit agreement. *Id.* It was this aspect of *Greatwide* upon which the *Chrysler* court relied. In *Chrysler*, objectors had relied on a very similar all-lender requirement for waivers, amendments, supplements or modifications. Judge Gonzalez elaborated on Judge Walsh’s *Greatwide* opinion by saying that the purpose of such all-lender requirements is:

to ensure that unless there is unanimous consent by all lenders under the related loan agreements, the terms of those agreements cannot be altered in a manner that is inconsistent with the terms originally agreed to by the parties. It does not concern collective action to enforce rights as authorized under the agreed-upon specific provisions of the parties’ loan agreements.

In re Chrysler LLC, 405 B.R. at 102-103 (internal citations omitted).

Greatwide was cited in another recent Delaware case – *In re Foamex International Inc.*, Case No. 09-10560 (Bankr. D. Del. 2009). On May 27, 2009, the *Foamex* court entered an order authorizing a 363 sale of substantially all the debtors’ assets to an entity formed by a (slight) majority of first lien lenders. The *Foamex* court allowed majority lenders to credit bid up to the full value of the entire first lien loan despite protests from various minority lender groups, who argued that the loan documents only allowed majority lenders to credit bid their pro rata portion of the debt. Further complicating the sale was the existence of a competing all-cash bid. In

response to that cash bid, the majority lenders ultimately offered a credit bid of \$155 million (slightly less than 50% of the outstanding senior indebtedness) and offered non-consenting lenders a “cash-out” option capped at an assumed cash price of \$146.5 million. The competing all cash bid was \$151.5 million. The debtors supported the credit bid offer. Debtors also asserted that that majority lenders could continue to credit bid up to the full face value of the senior loans (\$324.8 million) while keeping the “cash-out” option capped based on the assumed price of \$146.5 million. While no opinion was issued, the sale order approved the \$155 million credit bid and \$146.5 million “cash-out.”

Relying on *Greatwide*, the majority lenders in the *Foamex* case argued that their credit bid was authorized under the loan documents via an authorization of the collateral agent to act at the instruction of the required lenders during an event of default. Minority lenders argued that the loan documentation in *Foamex* differed from that in *Greatwide* because the specific authority of the collateral agent to credit bid after an event of default was limited to the debt held by consenting lenders. Minority lenders also argued that *Greatwide* involved a syndicate where a substantial majority (more than enough to vote the class in the plan context) approved the credit bid. In *Foamex* the consenting class was a bare majority (51%), which is insufficient to vote the class in the plan context. The *Foamex* court approved the sale over minority lender objections.

Both the *Foamex* and *Greatwide* sale orders have been appealed to the United States District Court for the District of Delaware. Any appellate decisions will be closely monitored for further guidance on the complicated and developing issue of syndicate lender consent in the 363 sale context.

B. The effect of section 363 sales on successor liability claims

Because of nature of their business, automobile manufacturers have historically been the target of some of the largest and most complicated product liability lawsuits. It is therefore unsurprising that the recent section 363 asset sales of substantially all the assets of GM and Chrysler have brought to the forefront the treatment of tort claimants after such sales. As noted by tort claimant objectors to the GM sale, the way each sale was structured – with the surviving purchaser continuing to operate similarly and under many of the same brands as their previous incarnations – may implicate “mere continuation,” “continuity of enterprise,” or “product line exception” tests for successor liability under state law. Chrysler, GM, and their purchasers argued that “free and clear” asset sales extinguish the possibility of such successor claims. Various tort claimants opposed the sales under those terms, arguing that extinguishing successor tort claims was beyond the power of the bankruptcy court.

Successor liability and tort claimant issues were only briefly addressed by the *Chrysler* court, yet the *Chrysler* opinion and its subsequent affirmation on appeal was used as the principal justification for the *GM* court’s rejection of continuing successor liability in that case. *See In re General Motors Corp.*, No. 09-50026, 2009 Bankr. LEXIS 1687 at *96 (Bankr. S.D.N.Y. July 5, 2009) (“On this issue, it is not just that the Court feels that it *should* follow *Chrysler*. It *must* follow *Chrysler*. The Second Circuit’s *Chrysler* affirmance, even if reduced solely to affirmance of the judgment, is controlling authority”) (emphasis in original).

The dispute over whether successor liability can be eliminated by section 363 sales turns on the interpretation of the word “interest” as used in 363(f), which authorizes sales of the a debtor’s property free and clear of “any interest in such property.” As discussed at length by the *GM* court, there is no “plain meaning” of the word “interest.” Tort claimants opposing the GM sale directed the court to section 1141(c)’s authorization of sales free and clear of “claims and interests” in the plan of reorganization context. Tort claimants argued that the reference to both “claims” and “interests” in section 1141(c) of the Bankruptcy Code means that any interpretation of “interest” in 363(f) of the Bankruptcy Code should not include “claims” such as tort claims. Judge Gerber rejected the comparison to 1141(c) by noting that the meaning of “interest” differs in different sections of the Bankruptcy Code.

With no plain meaning to rely on, Judge Gerber turned to case law. Acknowledging a significant circuit split on the issue, the *GM* court followed the *Chrysler* bankruptcy court opinion (and the Second Circuit’s affirmance thereof) and held that extinguishing preexisting liability claims was within its power under 363(f). *Chrysler*, in turn, relied heavily on the Third Circuit’s holding in *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3rd Cir. 2003) (“TWA”). *TWA* reflects a growing majority approach that allows successor liability claims to be extinguished via section 363(f) of the Bankruptcy Code. *See, e.g.*, Cohen, *Successor Liability in 363 Sales*, 22-9 ABIJ 18 (Nov. 1, 2003).

In *TWA*, the Third Circuit authorized a section 363 sale free and clear of pending employment discrimination claims against the airline. These claims were able to be extinguished because “it was the assets of the debtor which gave rise to the claims.” *TWA*, 322 F.3d at 289; *see also In re Leckie Smokeless Coal Co.*, 99 F.3d 573 (4th Cir. 1996). This rationale has been criticized as overly broad. *See In re Eveleth Mines, LLC*, 312 B.R. 634, 654 (Bankr. D. Minn. 2004) (criticizing *TWA* as “built on an amorphously inclusive rationalization; it posits a loose sort of “but-for” causality that is thrown up to identify the straw-built “interest” that then is vanquished”).

The continuing disparity in the case law regarding successor liability reflects competing concerns about the policy rationales for, and constitutionality of, the varying applications of section 363(f). On one hand, courts adopting the majority view of a broad interpretation of section 363(f) often cite two goals of the Bankruptcy Code to justify their position – maximizing the value of estate property and adhering to the Code’s priority scheme. *See, e.g., Ninth Ave. Remedial Group. v. Allis-Chalmers Corp.*, 195 B.R. 716, 731 (N.D. Ind. 1996) (citing cases). Underlying this view is a belief that that (a) by extinguishing successor liability claims, they enhance the sale price of debtor assets and (b) that permitting successor liability claims to survive a section 363(f) “free and clear” sale would upset the priority scheme in bankruptcy by allowing some creditors to recover in full from successors, rather than in the amount provided to their impaired class in the debtor’s plan of reorganization.

On the other hand, some courts have expressed the view that successor liability claims that arise only after the conclusion of the bankruptcy case cannot be extinguished under section 363(f) of the Bankruptcy Code because the claimants would otherwise have been deprived of due process. *See, e.g., In re Savage Ind., Inc.*, 43 F.3d 714 (1st Cir. 1994) (affirming the district court order vacating the bankruptcy court’s injunction barring all but specifically assumed

successor liability claims). Moreover, commentators have expressed doubt whether bankruptcy courts have constitutional authority to deprive a non-debtor of a statutory or common-law successor liability claim against another non-debtor. See George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 AM. BANKR. L.J. 235 at 262, n.104 (2002).

Such constitutional and due process concerns are heightened in the context of *future* tort claims (e.g., claims arising in the future but based on a design flaw arising before the section 363 sale), primarily because such future claims do not exist as of the date that the asset sale closes. Characterizing such future claims as an “interest” in the property of the debtor is problematic; as is the ability of such potential future claims to meet the requirement of section 363(f)(5) that the “interest” be of the type that can be “compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.” Moreover, it is difficult to conceptualize how such future tort claimants can receive notice of a section 363 sale. The inability to provide notice and an opportunity to be heard to such potential future victims arguably implicates constitutional due process concerns.

C. Sales of intellectual property licenses and section 365(c)(1) of the Bankruptcy Code

The broad powers of a debtor to assume and assign executory contracts pursuant to sections 365(a) and (f) of the Bankruptcy Code are circumscribed in the context of intellectual property (“IP”) licenses. Under section 365(c)(1) of the Bankruptcy Code, a debtor’s ability to “assume or assign” executory contracts is restricted when “applicable law” gives the non-debtor party to the contract the right to refuse to accept performance from a third party. IP licenses are usually deemed to be executory contracts because they contain ongoing obligations, such as duties to indemnify, pay royalties, and uphold quality control standards. See *In re Golden Books Family Entm’t, Inc.*, 269 B.R. 311, 314 (Bankr. D. Del. 2001) (noting that courts commonly find IP licenses to be “executory contracts” under the Countryman test). Whether such contracts can be assumed and assigned to a purchaser depends on an application of section 365(c)(1) of the Bankruptcy Code.

Courts agree that the term “applicable law” in 365(c)(1) covers prohibitions on the assignment of personal service contracts without consent, but courts diverge as to how far this restriction should extend. Non-bankruptcy anti-assignment laws that are predicated on the rationale that the identity of the contracting party is material to the agreement are considered to be “applicable law” under section 365(c)(1) and can thus limit a debtor-in-possession’s rights that they would otherwise have under sections 365(a) and (f). See *RCI Tech. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 266-67 (4th Cir. 2004). Similarly, courts have generally found that the identity of the licensee is material in the context of non-exclusive IP license agreements, including patent or copyright licenses, and are thus non-assignable without the licensor’s consent. See *Perlman v. Catapult Entm’t, Inc. (In re Catapult Entm’t, Inc.)*, 165 F.3d 747, 749-50; *Everex Sys., Inc. v. Cadtrax Corp. (In re CRLC, Inc.)*, 89 F.3d 673, 677-78 (9th Cir. 1996); *Harris v. Emus Records Corp.*, 734 F.2d 1329, 1333-34 (9th Cir. 1984); *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997). Conversely, many exclusive

licenses are held to be assignable on the rationale that an exclusive grant is more akin to a sale, where the owner gives up control and ownership rights.

Courts are split on the issue of whether a debtor can even assume an executory contract that is not assignable pursuant to section 365(c)(1) of the Bankruptcy Code. The difference of opinion turns on the interpretation of the phrase “assume *or* assign” in 365(c)(1) of the Bankruptcy Code, disagreeing as to whether the “or” should be read as “or” or as “and/or.” Under the so-called “hypothetical test,” adopted by a majority of circuit courts that have addressed this question, section 365(c)(1) permits a debtor-in-possession to assume an executory contract only if it could “hypothetically” assign the contract to a third party. Therefore, under the hypothetical test, if the debtor-in-possession lacks hypothetical authority to assign an executory contract, the debtor-in-possession may not assume the contract for its own use either—even if the debtor-in-possession has no *actual* intention to assign the contract to a third party.⁵ The hypothetical test has been adopted by the Third, Fourth, Ninth, and Eleventh Circuits. *See In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004); *In re Catapult Entm’t, Inc.*, 165 F.3d 747 (9th Cir. 1999); *In re James Cable Partners, L.P.*, 27 F.3d 534, (11th Cir. 1994); *In re West Electronics, Inc.*, 852 F.2d 79 (3rd Cir. 1998).

On the other side of the split, the First and Fifth Circuits, as well as a number of bankruptcy courts, have adopted the “actual test,” which permits a debtor-in-possession to assume an executory contract if it has no actual intent to assign the contract to a third party. *See Bonneville Power Admin v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238 (5th Cir. 2006); *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997); *In re Aerobox Composite Structures, LLC*, 373 B.R. 135 (Bankr. D.N.M. 2007); *In re GP Express Airlines, Inc.*, 200 B.R. 222 (Bankr. D. Neb. 1996). Under the actual test, assignment limitations are not triggered unless there is an actual intent to assign the executory contract to a third party. Courts that adopt the actual test, therefore, focus on a case-by-case basis on the likelihood of performance by the debtor-in-possession under the contract going forward.

The specific drafting language of an IP license agreement can determine if it is capable of being assumed and/or assigned, which, depending on the applicable side of the circuit split, can decide whether the particular IP license can be included in an asset sale. As noted above, non-exclusive licenses are generally held to be non-assignable because the identities of the contracting parties are considered to be material. The question of whether or not a right is “exclusive” can raise unique questions in the realm of IP law, because the court is required to examine discrete IP rights and evaluate the extent the retention of control by the non-debtor party. Contracts where the party’s special qualities such as reputation, capabilities, experience, and industry knowledge are well documented resemble personal service contracts and are more likely to be held non-assignable. The practical effect is that in courts following the actual test, IP

⁵ A recent case takes the hypothetical test a step further and suggests that a contractual provision permitting parties to assign the contract is not sufficient to establish ability to assume. *See RCI Tech. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 267 (4th Cir. 2004) (holding that contract provision permitting assignment to acquirers is not sufficient to permit assumption by the debtor if applicable non-bankruptcy law would excuse non-debtor party to the contract from accepting performance from a party other than the debtor).

contracts whose parties are determined to be special and material to the agreement cannot be sold under a section 363 sale because the contract will be non-assignable.

In March 2009, the Supreme Court declined to hear the *N.C.P. Marketing Group v. BG Star Productions*, which would have given the Court the opportunity to address the split of authority concerning the correct interpretation of section 365(c)(1) of the Bankruptcy Code. 129 S.Ct. 1577 (2009).⁶ In a rare move, however, Justices Kennedy and Breyer issued an accompanying statement denying writ of certiorari, which indicates that although they “reluctantly agree with the Court’s decision to deny certiorari,” they believe that “[t]he division in the courts over the meaning of § 365(c)(1) is an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization.” *N.C.P. Mktg. Group*, 129 S.Ct. at 1578. *N.C.P. Marketing* involved the assumption of an executory trademark contract, which the Court believed made the case not the “most suitable case” for resolving this split in bankruptcy law because it would likely require the Court to first interpret “antecedent questions under state law and trademark protection principles.” *Id.* In *N.C.P. Marketing*, the debtor-licensee, N.C.P. Marketing Group, Inc., sought to assume a non-exclusive trademark license for rights over the TAE BO fitness system. Because the case arose in the Ninth Circuit, which follows the hypothetical test, N.C.P. Marketing could not assume the license rights to the TAE BO trademark because it would not have been able to assign those rights to a hypothetical third party.

As Justice Kennedy noted in his statement, the application of the hypothetical test versus the actual test can significantly impact a debtor-in-possession’s ability to maintain its operations and thus achieve a successful reorganization. *N.C.P. Mktg. Group*, 129 S.Ct. at 1577. A strong criticism of the hypothetical test is that it “may prevent debtors-in-possession from continuing to exercise their rights under non-assignable contracts, such as patent and copyright licenses.” *Id.* Justice Kennedy further asserted that, “[w]ithout these contracts, some debtors-in-possession may be unable to effect the successful reorganization that Chapter 11 was designed to promote.” *Id.*

D. Circumvention of stockholder votes

Section 363 sales of substantially all of a debtor’s assets are clearly becoming an increasingly popular part of the reorganization and are, increasingly, being considered an alternative to traditional M&A activity. Over the past year, in addition to the cases described above, entities such as Filene’s Basement, Bally Total Fitness Holding Corp., Linens ‘N Things, Sharper Image and Bombay Co. have been acquired out of bankruptcy. These, as well as the recent “blockbuster” sales, illustrate the great flexibility provided by the Bankruptcy Code. However, there are limits to that flexibility.

One barrier to a company to avail itself of section 363 of the Bankruptcy Code was articulated by the Delaware Court of Chancery in *Esopus Creek Value LP v. Hauf.*, 913 A.2d 593, 596 (Del. Ch. 2006). In *Esopus Creek*, Metromedia International Group, Inc.

⁶ For the district court’s opinion in *N.C.P. Mktg.*, see *In re N.C.P. Mktg. Group, Inc.*, 337 B.R. 230 (D. Nev. 2005), and for the Ninth Circuit’s affirming opinion, see *In re N.C.P. Mktg. Group, Inc.*, 279 Fed. Appx. 561, No. 05-17384, slip op. (9th Cir. May 23, 2008).

(“Metromedia”), a solvent Delaware corporation, sought to consummate a sale of its principal asset that, outside of bankruptcy, would have required the affirmative vote of a majority of its common stockholders. The corporation is a registrant under the Securities and Exchange Act of 1934, but had not filed a form 10-K for several years. As a result, the company was prohibited from calling a meeting of stockholders for the purpose of voting on the proposed transaction. *Id.* To circumvent this ban, the board of directors adopted a plan to file a voluntary bankruptcy petition once the asset sale agreement was signed, even though the company was neither insolvent nor had any financial difficulty. *Id.*

The plaintiffs, two investment vehicles that own a substantial amount of the common stock of Metromedia, filed a motion to preliminarily enjoin Metromedia from executing an agreement with a buying group. *Id.* at 597, 601. The court entered an order prohibiting the corporation and its directors from making any agreement to sell all or substantially all of the assets that is not conditioned upon the approval of the corporation’s common stockholders. In granting the injunction, the Chancery Court found that the company’s proposed use of the bankruptcy process amounted to inequitable conduct: “[i]t therefore seems an abuse of the bankruptcy process for a robust and healthy company, encumbered by virtually no debt, to seek out the vast and extraordinary relief a bankruptcy court is capable of providing.” *Id.* at 604.

In its opinion, the court noted that protections of the business judgment rule provides a board with substantial discretion in determining the proper method by which to structure a material corporate transaction. That discretion, however, remains bounded by fundamental principles of equity that necessarily limits what a board of directors can do in its attempt to consummate a transaction. *See id.* at 603. The court noted that “inequitable action does not become permissible simply because it is legally possible.” *See id.* The court concluded that the directors’ actions in approving the sale offended fundamental notions of equitable conduct. Specifically, it found that Metromedia’s financial circumstances (it was a “clearly solvent” entity) provided strong evidence of the inequity of a bankruptcy sale. Moreover, the asset to be sold was forecast to generate substantial cash in the coming years. The court thus concluded that it was an abuse of the bankruptcy process for a robust and healthy company, encumbered by virtually no debt, to seek out the vast and extraordinary relief a bankruptcy court is capable of providing. *See id.* at 603-04.

While section 363 of the Bankruptcy Code may, in certain circumstances, be more attractive than traditional M&A processes outside of bankruptcy court, many courts will not tolerate an otherwise healthy company attempting to avail itself of section 363 of the Bankruptcy Code in an effort to circumvent the vote of stockholders.