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§ 363 Sale Issues

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OUTLINE ON THE 365/363 ISSUE

1) The issue: apparent conflict between section 363(f) and section 365(h)
   a) 363(f): Property of the estate may be sold free and clear of any other interest under certain specified conditions ((f)(1) through (f)(5))
   b) 365(h): if the trustee rejects a lease, the lessee on a lease whose term has already begun may, at its option, retain its lease rights for the duration of the lease.
   c) What happens when a trustee seeks to sell property free and clear of an existing lease?
2) First approach: older/"majority" approach
   a) 365(h), as the more specific rule, trumps 363(f).
   b) A sale under 363(f) does not deprive lessees of their right to maintain the lease. 363(f) is essentially ineffective against leases.
   c) Otherwise, courts could use 363(f) to make an end run around the rights of lessees under 365(h).
   d) Example cases: *In re Churchill Props.*, 197 B.R. 283 (Bankr. N.D. Ill. 1996); *In re Haskell, LP*, 321 B.R. 1 (Bankr. D. Mass. 2005); *In re Taylor*, 198 B.R. 142 (Bankr. D.S.C. 1996).
3) Second approach: newer/"minority" approach
   a) 365(h) and 363(f) are not in conflict but apply to different circumstances. 365(h) applies when a trustee affirmatively rejects the lease; 363(f) applies when a trustee simply seeks to sell the property free and clear.

b) The lessee is still protected by 363(e) and the requirements for a free and clear sale under 363(f).

i) 363(e): requires court to provide, upon request, "adequate protection" to the holder of an interest in the property being sold. "Adequate protection" is defined by section 361 and could mean:

(1) Cash payments, to the extent of the lost value in the interest from the sale;

(2) An additional or replacement lien, to the extent of the lost value in the interest from the sale;

(3) "granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property."

ii) 363(f) itself is only applicable if one of five conditions is met.

(1) (f)(1): nonbankruptcy law permits sale free and clear of the interest.

(2) (f)(2): the interest holder consents.

(3) (f)(3): the interest is a lien and the sale price is greater than the aggregate value of all liens on the property.

(4) (f)(4): interest is in bona fide dispute.

(5) (f)(5): holder of interest could be compelled to accept money satisfaction.

c) Example applications:

i) *In re Qualitech Steel Corporation*, 327 F.3d 537 (7th Cir. 2003):

(1) Bankruptcy court approved sale order of property subject to a lease under 363, without objection by the lessee; buyer assumed possession. Lessee sued; case was referred to bankruptcy court, which held that the 363 sale had extinguished the lease. District court reversed, following majority view. Buyer appealed.

(2) First circuit court decision addressing this issue

(3) Seventh Circuit: The lease is an interest under 363(f), so standing alone, 363(f) would extinguish the lease.

(4) Seventh Circuit: 365(h) does not conflict with 363(f) because it only applies when a trustee affirmatively rejects a lease in the first instance, instead of simply selling the property under 363; that did not happen here.

(5) Seventh Circuit: Thus, since lessee did not object to the sale or seek adequate protection under 363(e), its interest was extinguished.

ii) *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696 (S.D.N.Y. 2014)

(1) Trustee sold property under 363(f) to buyer; buyer sought a ruling that sale nullified lease to lessee. Bankruptcy court held, like majority view, that 365(h) preserved the lease, and in the alternative, that preserving the lease was adequate protection under 363(e). Buyer appealed to district court.

(2) District court: 365(h) simply means that rejection alone does not displace a lessee's lease rights. It doesn't affect sales under 363(f).

(3) District court: Nonetheless, the conditions for 363(f) are not satisfied here because the lease could only be displaced in foreclosure, and involuntary sale does not count under 363(f)(1) or 363(f)(5).

(4) District court: Also, since a lease interest is hard to value, continued possession is appropriate "adequate protection" under 363(e) in this case.

(5) Thus, lessee wins even under minority view.

iii) *In re Spanish Peaks Holdings II, LLC*, 872 F.3d 892 (9th Cir. 2017)

(1) Underlying property was subject to two leases, both entered subsequent to a mortgage between entities controlled by the same individuals. Trustee sold the property under 363. Leaseholders sought protection for their leases. Bankruptcy court: sale was free and clear of leases. District court affirmed. Leaseholders appealed.

(2) Ninth Circuit: As *Qualitech* held, the two sections do not conflict; 363 governs "the sale of estate property" while 365 governs "the formal rejection of a lease."

(3) Ninth Circuit: We do not address the situation where the lease is formally rejected prior to the sale.

(4) Ninth Circuit: 363(f)(1) was satisfied because, under Montana law, a foreclosure sale could have terminated the lease.

(5) Ninth Circuit: *Dishi* holding that foreclosure sales do not count is wrong; 363(f)(1) should not be understood to *enhance* the rights of a third party like the lessees here (who absent bankruptcy would likely have seen their rights terminated in foreclosure), rather than simply preserving them

(6) Ninth Circuit: Question of what adequate protection should be afforded to these lessees not before us (not part of appeal).

d) Remaining questions:

i) What is "adequate protection"?

(1) In *Dishi*, "adequate protection" meant preserving the possessory rights of the lessee. When can cash payments under 361(a), perhaps from sale proceeds, be an adequate substitute?

ii) Do involuntary sales count for purposes of 363(f)(1)?

(1) Disagreement between *Dishi*, which emphasizes that a 363 sale is not a foreclosure, and *Spanish Peaks*, which seems to see a 363 sale as a functional equivalent of a foreclosure, at least for purposes of 363(f).

iii) What if the lease is rejected prior to the sale?

(1) *Dishi* is relatively clear that this doesn't matter. *Qualitech* and *Spanish Peaks* distinguish this question rather than addressing it directly.

4) What's the status of the old approach?

a) Two circuit court opinions on the side of the newer minority approach (*Qualitech* and *Spanish Peaks*) and none on the side of the majority approach

b) Bankruptcy courts sometimes continue to side with majority approach

i) *In re Zota Petroleums, LLC*, 482 B.R. 154 (Bankr. E.D. Va. 2012)

(1) Factually distinguishes *Qualitech*: in *Zota*, there was a formal rejection of the lease.

(2) Also agrees on the law with the majority approach, however, reasoning that "the rights of the tenant may not be extinguished by a § 363 sale; to hold to the contrary would give open license to debtors to dispossess tenants by utilizing the § 363 sale mechanism."

ii) *In re Crumbs Bake Shop*, 522 B.R. 766 (Bankr. N.J. 2014)

(1) Decision under 365(n), involving similar protections for intellectual property as for leases; relies on 365(h) case law.

(2) Decided after *Dishi* but does not cite it.

(3) Cites and disagrees with *Qualitech*, relying on the argument that 365(h) (and 365(n)) are more specific than 363(f), and that permitting lease-stripping through a 363 sale would allow the 365 protections to be circumvented.

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Loan-to-Own Strategy and Section 363

- In recent years, the "loan-to-own" strategy has been increasingly employed by private equity groups, hedge funds and other distressed investors to acquire ownership of a distressed company's assets through the purchase of the company's senior secured debt or providing a senior secured loan, often at a deep discount. This process may take place on either a consensual or hostile basis. Following the acquisition of the debt, the lender may (1) participate in a consensual out-of-court restructuring to swap its debt interests for equity; (2) foreclose on the assets securing the lender's debt should the borrower default; (3) credit bid its debt in a section 363 sale or sale of assets under a plan or (4) use its position in the debtor's capital structure to negotiate a plan that converts the lender's debt to equity. The lender may also provide DIP financing pursuant to which the lender requires a sale of the debtor's assets in which the lender acts as the stalking horse bidder.
- The out-of-court process may be quicker and cheaper than a bankruptcy filing while also providing less scrutiny from third parties. However, a bankruptcy filing may provide the lender with (i) the opportunity to obtain assets free and clear of liens, claims or interests pursuant to section 363, (ii) the opportunity to purchase the debtor's assets at discounted prices due to generally fewer potential purchasers because of the bankruptcy filing (iii)ability to credit bid the secured debt, and (iv) good faith purchaser protections.

Restructuring Support Agreement/DIP Financing.

- In loan-to-own scenarios, the lender may enter into a restructuring support agreement with the debtors, and, in conjunction therewith, may provide DIP financing. The RSA and DIP

Financing may provide for the sale of the debtor's assets on an expedited timeline with the lender designated as the stalking horse bidder or the RSA may provide for a prenegotiated plan. The lender may include the secured claims under its DIP loan in any credit bid in a 363 sale or in a sale of the debtor's assets under a plan. To further ensure a successful takeover of the debtor, the lender may require a no shop provision in the RSA, which prevents the debtor from seeking alternative restructuring transactions. The RSA and the DIP may provide consent rights to the lender, which would provide for a default under the RSA and/or the DIP loan if the debtor filed a plan without the lender's approval. Significantly, the prenegotiated plan would provide for broad releases for the lender.

- Where there is no sale of the debtor's assets, the lender may use its position in the debtor's capital structure as leverage to control the formulation and terms of the debtor's plan of reorganization. Using its power, the lender will negotiate a plan of reorganization under which it would receive equity in the reorganized debtor in exchange for its claims. Upon the effective date, the "old" equity is cancelled and new shares are issued, providing the lender with ownership of the reorganized debtor.

Credit Bidding

- Pursuant to section 363(k) of the Bankruptcy Code, a lender may credit bid all or part of its secured claim to acquire the debtor's assets on which it holds a lien in exchange for the cancellation of the debt, unless the court for cause orders otherwise. 11 U.S.C.§ 363(k).
- A lender faces certain risks when it embarks on a loan-to-own strategy via credit bidding in a 363 sale. The court may prevent a lender from credit bidding "for cause" pursuant to section 363(k). A lender may face a challenge to the validity, extent or priority of their liens – if the liens are not perfected or are avoidable, the lender will not be permitted to

credit bid. The debtor or the Official Committee of Unsecured Creditors may attempt to recharacterize or equitably subordinate the lender's claims, which, if successful, would remove the lender's ability to credit bid the recharacterized or equitably subordinated debt.

- Additionally, a court may limit a lender's credit bidding rights due to the possibility that such credit bidding may chill the entire bidding process. Moreover, the debt was likely purchased at a discount. The discounted purchase price should reflect market value, which may be in stark contrast to the face value of the debt, thereby creating an artificial minimum bid threshold well in excess of the market value of the assets. If the face, the debtor may not see a competitive bidding process. Although certain courts have limited credit bidding rights (*see In re Free Lance-Star Publ'g Co. of Fredericksburg, VA,* 512 B.R. 798 (Bankr. E.D. Va. 2014); *In re Fisker Automotive Holdings, Inc. et al.*, 510 B.R. 55 (Bankr. D. Del. 2014)), recently, the United States Bankruptcy Court for the Southern District of New York found that the chilling of bidding alone was not sufficient to limit a credit bid. *In re Aéropostale, Inc.,* 55 B.R. 369, 417 (Bankr. S.D.N.Y. 2016).

Cases

Credit Bidding: *In re Aéropostale, Inc., et al.* (Bankr. S.D.N.Y. 2016)

- *Aéropostale* is a retailer of casual apparel and accessories for children and young adults with more than 800 stores across the country. Sycamore Partners ("Sycamore") was a significant equity holder and a Sycamore-related entity held two seats on Aéropostale's board of directors. Aéropostale's secured debt included a $150 million term loan lent by two Sycamore affiliates. In addition, Sycamore was the majority owner of one of Aéropostale's largest merchandise sourcers and suppliers.

- The Debtors filed a motion to (i) equitably subordinate Sycamore's claims pursuant to section 501(c), (ii) disqualify Sycamore from credit bidding its secured debt in a section 363 sale and (iii) recharacterize Sycamore's secured debt pursuant to section 105(a). The Debtors alleged, among other things, that Sycamore created and enacted a secret and improper plan to buy Aéropostale at a discount and had improperly traded stock while in possession of Aéropostale's material non-public information.
- The Court ruled that Sycamore could credit bid up to the full amount of its $150 million prepetition secured debt at the section 363 sale of the debtors' assets. The Court found that although a credit bid from a secured lender may chill other bidders from participating in the sale process, the possibility of the chilling of bids was not sufficient, by itself, to limit a secured creditor's right to credit bid some or all of its debt. The Court found that Sycamore had acted consistent with the exercise of their own legal rights and were relatively cooperative with the bidding and sale process. Therefore, the Court distinguished the *Free Lance-Star* and *Fisker* cases which both limited credit bidding due in part to a lender's inequitable conduct.
- Ultimately, Sycamore was not the successful bidder at the section 363 auction, . A joint venture of Authentic Brands Group, General Growth Properties, Simon Property Group, Hilco Merchant Resources, LLC and Gordon Brothers Retail Partners, LLC were determined to be the successful bidders and acquired substantially all of the assets of the debtors.

RSA – *In re American Apparel, Inc., et al.* (Bankr. D. Del. 2015)

- Facing significant liquidity issues, American Apparel, Inc., a clothing retailer, approached its prepetition ABL lenders and holders of its 13% Senior Secured Notes due 2020 with

the hope of negotiating a consensual restructuring. As a result of the negotiations, the parties entered into an RSA with proposed plan terms that provided for, among other things, (i) the conversion of $200 million of the Senior Secured Notes into equity interests of the reorganized American Apparel and (ii) $40 million in exit capital from the Supporting Parties to the RSA.

- The RSA contained a no-shop provision, which prevented the Debtors from directly or indirectly soliciting, encouraging, proposing, filing supporting or participating in the formulation of or vote for any restructuring, sale of assets, merger, workout or plan of reorganization for the Debtors other than the Plan set forth in the RSA. The Court noted that no shop provisions are "not particularly welcome to the Court" and make "the Debtor's case more challenging when the Debtor needs to make its case in confirmation that this is the appropriate and frankly, best transaction that's out there. How do you know?" In re American Apparel, Inc., et al., Nov. 19, 2015 Hrg. Tr. 180:10-13, 180:24-181:2. Following the Court's comments, the Senior Secured Notes agreed to permit the Debtors' investment banker to make outbound calls for a potential transaction, thereby freeing the Debtors from the no-shop clause.
- The Debtors received a takeover bid of more than $200 million from two investment firms and the Debtors' former CEO, Dov Charney. The RSA provided a fiduciary out provision, which permitted the Debtors' board of directors to exercise its fiduciary duties if such obligations required it to accept a proposal for an alternative transaction. The Debtors determined that the takeover bid was not a better transaction for the estates. The Plan converting $200 million of the Senior Secured Notes into equity was ultimately confirmed. However, the Debtors filed for chapter 11 again just over a year after its first filing.

RSA/DIP Financing – Debt to Equity Conversion: *In re Taco Bueno Restaurants, Inc., et al.* (Bankr. N.D. Tex. 2018)

- Taco Bueno Restaurants, Inc. is a quick service, Tex-Mex style Mexican cuisine restaurant chain with over 170 locations. Facing significant liquidity issues, the company marketed a potential sale of all of the company's debt as a first step in a new-money capital contribution and ultimate debt-for-equity swap. Less than two weeks prior to the petition date, the company's initial lender group, holding in excess of $130 million in secured debt, agreed to terms with Taco Supremo, LLC, an affiliate of Sun Holdings, Inc. for the sale of 100% of the secured debt following a silent auction.
- Although the company explored whether Taco Supremo would be interest in conducting an out-of-court transition of ownership, Taco Supremo preferred a chapter 11 process and agreed to provide the necessary financing. In addition to acquiring all of the company's funded secured debt, Taco Supremo agreed to execute a restructuring support agreement containing terms and milestones for a comprehensive restructuring transaction that would convert all of the company's funded debt into equity.
- On the petition date, the debtors file a prepackaged plan and sought a combined hearing on the adequacy of the disclosure statement and confirmation of the prepackaged plan, which
- On November 6, 2018, the company filed voluntary Chapter 11 petitions. On the same date, the company and Taco Supremo executed the RSA. Taco Supremo provided the debtors with $10 million in DIP financing. Just 43 days into the case, the prepackaged plan converting Taco Supremo's debt into equity was confirmed. On December 31, 2018, the Plan went effective. From the acquisition of the initial lender group's secured debt to the Effective Date, Taco Supremo acquired ownership of the debtors in just 68 days.

Indenture Trustee Credit Bid & Liquidation – In re Bon-Ton Stores, Inc., et al. (Bankr. D. Del. 2018)

- Prior to the petition date, Bon-Ton Stores, a department store retailer, sought a consensual standalone restructuring with an ad hoc group of its second lien senior secured notes due 2021 ("Second Lien Notes"). Simultaneously, the company prepared for a chapter 11 filing and a section 363 sale of substantially all of its assets. The Debtors and the ad hoc group of Second Lien Notes were unable to come to a consensual agreement, and the Debtors proceeded with bankruptcy filings and a section 363 sale of substantially all of their assets.
- The Indenture Trustee for the Second Lien Notes, in conjunction with a joint venture of GA Retail, Inc. and Tiger Capital Group, LLC, submitted a bid for the assets. The bid consisted in part of a credit bid of $125 million in Second Lien Notes claims. The Indenture Trustee, GA Retail, Inc., and Tiger Capital Group, LLC were declared the successful bidder for the assets, which were ultimately liquidated.

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Section 363 Sale Issues

Bankruptcy Auctions – Issues and Considerations

I. Why a Bankruptcy Auction?

a. Section 363(b)(1) of the Bankruptcy Code provides that a trustee "after notice and a hearing, may . . . sell . . . other than in the ordinary course of business . . . property of the estate." 11 U.S.C. § 363(b)(1)

i. Thus, although a debtor may sell property of the estate outside the ordinary course of business, it may only do so after notice and a hearing and obtaining bankruptcy court approval

b. The standard to obtain such approval is business judgment. *See In re Montgomery Ward Holding Corp.*, 242 B.R. 147, 153 (D. Del. 1999) ("In evaluating whether a sound business purposes justifies the use [of estate] property . . . courts consider a variety of factors, which essentially represent a 'business judgment test.'")

i. In addition, to obtain approval to sell substantially all of the assets of a debtor prior to approval of a chapter 11 plan, a

debtor must also demonstrate that: (i) the debtors have provided interested parties with adequate and reasonable notice; (ii) **the sale price is fair and reasonable**; and (iii) the buyer is proceeding in good faith. *See In re Gen. Motors Corp.*, 407 B.R. 463, 493-94 (Bankr. S.D.N.Y. 2009).

c. Often the best way to demonstrate that a sale is "fair and reasonable," and that the Debtors received maximum value in return for property of the estate, is to conduct an open and transparent auction process with notice to all parties and under the supervision of the bankruptcy court

II. What Does a Bankruptcy Auction Process Typically Entail?

a. Marketing the assets

i. Due diligence stage

1. NDAs

2. Data room access

b. Selecting a winning stalking-horse bidder

c. Obtaining approval of the stalking-horse purchaser, draft purchase agreement, and bidding procedures designed to maximize value

d. Further marketing and diligence

e. Deadline for new bids to be submitted and qualified

f. An auction among qualified bidders

g. Final bankruptcy court approval of sale to winning bidder

III. What Are the Benefits of Running an Auction With a Stalking-Horse in Place?

a. Creates a price floor

b. Allows a debtor to negotiate a preferred asset purchase agreement ahead of the auction that other bidders will have to accept or improve upon

i. Provides control of the issues open for negotiation

c. Eliminates the risk inherent in conducting a "naked" auction

d. Creates a record for the bankruptcy court that the debtor conducted an open and fair sale process designed to maximize value to the estate

IV. What Are the Risks of Approving a Stalking Horse Bid?

a. If not properly structured (particularly with regards to the break-up fee and expense reimbursement), it may chill bidding

b. Debtor may have to agree to case milestones as part of stalking horse agreement (particularly if stalking horse also DIP lender) and have to pay significant break-up fees and expense reimbursements to stalking-horse

i. Loss of control and flexibility

V. What Factors Do Courts Consider When Evaluating a Stalking Horse Agreement and Bidding Procedures?

a. Debtor will still need to show that they ran a robust process in selecting their stalking horse.
    i. Most likely to be challenged if stalking-horse is an insider or the prepetition or DIP lender. Will need to overcome any appearance of a sweetheart deal
    ii. Additional scrutiny will be given to a stalking-horse selected prepetition outside the supervision of the bankruptcy court
    iii. Terms of bid protections and bidding procedures will be scrutinized
    iv. Level of official committee involvement and support will be considered
b. Typical bid protections for a stalking-horse bidder
    i. Break-up fee
        1. Different standards in different jurisdictions for approval of a break-up fee
            a. SDNY three part *Integrated Resources* test: (i) is the relationship between the parties tainted by self-dealing or manipulation (an insider or lender with considerable leverage); (ii) would the fee hamper rather than encourage bidding; and (iii) is the amount of the fee unreasonable as a percentage of the purchase price?

b. Third Circuit "actually necessary" in benefiting and preserving the estate

ii. Expense reimbursement

1. Most courts will consider a combined break-up fee and expense reimbursements of 3% or less than the purchase price to be reasonable. Anything above that will be subject to heightened scrutiny

a. Ultimately the reasonableness of break-up fees and expense reimbursements are determined by the particular facts and circumstances of a case. The necessity of such fees to induce a committed stalking-horse bid and the extent of the diligence the stalking-horse bidder was required to perform will factor into any reasonableness analysis

iii. Minimum overbid increments

iv. No-shop or other limitations on debtors' ability to further market assets

v. Strict requirements for additional bidders to become qualified bidders

vi. Short time frame for additional bidders to conduct due diligence and make a qualifying bid

c. Bidding procedures tailored to encourage as opposed to chill bidding.

    i. Minimum initial overbid increment must be sufficient to cover costs to the estate of combined break-up fee and expense reimbursement

    ii. Credit bidding

        1. Some courts will cap the amount that can be credit bid – cash is king

            a. Loan to own strategies

    iii. Essential to be clear regarding conditions to qualify a bid

    iv. Who gets to determine that a bid is qualified?

        1. Debtors will want to have discretion to relax or alter qualifying requirements.

            a. However, being too lenient with qualification requirements can open a debtor up to legal challenge particularly if a stalking-horse believes it is being forced to bid against a competitor whose bona fides are in question

                i. Risk the stalking-horse refusing to participate and accusing the debtor of breaching the stalking horse agreement

2. Other parties will seek to have a say in who is qualified, including official committees, DIP lenders, and even, in some instances, the stalking-horse bidder

v. Good faith deposit

vi. Requirement to keep bids open for a period of time and agree to be back-up bidder. Procedures often require bids to remain open for the earlier of (i) some amount of time such as 30 days and (ii) the entry of an order approving the sale to another bidder. Deposits often are not returned for a back-up bidder until after entry of an order-approving sale to the winning bidder of even the close of the sale to the successful bidder.

vii. Evidence of sufficient funds or financing to close

viii. Minimum overbids

d. Need to balance the desire to facilitate competition with need to preserve stalking horse bid – *Synergy* example

VI. What Does a Successful Auction Process Look Like?

a. Multiple, clearly qualified bids

b. Robust auction with several rounds of bidding

c. Clear winner with highest and best bid

VII. What Goes Wrong?

a. Bids that require some discretion to qualify

i. Questionable financing

ii. Unknown identity of a bidder, its principals, or its financing sources

1. Risk losing stalking horse for a deal that is not real

iii. Regulatory or anti-trust concerns

iv. Deposit not delivered timely, in proper amount, or in acceptable form of currency

b. Qualified bidders show up, but stalking-horse becomes a walking horse

i. Should the other bidders still be required to meet qualification standards if stalking-horse walks? *SunEdison* – Shearman, Texas Property example

c. Highest is not "Best"

i. Losing party with highest offer is likely to object

1. Debtor will need to put on evidence to demonstrate why winning bidder is best or discredit the losing parties ability to close. *SunEdison* – Shearman, Texas Property example

ii. Committee and other constituents may object to a debtor's business judgment even if highest bid chosen

1. Choxi sample of court overturning debtors' business judgment and finding that the highest bid selected by the debtor was not the best bid

d. Winner fails to or can't close
    i. Is there a back up bidder?
    ii. Back to the drawing board?
    iii. Should auction be re-opened, revisited?
    iv. What price should back-up bidder have to pay?
        1. The back-up bidders final offer at the auction?
        2. The back-up bidders last offer before bidders other than the winning bidder dropped out? *Hellenic Lines* sample

e. It's not over until it's over. When should a Court re-open a properly conducted and closed auction, or otherwise allow a late bid to be entertained?
    i. Obligation to maximize value versus the need to protect integrity of the process and expectations of parties
    ii. Losing Bidder arrives at the hearing with a topping bid
        1. Substantially over bids
        2. Barely overbids
    iii. Entity that didn't participate in the auction arrives at the hearing for the first time with a topping bid

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[Current Case Developments Relating to GM Notice Issue]

I. The GM Case

A. Background

1. In 2002, GM began producing vehicles with a faulty ignition switch. Cars malfunctioned, with moving stalls and non-deployment of airbags in certain models.

2. Claims brought by those injured became relevant in GM's bankruptcy case. In the section 363 context, at issue was the proper notice required to be given to accident victims and those who suffered economic loss due to the decrease in value of GM cars.

B. The Bankruptcy Court Decision: *In re Motors Liquidation Company*, No. 09-50026, 2015 Bankr. LEXIS 1296 (S.D.N.Y. Bankr. 2015)

1. Claimants asserting pre-363 sale accident claims and economic loss claims were entitled to actual notice: they were "known" holders of contingent claims.

a. Standard of deciding whether a creditor is "known": the debtor must make *effective use of the information already available*, but the fact that additional claims may be foreseeable does *not* make them "known."

2. The Bankruptcy Court held that the claimants did not receive adequate notice but still declined to exempt pre-sale accident claims and economic loss claims from the

363 Sale Order on the ground that the due process violation at issue was harmless: the Bankruptcy Court would have approved the section 363 sale in any event.

C. The Second Circuit Decision: *Elliott v GM LLC (In re Motors Liquidation Co.*), 829 F.3d 135 (2d Cir. 2016)

1. Issue: whether the claimant was a creditor "known" or "unknown" to the debtor — "If the debtor knew or reasonably should have known about the claims, then due process entitles potential claimants to actual notice of the bankruptcy proceedings, but if the claims were unknown, publication notice suffices." 829 F.3d at 159.

2. The Second Circuit held that whether a claimant was a "known" creditor is a *factual* one.

a. The Court held that there was no error in the Bankruptcy Court's finding about the pre-sale GM's knowledge of the defect based on the following facts: i) as soon as the allegedly defective ignition switch was installed, the pre-sale GM received complaints; ii) news outlets covered this issue, and the National Highway Traffic Safety Administration approached pre-sale GM about malfunctions; and iii) pre-sale GM's legal team possessed a police report that linked those malfunctions to a defect in the ignition switch.

b. Even if the facts mentioned above were not to be deemed sufficient to establish the pre-sale GM's knowledge of the existence of potential claimants based on the switch defect, the Second Circuit stated that pre-sale GM's "reckless disregard" of the switch defect was sufficient to satisfy the knowledge requirement for the purpose of procedural due

process: those facts *at minimum* triggered the pre-sale GM's duty to investigate further into the switch defect issue.

i. Given numerous reports and complaints of faulty ignition switches, moving stalls, airbag non-deployments, and serious accidents, GM had an obligation to take steps to investigate the nature and extent of the defect.

c. Although the link between the ignition switch defect and the malfunctions was still unclear, GM should have at least disclosed the facts of those malfunctions during the bankruptcy process so that potential claimants could come forward and assert claims.

i. That the claims at issue were "contingent" did not render the claimants "unknown." And holders of any such "known" claims were entitled to adequate notice.

II. Subsequent Cases Dealing with the Notice Issue

A. In re GEO Specialty Chems., Ltd., 577 B.R. 142 (Bankr. D.N.J. 2017):

1. Summary of Facts: In 2004, the Bankruptcy Court entered an order confirming a plan of reorganization, which discharged the debtor from all claims or potential claims not specified in the plan and provided for an injunction against any attempt to collect the discharged claims. In February 2016, the plaintiffs brought antitrust class action lawsuits alleging that from 1997 through 2011, the debtor engaged into a conspiracy to suppress and eliminate competition in the sale and marketing of liquidate aluminum sulfate. In June 2016, the reorganized debtor pled guilty to an antitrust criminal charge. Subsequently, the reorganized

debtor and its reorganized subsidiaries moved to reopen their chapter 11 case for the limited purpose of enforcing the plan's discharge and injunction provisions.

2. Citing the Second Circuit's GM decision, the Bankruptcy Court held that actual notice was required for the plaintiffs asserting those antitrust claims: GEO knew about the conspiracies it originated, which were the subjects of the antitrust claims at issue. The Bankruptcy Court noted the following facts:

i. In its guilty plea, GEO admitted that it participated in the conspiracy alleged by the antitrust plaintiffs and that its employees knowingly and intentionally conspired.

ii. Therefore, the antitrust plaintiffs, who were the upstream and downstream purchasers of the alleged conspiracy, were easily ascertainable.

b. In deciding the knowledge issue, the Court rejected the debtor's arguments that 1) "the standard for ascertaining knowing claimants is limited to the perspective of *the persons responsible for administering a bankruptcy case*" and that 2) "all is required is a diligent review of the debtor's books and records maintained in the ordinary course of business."

B. In re HNRC Dissolution Co., No. 02-14261, 2018 Bankr. LEXIS 1739 (Bankr. E.D. Ky. Jun. 11, 2018).

1. Summary of Facts

a. In November 2002, the debtor and its affiliates filed for bankruptcy. The Bankruptcy Court approved a sale of substantially all of their assets "free and

clear of all liens, claims, interests and other encumbrances." One of the assets sold was the debtors' interest in a coal located in Illinois. Following many intermediate transfers, Alliance acquired that interest. In May 2017, Methane filed suit against Alliance, seeking to collect certain amount of payments based on its interest in the coalbed methane gas rights in the coal reserve, interest in which was acquired by Alliance. [The prior sentence needs to be clarified. I don't understand "to collect base on interest."] In September 2017, Alliance moved to reopen the debtors' bankruptcy case to enforce the Bankruptcy Court's sale order.

2. The Bankruptcy Court held that actual notice was required and therefore Methane did not receive an adequate notice. The Bankruptcy Court said the pre-sale debtor should have known of those interests. Adequate review of its records would have revealed Methane's interests:

a. Methane acquired its interest in the coal reserve at issue as part of a $2.6 million with the debtor, which was memorialized in a deed. The transaction was recorded in the debtor's records.[1]

b. Some of documents submitted in the bankruptcy case referred to the region where the coal reserve at issue was located, and one referred to an "easement/right of way" in Illinois between Methane "as lessee" and an affiliate of the debtor. This affiliate was also one of the grantors in the deed that memorialized the transaction between Methane and the debtor.

III. **Unresolved Issue — Prejudice Requirement**

[1] Conceded by Alliance's counsel at a hearing.

A. The Bankruptcy Court in GM had held that prejudice is an essential element for vacating or modifying a 363 sale order on the ground of inadequate notice. The Second Circuit in the GM Case acknowledged a split of authorities but chose not to decide this issue.[2]

B. Prejudice Issue in Subsequent Cases

1. Both the *GEO* and *HNRC* courts did not discuss the prejudice issue despite finding that actual notice was required but not been provided.

a. *GEO* (Bankr. D.N.J.): consistent with the Third Circuit's approach to not require a proof of prejudice arising from a due process violation.[3]

b. *HNRC* (Bankr. E.D. Ky.): in *Haffey v. Crocker*, 576 B.R. (6th Cir. 2017), the Sixth Circuit **Bankruptcy Appellate Panel** applied the harmless error analysis to a due process violation in the context of a bankruptcy case—*i.e.* prejudice must be shown—based upon the belief that the Court of Appeals for the Sixth Circuit would have done so. However, the *HNRC* Bankruptcy Court did *not* apply the harmless error analysis.

i. Therefore, it remains unclear whether the harmless error analysis would not apply to a due process violation claim in the context of a §363 sale, at least in the Sixth Circuit.

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[2] The Second Circuit's survey indicates that the majority rule is to not require a showing of prejudice. *See Elliott v. GM LLC*, 829 F.3d at 161 n.25. In contrast, for example, the First Circuit still requires a party claiming a due process violation to show prejudice. *Id.* at 161.

[3] *See In re George W. Myers Co.*, 412 F.2d 785, 786 (3d Cir. 1969) (holding that alleged bankrupt was denied procedural due process by the refusal of its offer to present evidence and that such denial could not be "harmless error").

Bankruptcy Sales – Do They Clean Up Environmental Liabilities?

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Introduction

- Debtors facing environmental liability often seek to use the Bankruptcy Code to discharge, avoid or defer environmental obligations, including, among others, compliance with cleanup orders, injunctions, and liabilities arising out of cost recovery or contribution actions filed by other potentially responsible parties (PRPs). A number of bankruptcies involving significant environmental issues, including chapter 11 cases filed by Chrysler, General Motors and La Paloma, have been resolved by asset sales under section 363 of the Bankruptcy Code. The central question to be resolved by the bankruptcy courts is the extent to which a section 363 purchaser will have successor liability for the debtor's environmental liabilities.

Successor Liability for Environmental Liabilities

- In general, purchasers of a company's assets are generally not liable for the seller's liabilities unless: (a) the liabilities are expressly assumed, (b) consolidation or de facto merger of the two entities, (c) the buyer is considered a mere continuation of seller, or (d) the sale involves fraud to escape liability. *See PCS Nitrogen Inc. V. Ashley II of Charleston LLC*, 714 F.3d 161, 173 (4th Cir. 2013).

- The Comprehensive Environmental Response Compensation and Liability Act of 1980, 42 U.S.C. §§ 9607, *et seq*. (CERCLA), however, has been interpreted to impose successor liability on purchasers of a company's assets. *See New York State Elec. & Gas Corp. v. FirstEnergy Corp.*, 766 F.3d 212 (2d Cir. 2014).

- CERCLA and the Resource Conservation and Recovery Act (as well as state analogs) authorize the U.S. Environmental Protection Agency, various state environmental agencies, and/or private parties to: (1) compel owners and operators of contaminated properties to remediate contamination; (2) obtain the recovery of remediation costs they have incurred; or both (1) and (2). Under CERCLA, the owner of an environmentally contaminated asset purchased under section 363 may face successor environmental liability through its status as an "owner" or "operator."[1]

[1] CERLCA gives EPA broad powers to identify parties responsible for the release or threatened release of hazardous substances. The agency can seek to impose liability and require cleanup measures. CERCLA liens can be imposed on an owner or operator of a facility where hazardous materials were disposed of (regardless of fault).

Free and Clear Sales Under Section 363(f)

- Sales "Free and Clear of Any Interest". Section 363 of the Bankruptcy Code allows the debtor to sell its property "free and clear of any interest" in the property, with such interests attaching to the sale proceeds. 11 U.S.C. § 363(f).

- Section 363(f)(1) allows a debtor to sell property "free and clear of any such interests in such property" if:

  (1) applicable non-bankruptcy law permits sale of such property free and clear of such interest;

  (2) such entity consents;

  (3) such interest is a lien, and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

  (4) such interest is in bona fide dispute; or

  (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

- What constitutes an "interest in such property"? Essential to determining whether assets may be sold free and clear of environmental claims and liabilities is the interpretation and meaning of the phrase: "free and clear of any such interests in such property". What constitutes an "interest in such property," and whether non-bankruptcy law allows for a "free and clear" sale, is unclear.

- While sales under 363 are typically "free and clear", certain liabilities will survive, including continuing obligations to comply with applicable laws (including environmental laws and regulations), liabilities assumed by the buyer, liabilities arising under clean-up injunctions and successor-liability claims.

- Early Decisions - Narrow Interpretation of "Interests in Property". Not always clear whether a section 363 sale could extinguish successor liability claims.

  - *In re CMC Heartland Partners*, 966 F.2d 1143 (7th Cir. 1992) (finding that an order requiring a successor to a debtor railroad clean up the site it owned was not mere repackaging of a claim for damages that was forfeited by failure to file a proof of claim in railroad reorganization, but, rather, the U.S. Environmental Protection Agency established that its order depended on the successor's current ownership).

  - In *Ninth Avenue Remedial Group v. Allis-Chalmers Corp*., 195 B.R.716 (N.D. Ind. 1996), a remedial waste cleanup group sued a group of defendants for contribution to cleanup costs of a chemical and industrial waste disposal facility

under CERCLA on a successor liability theory. One defendant previously had purchased certain assets from the debtors, including the debtors' oil refining facilities, and the purchase agreement explicitly excluded the assumption of any liability for environmental claims arising prior to the closing of the sale. The bankruptcy sale order provided that the transfer was "free and clear of all liens, claims, taxes, encumbrances, obligations, contractual commitments, and interests." The confirmation order discharged the debtors of any claims arising prior to the confirmation order. The defendant-purchaser moved to dismiss arguing that successor liability could not attach because its predecessor remained a viable company from which the plaintiff could recover, and that the bankruptcy court's sale order found that the assets sold would be free and clear of all interests, including CERCLA liability. The court denied the defendant-purchaser's motion, concluding that material fact questions existed precluding summary judgment on the successor liability claim on "mere continuation" or "substantial continuity" theory, and that a sale free and clear does not include future claims that did not arise until after the bankruptcy case had concluded. Applying this rationale, the court found that the bankruptcy court's sale order precluded suits against the defendant-purchaser for any claims that could have been brought against the debtor-seller before or during the bankruptcy case, but not if the CERCLA claim did not arise until after the case, because a bankruptcy court could not have discharged claims that did not yet exist. According to the court, section 363 applies to *in rem* interests in property and not CERCLA cause of action that had not arisen during the pendency of the bankruptcy; approval of asset sale "free and clear" does not affect or discharge environmental claims brought later against the purchaser under successor liability theory. *Id.* at 733 ("the fact that the Purchase Asset Agreement explicitly states that Clark will not assume any environmental liability arising from the operation of the facilities prior to the sale does not affect a determination of liability under CERCLA.").

- "Interest in such property" broadly defined. One of the earliest decisions dealing with the use of a section 363 to cutoff environmental liability was *In re Heldor Industries, Inc.*, 131 B.R. 578 (Bankr. D. N.J. 1991), *vacated on other grounds*, 989 F.2d 702 (3d Cir. 1993). In *Heldor*, the debtor sold substantially all of its assets "free and clear" and without setting aside proceeds to comply with state environmental cleanup laws. The sale agreement contained no terms requiring that the debtor comply with, and specifically allowed the purchaser to purchase free and clear of complying with, environmental laws. The New Jersey DEP received notice of the impending sale but failed to object until after the sale order became final. The NJDEP then argued that the sale order could be voided because a debtor must comply with environmental cleanup laws. The court disagreed and held that the order became final after the NJDEP failed to object in a timely manner, having received sufficient notice, citing the need for finality of bankruptcy court orders.

- In *In re Trans World Airlines*, 322 F.3d 283 (3d Cir. 2003), the Third Circuit held that certain settled employment discrimination claims were "interests in property" and barred TWA employees from enforcing the terms of the settlement agreement (and other pending EEOC charges) against American Airlines as purchaser of TWA's assets under a section 363 sale. The employees argued that American Airlines should be liable as a successor to TWA on the basis that "interests in property" within the meaning of section 363 was limited to "liens, mortgages, money judgments, writs of garnishment and attachment, and the like and cannot encompass successor liability claims arising under federal antidiscrimination statutes and judicial decrees implementing those statutes." *Id.* at 288. The Third Circuit rejected this narrow reading and held that "'the term 'any interest' is intended to refer to obligations that are connected to, or arise from, the property being sold.'" *Id.* at 290 (quoting *Folger Adam Sec., Inc. v. DeMatteis/MacGregor, JV*, 209 F.3d 252, 259 (3d Cir. 2000)). The court explained that the settlement and the employment discrimination claims at issue qualified as "interests" because "[i]n each case it was the assets of the debtor which gave rise to the claims." *Id*.

- The Third Circuit's broad interpretation of the term "interests in such property" was followed by courts in addressing claims of environmental and toxic tort liability, including the Chrysler and General Motors courts. *See In re General Motors Corp*., 407 B.R. 463, 508 (Bankr. S.D.N.Y. 2009) ("The Environmental Matters Objectors understandably would like New GM to satisfy cleanup obligations that were the responsibility of Old GM, on theories of successor liability. . . . however, the property may be sold free and clear of such claims"). *See also In re Leckie Smokeless Coal Co.*, 99 F.3d 573, 581-82 (4th Cir. 1996) (section 363 sale order barred successor liability claims under Coal Act)

- The Second Circuit, in *Elliott v. General Motors LLC* (*In re Motors Liquidation Company*), 829 F.3d 135 (2d Cir. 2016), agreed with TWA that successor liability claims may be discharged under 363 sales. In *Motors Liquidation*, the Second Circuit adopted a broad interpretation of the statutorily undefined term "interest" to encompass successor liability for claims that flow from the property and businesses being sold. *Id*. at 155. The court held that section 363(f) authorizes sales free and clear of interests covering pre-closing accident claims and economic loss claims relating to the debtor's conduct. However, claims arising out of buyer's conduct are not dischargeable.

- 363 Sale Orders Do Not Discharge Buyer's Obligations to Comply with Post-Sale Environmental Obligations. While a section 363 sale may provide for the sale to be "free and clear" of the debtor's pre-sale environmental liabilities, a sale order does not diminish the buyer's obligation to clean up the contaminated property that is the subject of the sale or otherwise maintain the property in compliance with applicable law. *See Ohio v. Kovacs*, 469 U.S. 274, 285 (1985) ("[w]e do not question that anyone in possession of the site – whether it is Kovacs [the debtor] or another . . ., or a vendee from the receiver or the bankruptcy trustee – must comply with the environmental laws of the

State of Ohio. Plainly, that person or firm may not maintain a nuisance, pollute the waters of the State, or refuse to remove the source of such conditions").

- As Judge Gerber noted in General Motors:

> Any Old GM properties to be transferred will be transferred free and clear of successor liability, but New GM will be liable from the day it gets any such properties for its environmental responsibilities going forward. And if the State of New York . . . feels a need to cause any acquirer of Old GM property to engage in remedial action because of environmental issues existing even at the outset of the acquirer's ownership, nothing in this Court's order will stand in its way.

407 B.R. at 508.

- Environmental liability clean-up injunctions are not dischargeable under chapter 11 plans. Injunctions obtained under environmental statutes to abate ongoing pollution are not within the meaning of the term "claims" under the Bankruptcy Code and, accordingly, are not dischargeable under a plan. *See In re Chateaugay Corp.*, 944 F.2d 997 (2d Cir. 1991); *In re Torwico Elecs. Inc.*, 8 F.3d 146 (3d Cir. 1993), cert. denied, 511 U.S. 1046 (1994); *United States v. Apex Oil Co.*, 579 F.3d 734 (7th Cir. 2009), cert. denied, 562 U.S. 827 (2010).

La Paloma – Sale of Assets Free and Clear of Debtors' Obligations Under California's Cap-and-Trade Program

- La Paloma Generating Company, LLC filed for chapter 11 relief in Delaware in December 2016. The filing was attributed to several factors, including "adverse market developments, a challenged regulatory environment, mounting compliance obligations under California's "cap and trade" scheme, and substantial debt service requirements." *Declaration of Niranjan Ravindran in Support of Chapter 11 Petitions*, *In re La Paloma Generating Co., LLC*, Case No. 16-12700 (CSS), Dkt. No. 10 ¶ 30.

- La Paloma operated a natural gas facility located in California which it sought to sell under a plan in October 2017. The Delaware Bankruptcy Court was asked to determine whether California's Cap-and-Trade Regulations gave rise to successor liability for the debtors' pre-sale obligations arising under the Cap-and-Trade Program and whether the debtors could sell their natural gas facility free and clear of those obligations. *See In re La Paloma Generating, Co.*, No. 16-12700 (CSS), 2017 WL 5197116 (Bankr. D. Del. Nov. 9, 2017)

- Background on California's Cap-and-Trade Program. The California Air Resources Board (CARB) has authority to create and regulate a Cap-and-Trade Program to limit greenhouse emissions in California. CARB enacted certain regulations that limited the number of "compliance instruments" available per year. California's Cap-and-Trade

Regulations impose compliance obligations on so-called "Covered Entities". The Compliance Instruments were freely tradable among "Covered Entities" (like La Paloma). Every year on November 1, Covered Entities must surrender compliance instruments to CARB. Covered Entities in the Cap-and-Trade Program can emit greenhouse gases in an amount that they choose, but they must surrender compliance instruments equivalent to such emissions.

- La Paloma's Pre-Sale Cap-and-Trade Obligations. La Paloma estimated during its bankruptcy case that it would be obligated to surrender $63 million in compliance instruments by November 1, 2018 to cover its remaining obligations for the pre-sale periods.

- The Proposed Sale. La Paloma's plan provided for a sale of substantially all of its assets to its senior secured creditor, LNV Corporation, "free and clear" of La Paloma's obligation to surrender its compliance instruments. CARB objected to the sale and argued that LNV should be responsible for the full amount of the surrender obligation when due in November 2018.

- The La Paloma Decision. The court noted that a buyer of assets could be liable under successor liability theory if: (1) there is an express or implied assumption of liability, (2) the transaction amounts to a consolidation or merger of the two corporations, (3) the purchasing corporation is a mere continuation of the sellers, or (4) the transfer of assets to the purchaser is for the fraudulent purpose of escaping liability for the seller's debts.

- To determine whether successor liability applied as an express assumption, the Bankruptcy Court was required to interpret the Cap-and-Trade Regulations. *La Paloma*, 2017 WL 5197116, at *4.[2] According to the court, the Regulations only impose liability on an entity-specific basis rather than on an asset-specific basis. In particular, the Regulations only impose obligations on a "Covered Entity" for "***its emissions***" and to become a Covered Entity, a party must engage in certain enumerated activities, such as owning and operating an electricity generation facility, and operating such a facility in a manner that exceeds the applicable annual emission threshold. *Id.* at *6. Accordingly, the purchaser could become a Covered Entity only after the sale closed and it operated the facility. Because the purchaser would not be a Covered Entity until after the sale closed, it would not assume the obligation to acquire compliance instruments for pre-sale greenhouse gas emissions. *Id.*

- CARB, calling for a narrow interpretation of the term "interest", argued that the debtors' obligations under the Cap-and Trade Regulations was not an "interest" under section

[2] There was no issue over whether the purchaser would be required to comply with the Cap-and-Trade obligations post-acquisition.

363(f). The court disagreed, noting that the Third Circuit has adopted a broad reading of the term "interest". *Id.* at *9.

- The court, relying on the General Motors decision approving the GM debtors' sale free and clear of interests, noted that continuing environmental obligations are not excepted by section 363(f). *Id.* It quoted the GM decision:

> Under section 363(f), there could be no successor liability imposed on the purchaser for the seller[ ]'s monetary obligations related to cleanup costs, or any other obligations that were obligations of the seller. But the purchaser would have to comply with its environmental responsibilities starting with the day it got the property, and if the property required remediation as of that time, any such remediation would be the buyer's responsibility:
>
> When you are talking about free and clear of liens, it means you don't take it subject to claims which, in essence, carry with the property. It doesn't absolve you from compliance with the law going forward.

- *Id.* at *9 (quoting, *In re Gen. Motors Corp.*, 407 B.R. 463, 508 (Bankr. S.D.N.Y. 2009)).

- Furthermore, because the CARB Regulations do not permit successor liability, the obligation to surrender compliance instruments qualifies as an "interest" that is discharged by section 363(f). *Id.*

Use of Clean Up Trusts to Deal with Environmental Liabilities

- To insulate purchaser for successor liability from potential environmental liabilities, a sale may be consummated through a plan in which a representative of the putative claimants is appointed to represent claimants' interests, and provisions will be made, usually by way of a trust fund, for the treatment of such claims.

- Environmental trusts established to address environmental cleanup obligations have been used in several chapter 11 cases. *See, e.g., In re Lyondell Chemical Co.*, 09-10023, 2010 WL 1544411 (Bankr. S.D.N.Y. April 19, 2010) (debtors transferred twenty-three sites and facilities to custodial trust funded with $108 million for clean operations); *In re Tronox Inc., et al.*, 09-10156, 2010 WL 2835545 (Bankr. S.D.N.Y. June 28, 2010) (debtors agreed to pay $115 million into custodial trusts as part of a deal to resolve environmental liabilities rather than sell off its assets).