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A Tale of Two Business Courts

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A TALE OF TWO BUSINESS COURTS: JUDICIAL APPROACHES IN THE DELAWARE COURT OF CHANCERY AND THE DELAWARE BANKRUPTCY COURT

I. How and When Will Courts Review Proposed Transactions?

A. Bankruptcy Court Context

1. **Transactions Not Requiring Bankruptcy Court Approval (Unless Challenged)**

   (a) Debtor Sale, Use or Lease of Assets in the Ordinary Course

      (i) What is "Ordinary Course"? Courts within the Third Circuit conduct a two-part inquiry to determine if a transaction is within the ordinary course.

         (1) First, the transaction must pass the "vertical" test which asks, based on the debtor's pre-petition business practices, whether a hypothetical creditor would be subject "'to economic risk of a nature different from those he accepted when he decided to extend credit.'"[1]

         (2) Second, the transaction must pass the "horizontal" test which asks "whether from an industry-wide perspective, the transaction is of the sort commonly undertaken by companies in that industry."[2]

   (b) A transaction within the ordinary course of business need only be "taken in good faith and with sound business judgment."[3]

   (c) Minimal Judicial Oversight Role

      (i) Debtors are permitted to sell, use or lease assets in the ordinary course of business "without notice or a hearing" under Section 363(c).[4]

   (d) Creditors are not given the right to notice and a hearing to challenge transactions within the ordinary course "because their

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1 *In re Blitz U.S.A. Inc.*, 475 B.R. 209, 214 (Bankr. D. Del. 2012) (citations omitted).

2 *Id.* (citations omitted).

3 *Id.* at 215.

4 11 U.S.C. § 363(c)(1).

objections to such transactions are likely to relate to the bankrupt's chapter 11 status, not the particular transactions themselves."[5]

2. **Transactions Requiring Bankruptcy Court Approval (Whether Or Not Challenged)**

(a) Section 363 Motions

(i) Section 363 authorizes a debtor to sell, use or lease property outside of the ordinary course of business "after notice and a hearing."[6]

(ii) A transaction outside of the ordinary course conducted without notice and a hearing may be avoided or unwound.[7]

(b) Sale, Use or Lease of Property not in the Ordinary Course

(i) The Debtor bears the burden of proving, for a sale outside the ordinary course of business, that "(1) there was a sound business purpose for the sale; (2) the proposed sale price was fair; (3) the trustee [or debtor-in-possession] had provided adequate and reasonable notice; and (4) the buyer has acted in good faith."[8]

(c) Process Considerations/Judicial Role

(i) "The framework of section 363 is designed to allow a trustee (or debtor-in-possession) the flexibility to engage in ordinary transactions without unnecessary creditor and bankruptcy court oversight, while protecting creditors by giving them an opportunity to be heard when transactions are not ordinary."[9]

3. **Chapter 11 Plan-Based Transactions**

(a) Approval/Confirmation Standards

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5 *In re Roth Am., Inc.*, 975 F.2d 949, 952 (3d Cir. 1992) (quoting *In re James A. Phillips, Inc.*, 29 B.R. 391, 394 (S.D.N.Y. 1983)).

6 11 U.S.C. § 363(b)(1).

7 *See* 11 U.S.C. § 549(a)(2)(B); *In re Roth Am., Inc.*, 975 F.2d at 952 n.3.

8 *Pursuit Parties v. Burtch* (*In re Pursuit Capital Mgmt., LLC*), No. 14-10610-LSS, 2016 WL 5402735, at *4 n.10 (D. Del. Sept. 26, 2016) (citing *In re Del. & Hudson Ry. Co.*, 124 B.R. 169, 176 (D. Del. 1991)).

9 *In re Roth Am., Inc.*, 975 F.2d at 952.

(i) A debtor has the burden of proof to establish that "the Plan comports with [11 U.S.C.] § 1129's requirements by a preponderance of the evidence."[10] Section 1129 includes the following requirements, among many others, that the plan:

(1) has been "proposed in good faith and not by any means prohibited by law;"[11]

(2) meets the best interests of creditors test;[12]

(3) is accepted by at least one impaired class;[13] and

(4) is feasible.[14]

(ii) A debtor also has the exclusive right to submit a plan of reorganization for 120 days after the petition date and the exclusivity period may be further extended by the Bankruptcy Court.[15]

(b) Examples

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[10] *In re Armstrong World Indus. Inc.*, 348 B.R. 111, 122 (D. Del. 2006).

[11] 11 U.S.C. § 1129(a)(3); *see also In re SGL Carbon Corp.*, 200 F.3d 154, 165 (3d Cir. 1999) (the good faith standard in section 1129(a)(3) requires that there must be "some relation" between the chapter 11 plan and the "reorganization-related purposes that [Chapter 11] was designed to serve") (citation omitted).

[12] *See* 11 U.S.C. § 1129(a)(7) (requiring that each holder of a claim or interest in an impaired class must either (a) accept the plan; or (b) not receive less for their claim under the plan than they would in a Chapter 7 liquidation).

[13] 11 U.S.C. § 1129(a)(8) (requiring that each class of claims under the plan must either accept or be unimpaired), (a)(10) (requiring that "[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including acceptance of the plan by an insider"). The requirements for "acceptance" are defined in 11 U.S.C. § 1126. *See* 11 U.S.C. § 1126 (providing that an impaired class of creditors has accepted the plan if class members holding at least two-thirds in amount and more than one-half in number of claims vote in favor of the plan). However, a plan may still be confirmed even if an impaired class does not accept under the "cramdown" provisions of § 1129(b)(1).

[14] *See* 11 U.S.C. § 1129(a)(11) (requiring that a plan may be confirmed only if "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan").

[15] 11 U.S.C. § 1121(b); *see also Geriatrics Nursing Home, Inc. v. First Fidelity Bank, N.A.* (*In re Geriatrics Nursing Home, Inc.*), 187 B.R. 128, 131-32 (D.N.J. 1995) ("The exclusivity period affords the debtor the opportunity to negotiate the settlement of its debts by proposing and soliciting support for its plan of reorganization without interference—in the form of competing plans—from its creditors or others in interest. In crafting this legislation, Congress succeeded in balancing two competing interests: the interest of the debtor in the survival of its business (thus its resort to Chapter 11), and the interest of the creditors in avoiding undue delay in the satisfaction of the debtor's obligations.").

(i) Mergers, Recapitalizations, Exchanges, Sales of Assets, Sales of Reorganized Equity, Settlements.

(c) Process Considerations

(i) Prior to filing for bankruptcy relief, a debtor may negotiate the terms of a "pre-packaged" plan of reorganization with its key creditor constituents and/or execute plan support agreements (a "PSA") or restructuring support agreements (an "RSA") to solidify support for the debtor's plan pre-petition.

(ii) Delaware's local bankruptcy rules further provide for expedited process of liquidating plans of reorganization, allowing the debtor to have a combined hearing on approval of its disclosure statement and on plan confirmation.[16]

(d) Judicial Role

(i) The bankruptcy court has an independent duty to ensure that a plan meets the requirements of 11 U.S.C. § 1129 even in the absence of any objections to the plan.[17]

4. **Other Types Of Bankruptcy Transactions**

(a) 9019 Settlements

(i) Some jurisdictions, including the Third Circuit, may consider elements of Federal Rule of Bankruptcy Procedure 9019 settlements as sales triggering the requirements of Section 363.[18]

(b) The Third Circuit has established four factors, known as the *Martin* factors, for a court to consider in approving a settlement under Rule 9019: "(1) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation involved, and the expense, inconvenience and delay

[16] *See* Del. Bankr. L.R. 3017-2.

[17] *In re Flintkote Co.*, 486 B.R. 99, 122 (Bankr. D. Del. 2012), *aff'd*, 526 B.R. 515 (D. Del. 2014).

[18] *See Cadle Co. v. Mims* (*In re Moore*), 608 F.3d 253, 264 & n.21 (5th Cir. 2010) (discussing circuit split and citing, among others, *Myers v. Martin* (*In re Martin*), 91 F.3d 389, 394-95 (3d Cir. 1996)).

necessarily attending it; and (4) the paramount interest of the creditors."[19]

(c) However, in considering the *Martin* factors, the bankruptcy court weighing a settlement under Bankruptcy Rule 9019 need only canvass the issues to determine if the settlement "'falls below the lowest point in the range of reasonableness.'"[20]

(i) This test is more lenient than even the business judgment standard for 363 transactions.

(ii) Could a transaction be structured in a way that it could be approved under the 9019 standard?[21]

B. **Court of Chancery Context**

1. **The DGCL Does Not Require Judicial Approval Of Business Combinations**

(a) 8 Del. C. § 141 provides that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."

(b) Thus, business combinations entered into by a Delaware corporation typically do not require judicial approval in the ordinary course because they are considered to be within the purview of directors of the corporation under the powers provided by section 141 of the Delaware General Corporation Law ("DGCL").

(c) In addition, directors of Delaware corporations who are independent and well-informed are entitled to the presumption of the business judgment rule when entering into transactions on behalf of the Delaware corporation. Under Delaware law, the business judgment rule is a judicial extension of the cardinal precept, codified in section 141(a) of the DGCL. The business judgment rule creates a presumption that "'in making a business decision, the directors of a corporation acted on an informed basis,

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19 *In re Martin*, 91 F.3d at 393.

20 *In re W.R. Grace & Co.*, 475 B.R. 34, 77-78 (D. Del. 2012) (quoting *Travelers Cas. Sur. Co. v. Future Claimants Representatives*, No. 07-2785 (FLW), 2008 WL 821088, at *5 (D.N.J. Mar. 25, 2008)).

21 *See In re Energy Future Holdings Corp.*, 648 F. App'x 277, 279, 283 n.7 (3d Cir. 2016), *cert. denied sub nom. Del. Tr. Co. v. Energy Future Holdings Corp.*, 137 S. Ct. 447 (2016) (holding that settlement between debtors and secured creditors containing tender offer was in accord with the Bankruptcy Code and the *Martin* factors, but noting that "[t]his is not a blanket endorsement of all tender offers in bankruptcy").

in good faith and in the honest belief that the action taken was in the best interests of the company.'"[22] The effect of the business judgment rule presumption is that, when applied, a court will not substitute its judgment for that of the company's board (or "second guess" the board) in matters regarding the business and affairs of the corporation.[23]

(d) However, when a merger, acquisition, or other transaction is announced publicly, stockholders of the company to be acquired often file lawsuits alleging that members of the board of directors breached their fiduciary duties to stockholders in negotiating and approving the transaction. To challenge the actions of a corporation's board of directors, a plaintiff assumes "the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty — good faith, loyalty, or due care."[24] Failing to do so, a plaintiff "is not entitled to any remedy unless the transaction constitutes waste . . . [that is,] the exchange was 'so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.'"[25]

2. **Judicial Standards Of Review**

(a) A board of directors discharge of its fiduciary duties generally is reviewed by courts under one of three standards of review, depending on the situation: (1) the "business judgment rule" (described above); (2) entire fairness; or (3) "enhanced" or

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[22] *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984)), *overruled on other grounds by Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

[23] *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697, 750 (Del. Ch. 2005) (applying business judgment rule and explaining that Delaware courts will not substitute their judgment for informed judgment of unconflicted directors, even if, in hindsight, directors' decision may not have complied with "the aspirational ideal of best practices"), *aff'd*, 906 A.2d 27 (Del. 2006); *see also In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813, 831 (Del. Ch. 2011) ("If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination."); *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 278 (Del. Ch. 2003) ("[T]his Court is hesitant to second-guess the business judgment of a disinterested and independent board of directors."); *Shenk v. Karmazin*, 868 F. Supp. 2d 299, 311 (S.D.N.Y. 2012) (applying Delaware law and dismissing derivative claims, holding plaintiffs failed to "overcome the Delaware law's presumption that the defendants impartially exercised their best judgment" by favoring one merger partner over another, because the directors had a "reasonable basis" for favoring the chosen merger partner (i.e., billions in tax savings) that "did not depend on any interest they may have had in retaining their positions," notwithstanding that nonfavored bidder wanted to replace some of the directors).

[24] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

[25] *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006).

"intermediate" scrutiny. Determination of the appropriate standard of review is important because, particularly where the business judgment rule applies, the determination may be case-dispositive.[26]

(i) *Business Judgment Rule*: The business judgment rule has been described by the Delaware Supreme Court as both a procedural presumption and a substantive rule of law.[27] This means that the business judgment rule places the evidentiary burden upon the stockholder who is challenging the transaction that was board-approved to rebut the presumption by establishing a breach of the duty of care or loyalty. If the business judgment rule is rebutted, then the burden of proof shifts to the directors to demonstrate that their actions were "entirely fair" to the corporation and the stockholders. However, if the stockholder fails to rebut the presumption, then the business judgment rule acts as a substantive rule of law to protect the directors from liability and the decisions they make from judicial scrutiny.[28]

(ii) *Entire Fairness*: If a stockholder successfully rebuts the business judgment presumption, the directors will have the burden of proving the "entire fairness" of the transaction. "Entire fairness" consists of fair dealing and fair price – but it is not bifurcated. Rather, an otherwise fair price can be rendered "not entirely fair" if it involved "a grossly unfair process."[29]

(1) Fair dealing focuses on the board members' conduct in connection with the transaction, including issues of timing, how the transaction was negotiated,

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[26] *See* Edward P. Welch, Edward B. Micheletti, Peter B. Morrison & Stephen D. Dargitz, *Mergers& Acquisitions Deal Litigation Under Delaware Corporation Law* § 4.01[B] (2017-1 Supplement) [hereinafter *MADL*] (citing *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d at 830).

[27] *See Citron v. Fairchild Camera & Instrument Corp*., 569 A.2d 53, 64 (Del. 1989).

[28] *See, e.g.*, *Gantler v. Stephens*, 965 A.2d 695, 706 (Del. 2009); *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001) ("If the presumption of the business judgment rule is rebutted, however, the burden shifts to the director defendants to prove to the trier of fact that the challenged transaction was 'entirely fair' to the shareholder plaintiff.") (citation omitted); *see generally MADL*, *supra* note 26, § 4.01[B][1].

[29] *See In re Nine Sys. Corp. S'holders Litig.*, C.A. No. 3940-VCN, 2014 WL 4383127, at *47 (Del. Ch. Sept. 4, 2014) (recognizing that a transaction at "an otherwise fair price" can be rendered "not entirely fair" if it involved "a grossly unfair process"), *aff'd sub nom. Fuchs v. Wren Holdings, LLC*, 29 A.3d 882 (Del. 2016); *In re Dole Food Co., Inc. Stockholder Litig.*, Consol. C.A. Nos. 8703-VCL & 9079-VCL, slip op. at 3 (Del. Ch. Aug. 27, 2015) (explaining that stockholders were "entitled to a fairer price designed to eliminate the ability of the defendants to profit from their breaches of the duty of loyalty").

structured and disclosed and then how approvals (board and stockholder) were obtained.

(2) Fair price focuses on the financial and economic considerations; however "fair price" is not necessarily the highest price that an acquiror subjectively could afford to pay, but rather, an objectively fair value.[30]

(iii) *Other standards of review*: In certain circumstances – primarily in cases where there is the sale of control or the board has taken a defensive measure – courts subject board decisions to enhanced scrutiny, an intermediate standard of review between the business judgment rule and entire fairness.

(1) *Unocal*: In transactions involving corporate control, the Delaware Supreme Court has recognized that a heightened level of scrutiny is appropriate. The "*Unocal* standard" has two elements: the board must show that (1) they had reasonable grounds to believe that a threat to corporate policy and effectiveness existed; and (2) the defensive measures adopted were reasonable in relation to the threat posed.[31]

(A) The Delaware Supreme Court further revised the *Unocal* standard in *Unitrin v. American General Corp.*, which explained that "disproportionate" responses tended to be "draconian" because they were either coercive ("cramming down" management-sponsored alternative on stockholders) or preclusive (preventing competing offers). Under *Unitrin*, if the defensive measure is neither coercive or preclusive, and it falls within a range of reasonableness, the Court will defer to the directors' judgment.[32]

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[30] *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del 1983).

[31] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). *See MADL*, *supra* note 26, §4.01[B][3][a].

[32] *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1367 (Del. 1995) (holding that the first inquiry under Unocal is whether the challenged defensive measure taken was "draconian, by being either preclusive or coercive" and; second, if not draconian, "whether it was within a range of reasonable responses to the threat").

(2) *Revlon*: The decision of a board of directors to approve the sale of Delaware corporation subjects the directors to the obligation to obtain the highest value reasonably available to the stockholders. Further, this requires that the directors exercise their fiduciary duties in pursuit of that goal.[33] "*Revlon* duties" arise in at least 3 scenarios: (1) when a corporation initiates an active bidding process; (2) when a corporation responds to a bidder's offer; or (3) when approval of a transaction results in a sale or change of control.[34] *Revlon* duties are not, however, ordinarily implicated in a stock-for-stock merger of widely held public companies where "[c]ontrol of both [companies] remain[s] in a large, fluid changeable and changing market."[35]

(A) When *Revlon* applies, the court will employ enhanced scrutiny at the outset, before the presumption of the business judgment rule will apply.

(B) At its base, the *Revlon* standard of review requires that the court consider whether the board undertook a well-reasoned process to get the best deal for the stockholders.

(C) However, Delaware courts have explained that *Revlon* does not create any different or distinct duties apart from the traditional fiduciary duties of care and loyalty. Thus, even when *Revlon* enhanced scrutiny applies, a party challenging a transaction

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[33] *RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816, 849 (Del. 2015) (quoting *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 44 (Del. 1993)); *see also Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182-183 (Del. 1986); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1288 (Del. 1989) ("[I]n a sale of corporate control the responsibility of the directors is to get the highest value reasonably attainable for the shareholders.").

[34] *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1290 (Del. 1994).

[35] *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 47 (Del. 1994). *See, e.g.*, *Arnold*, 650 A.2d 1270, 1289-1290 (holding that *Revlon* did not apply to a stock-for-stock merger); *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150-1151 (Del. 1990) (affirming denial of injunction and applying business judgment rule analysis because Revlon did not apply to the stock-for-stock merger).

must still prove that there was a breach of either the duty of care or loyalty.[36]

(D) Further, Delaware courts have explained that there is "no single blueprint" directors must follow to satisfy their obligations under *Revlon*.[37]

3. **Deal Litigation Claims**

(a) Shareholder claims

(i) Typical stockholder claims allege, among other things, that the board of directors breached their fiduciary duties by approving a transaction through a flawed process, agreeing to an unfair transaction price, agreeing to deal terms that prohibit or deter other bidders, and making inadequate disclosures concerning the transaction. The claims are often filed within days or even hours of the announcement of the transaction.[38]

(ii) Stockholders often allege that directors breached their fiduciary duty of loyalty because they lacked independence or were materially interested in the transaction. Other allegations are that the directors possessed an interest in the transaction that are not shared by other stockholders.

(1) If the majority of the directors are disinterested and independent, and fully informed, the directors of a Delaware corporation are protected from judicial scrutiny by the business judgment rule, which creates a rebuttable presumption that the directors acted in accordance with their fiduciary duties.[39]

(2) However, even if the majority of the board lacks an interest in the transaction that is being challenged,

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[36] *See In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 731 (Del. Ch. 1999), *aff'd mem. sub nom. Walker v. Lukens*, *Inc.*, 757 A.2d 1278 (Del. 2000).

[37] *RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816, 850 (Del. 2015) (citation omitted).

[38] *See MADL*, *supra* note 26 (containing a comprehensive discussion and analysis of current and historic deal litigation in Delaware – particularly in the Court of Chancery – and other jurisdictions).

[39] *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) ("The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a). . . . Absent an abuse of discretion, that judgment will be respected by the courts."), *overruled in part*, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

the business judgment rule will not protect directors who are controlled or dominated by an interested director. Entire fairness will apply if the majority of the directors are found to be interested in the merger.[40]

(b) Other stockholder claims

(i) Disclosure claims – because stockholder approval is required for a merger and certain other business combinations, deal litigation often includes a claim that directors have provided materially false or misleading, and/or inadequate disclosure to stockholders in connection with the a request for the stockholder vote on the proposed transaction, thereby preventing an informed vote. The Delaware Court of Chancery has suggested that the most appropriate time to seek relief or remedies for purported disclosure inadequacies is before the vote occurs.[41]

(1) Challenges based on improper disclosure vary widely but could be related to the following:

(A) Information about the background, negotiation and timing of the proposed transaction;

(B) Information about the financial advisors and other advisors who provided information and advice to the board and the company in connection with the transaction, including the fee earned by the bank and potential conflicts of interest;

(C) Actual or potential director, management or significant stockholder conflicts of interest;

(D) Management projections and the underlying assumptions; and

(E) Financial advisor analyses and underlying methodologies and key inputs, multiples and other information relied upon.

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[40] *See MADL*, *supra* note 26, § 4.02 (analyzing and collecting cases regarding various claims by stockholders).

[41] *In re Transkaryotic Therapies, Inc.*, 954 A.2d 346, 357 (Del. Ch. 2008).

(ii) Statutory appraisal proceedings – Under Delaware law, the appraisal statute, 8 Del. C. § 262(b), provides a means by which dissenting stockholders may challenge whether the consideration paid in a merger fairly compensates them for their shares. Not all transactions give rise to the right of appraisal and there are very specific requirements that must be fulfilled by the stockholder seeking appraisal to commence the proceeding.

(1) In such an action the "only litigable issue is the determination of the value of the appraisal petitioners' shares on the date of the merger, the only party defendant is the surviving corporation and the only relief available is a judgment against the surviving corporation for the fair value of the dissenters' shares."[42]

(iii) Section 225 actions – 8 Del. C. § 225 provides a statutory mechanism for seeking judicial review in the Court of Chancery to determine the validity of corporate elections, appointments, removals, or resignations, as well as the result of any stockholder vote on other matters, such as mergers. A party challenging the validity of an election or stockholder vote carries the burden in a section 225 action. A suit under section 225 is a summary proceeding.

(c) Claims by acquirors, sellers and unsuccessful bidders

(i) Parties to the agreement may sue to ensure that the transaction is completed.

(ii) A jilted merger partner may sue for specific performance or for damages.

II. The Animating Forces Behind Transactional Standards In Bankruptcy

A. Judicial Oversight

1. Unless the debtor seeks to use property of the estate in the ordinary course, transactions in bankruptcy require court approval. The entirety of the transactional process is conducted under the court's supervision with notice to affected parties and, in certain circumstances, pre-approval of incremental authority, such as bidding procedures, before a transaction can close.

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[42] *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1187 (Del. 1988).

2. The transactional process is also highly transparent: All material terms are filed on the court's public docket with generally a 21-day notice period for parties in interest to review and object.[43] At a bare minimum and for a proceeding to be afforded finality, notice must "reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action."[44]

3. The sale process under Bankruptcy Code section 363 is illustrative of the type of oversight and transparency of bankruptcy transactions. The process will often include pre-approval of bidding procedures, a meaningful marketing process for the assets, a public auction with competing bidders, and a final sale hearing requiring the debtor to provide evidence supporting the propriety of the sale.

4. Bankruptcy (forward looking with debtors seeking authority to sell); *versus* Chancery (backward looking with objectors seeking to enjoin pending transaction).

B. Bankruptcy Policy

1. One of the driving goals of the bankruptcy process is to maximize the value of the debtor's estate in order to maximize the return to creditors.[45] The congressional objective to enhance values can be inferred from the legislative history of chapter 11: "The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap."[46]

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[43] The type of notice (and the parties entitled to notice) for a 363 sale are governed by Federal Rules of Bankruptcy Procedure 2002(a)(2) and 6004(a), which require 21 days' notice unless such period is shortened by the court "for cause."

[44] *Mullane v. Cent. Hanover Bank & Tr. Co.*, 339 U.S. 306, 314 (1950).

[45] *See Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 453 (1999) (observing recognized policy of chapter 11 to be "maximizing property available to satisfy creditors") (citing *Toibb v. Radloff*, 501 U.S. 157, 163 (1991)); *Fields Station LLC v. Capitol Food Corp.* (*In re Capitol Food Corp. of Fields Corner*), 490 F.3d 21, 25 (1st Cir. 2007) ("Two primary purposes of chapter 11 relief are the preservation of businesses as going concerns, and the maximization of the assets recoverable to satisfy unsecured claims.").

[46] H.R. Rep. No. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179. The Supreme Court has affirmed this overriding consideration, noting in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984), that "[t]he fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources." *Id.* at 528.

2. As noted above, the principal statutory mechanism under which a debtor seeks to maximize value is Bankruptcy Code section 363.[47] Section 363(f), which allows sales of estate property free and clear of "any interest in such property," helps achieve this goal by garnering the highest possible sale price.[48] Section 363(f) is a powerful and critical tool for a debtor to maximize the return on its assets.[49]

C. Other Relevant Considerations

1. Speed

(a) *Context*: "Melting ice cube" in bankruptcy; often a lack of attractive alternatives to proposed sale/transaction.[50]

(i) A "melting ice cube" refers to a case involving assets subject to rapid decline in value because of the nature of such assets (often referred to as "perishable" assets) or unique, exigent circumstances that cannot otherwise be avoided.

(ii) The Chrysler case, for example, involved a sale of substantially all of the automaker's assets to Fiat just 42 days after the petition date. The Second Circuit Court of Appeals affirmed the bankruptcy court's decision to approve Chrysler's quick asset sale, citing the melting ice cube theory.

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47 *See In re Chung King, Inc.*, 753 F.2d 547, 549 (7th Cir. 1985) ("The governing principle at a [363 sale] confirmation proceeding is the securing of the highest price for the bankruptcy estate."); *In re Wilde Horse Enters., Inc.*, 136 B.R. 830, 841 (Bankr. C.D. Cal. 1991) ("In any sale of estate assets, the ultimate purpose is to obtain the highest price for the property sold."); *see also In re Alpha Indus., Inc.*, 84 B.R. 703, 705 (Bankr. D. Mont. 1988) (citing *In re Chung King, Inc.*, 753 F.2d 547, 549 (7th Cir. 1985)) (defining underlying principle of [363 sale] confirmation proceeding as receiving highest price for bankruptcy estate).

48 11 U.S.C. § 363(f); *see also In re Lady H Coal Co.*, 199 B.R. 595, 607 (S.D. W. Va. 1996) ("The rights of buyers at a bankruptcy sale free and clear of liens and other interests are given this protection to insure that the best offers are made and as many claims as possible are paid from the sale proceeds."), *aff'd sub nom. In re Leckie Smokeless Coal Co.*, 99 F.3d 573 (4th Cir. 1996).

49 *See, e.g.*, *In re Chung King*, 753 F.2d at 549; *In re Wilde Horse Enters.*, 136 B.R. at 841.

50 *See, e.g.*, *In re Refco Inc.*, 505 F.3d 109, 118 (2d Cir. 2007) ("'[I]t is important that a bankruptcy court is not too facile in granting applications for standing. Overly lenient standards may potentially over-burden the reorganization process by allowing numerous parties to interject themselves into the case on every issue, thereby thwarting the goal of a speedy and efficient reorganization . . . . Granting peripheral parties status as parties in interest thwarts the traditional purpose of bankruptcy laws which is to provide reasonably expeditious rehabilitation of financially distressed debtors with a consequent distribution to creditors who have acted diligently.'") (citation omitted).

2. Finality

(a) As discussed more fully below, despite the opportunity for appeals, there is a strong federal policy of protecting the finality of sales in bankruptcy, which, in turn, creates certainty in the market and helps maximize the value of the assets. One reflection of this policy of "finality" is provided by the doctrines of equitable and statutory mootness that may limit the ability of any party seeking to challenge a bankruptcy sale or confirmation order on appeal.

III. High Standard In Bankruptcy To Enjoin, Stay Or Overturn A Sale/Transaction

A. Bankruptcy Courts Rarely Stay Sales Or Transactions

1. *Injunctions/Stays*: Creditors must meet stringent standards to successfully block a sale transaction. Policy considerations favoring finality and efficiency in the bankruptcy process make enjoining a transaction an extraordinary remedy. Disgruntled creditors may seek a stay pending their appeal of the order approving the transaction, such as an order approving a sale or a confirming a plan. If the stay is granted, the transaction is enjoined from occurring.

2. *Stay pending appeal standard:* The Third Circuit recently set forth four factors governing whether a stay pending appeal is appropriate: "'(1) whether the stay applicant has made a strong showing that [it] is likely to succeed on the merits; (2) whether the applicant will be irreparably injured absent a stay; (3) whether issuance of the stay will substantially injure the other parties interested in the proceeding; and (4) where the public interest lies.'"[51] Likelihood of success on the merits is the most important consideration, but the Court weighs the first two factors together more heavily than the third and fourth factors. It is not sufficient for the stay applicants to show the potential harm they will suffer if the stay is not granted; rather, there must be some equitable right to relief shown by likelihood of success on the merits. The degree of success the applicant must show to prevail varies between the first two factors.

(a) Bond requirement: Additionally, the Court may require the stay applicant to post a *supersedeas* bond to compensate for risk of injury if the appeal is ultimately denied.[52] The Court has discretion to compute the bond value required.[53] Creditors may be required

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[51] *In re Revel AC, Inc.*, 802 F.3d 558, 568 (3d Cir. 2015) (citation omitted).

[52] *See* Fed. R. Bankr. P. 8007(a)(1)(B).

[53] *See In re Tribune Co.*, 477 B.R. 465, 476 (Bankr. D. Del. 2012).

to post substantial bonds depending on the scope of the transaction which may offer debtors additional protections.

3. *Standing to Object*: Bankruptcy courts take a flexible approach to whether a creditor has standing to appeal an approved final sale order (compared to an order approving bidding and sale procedures, which is not final). Not all parties to the bankruptcy case automatically possess the required standing. "Appellate standing in bankruptcy cases is limited to 'persons aggrieved.'"[54] Whether a creditor is a "person aggrieved" is a fact-based inquiry, but "only those whose pecuniary interests are directly and adversely affected by a bankruptcy court order" will possess requisite standing.[55] The Third Circuit considers parties aggrieved because their pecuniary interests are affected "if the order diminishes their property, increases their burdens, or impairs their rights."[56]

   (a) In the sale context, disappointed bidders generally do not qualify as a person aggrieved and thus lack appellate standing.[57] This principle reflects the Code's protections for only those actually affected by the transaction, not potential purchasers. However, in the interest of fairness in the sale process, additional parties possess appellate standing for the narrow and limited purpose of challenging the good-faith conduct of the sale.[58]

B. Sale Protections

1. Statutory and Equitable Mootness

   (a) The mootness doctrines assist debtors in protecting transaction finality by considering the practical difficulties inherent in unwinding potentially complex transactions under a plan or sale. There are three kinds of mootness relevant to the bankruptcy context: constitutional, equitable, and statutory.[59]

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[54] *In re Rose Color, Inc.*, 198 F. App'x 197, 202 (3d Cir. 2006) (citation omitted).

[55] *Krebs Chrysler-Plymouth, Inc. v. Valley Motors, Inc.*, 141 F.3d 490, 495 (3d Cir. 1998).

[56] *In re Dykes*, 10 F.3d 184, 187 (3d Cir. 1993).

[57] *See Calpine Corp. v. O'Brien Envtl. Energy, Inc.* (*In re O'Brien Envtl. Energy, Inc.*), 181 F.3d 527, 531 (3d Cir. 1999) ("Courts that have considered appellate standing in the context of the sale or other disposition of estate assets have generally held that creditors have standing to appeal, but disappointed prospective purchasers do not.").

[58] *See id*. ("Nor does Calpine's appeal challenge either the 'intrinsic fairness' of the process by which O'Brien's assets were sold or the good faith of NRG as the ultimate purchaser.").

[59] Constitutional mootness refers to a court's inability to grant the requested relief. This outline focuses on the mootness doctrines most likely to be implicated in sale transactions, equitable and statutory mootness.

(b) The equitable mootness doctrine refers to a court's unwillingness to unwind the occurrence of complex transactions or based on the effects of third parties' reliance on the transaction's finality. The doctrine was first recognized and approved by the Third Circuit in *In re Continental Airlines*.[60] Under *Continental*, courts must weigh the following "prudential" factors in deciding whether to dismiss an appeal as equitably moot: "'(1) whether the reorganization plan has been substantially consummated, (2) whether a stay has been obtained, (3) whether the relief requested would affect the rights of parties not before the court, (4) whether the relief requested would affect the success of the plan, and (5) the public policy of affording finality to bankruptcy judgments.'"[61]

(i) In 2015, the Third Circuit refined *Continental*'s five factor analysis. Now, courts considering whether an appeal is equitably moot collapse *Continental*'s five factors into two analytical steps.[62] First, courts must determine whether a confirmed plan has been substantially consummated and, if so, whether granting the relief requested in the appeal will: (1) fatally scramble the plan; and/or (2) significantly harm third parties who have justifiably relied on plan confirmation.[63] Courts emphasize that equitable mootness is a "narrow doctrine" and only rarely should appellate courts refrain from exercising jurisdiction where, for practical reasons, granting the relief requested will "undermine the finality and reliability of consummated plans of reorganization."[64]

(c) Statutory mootness refers the Bankruptcy Code's protections providing finality and certainty to good-faith purchasers of estate property. The Code limits creditors' ability to challenge approved sale orders by rendering them moot unless a stay was previously

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60 91 F.3d 553, 560 (3d Cir. 1996) (en banc).

61 *In re Phila. Newspapers, LLC*, 690 F.3d 161, 168 (3d Cir. 2012) (quoting *Continental*, 91 F.3d at 560). Depending on the circumstances, each factor is "'given varying weight.'" *Id.* (citation omitted).

62 *See In re Tribune Media Co.*, 799 F.3d 272, 278 (3d Cir. 2015) (citing *In re Semcrude, L.P.*, 728 F.3d 314, 321 (3d Cir. 2013)), *cert. denied sub nom. Aurelius Capital Mgmt., L.P. v. Tribune Media Co.*, 136 S. Ct. 1459 (2016).

63 *Id.*

64 *Id.* at 277. When courts are faced with determining whether an appeal is equitably moot their "starting point is the relief [an appellant] specifically asks for." *Id.* at 278.

sought. This harsh remedy encourages purchasers to bid on distressed assets.[65]

(i) The Third Circuit has rejected a per se rule mooting any appeal of a sale for which creditors did not seek a stay. Rather, the court will consider mootness using a two-pronged analysis: "'(1) the underlying sale or lease must not have been stayed pending appeal, and (2) reversing or modifying the authorization to sell would affect the validity of the sale or lease.'"[66]

(ii) Courts will find appeals of sale orders statutorily moot where modification of the sale order would "affect the validity of the sale. . . . In considering whether reversal or modification would affect the validity of a sale, courts must look to the remedies sought and assess whether these would impact the terms of the bargain struck by the buyer and seller. . . . A challenge to an authorized transaction will necessarily impact that transaction's validity if it seeks to affect 'the validity of a central element,' such as the sale price."[67] In determining whether the validity of the sale is impacted, a court will also consider whether it is capable of granting a remedy which will not affect the sale's validity.[68]

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[65] Section 363(m) provides: "The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal." 11 U.S.C. § 363(m).

[66] *Cinicola v. Scharffenberger*, 248 F.3d 110, 122 (3d Cir. 2001) (citation omitted). Statutory mootness protects buyers of estate property as well as assignees of contracts (though the latter are also required to meet Bankruptcy Code section 365's requirements for assigned agreements; *see id.* at 126-28).

[67] *In re Alabama Aircraft Indus., Inc.*, 514 F. App'x 193, 195 (3d Cir. 2013) (quoting *Pittsburgh Food & Beverage, Inc. v. Ranallo*, 112 F.3d 645, 649 (3d Cir. 1997)).

[68] *See In re Global Home Prods. LLC*, 369 B.R. 770, 775 (D. Del. 2007) (finding appeal statutorily moot where sale, including trademark conveyance, had already occurred, payment made, and significant steps taken to implement transaction).

IV. Statutory Interpretation

A. Section 105 of the Bankruptcy Code

1. Section 105(a) provides that "[t]he [bankruptcy] court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, *sua sponte*, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process."[69]

2. Section 105(a) empowers bankruptcy courts "to fashion such orders as are required to further the substantive provisions of the Code."[70] Section 105 has, therefore, been viewed as a statutory gap filler.[71]

3. Section 105 cannot be used, however, in a manner that is inconsistent with other Code provisions.[72] Courts have cautioned that Section 105 cannot be used as an independent source of relief and its use must be tied to some other Code provision.[73]

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69 11 U.S.C. § 105(a).

70 *In re Morristown & Erie R.R. Co.*, 885 F.2d 98, 100 (3d Cir. 1989); *see also United States v. Energy Res. Co.*, 495 U.S. 545, 549 (1990) ("[B]ankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships.").

71 *See Keough v. 217 Canner Assocs., LLC* (*In re Greenwich Sentry, L.P.*), 534 F. App'x 77, 80 (2d Cir. 2013) ("§ 105(a) … confer[s] authority to 'fill the gaps left by the statutory language.'") (quoting *Smart World Techs., LLC v. Juno Online Servs., Inc.* (*In re Smart World Techs., LLC*), 423 F.3d 166, 183 (2d Cir. 2005)); *Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 568 (3d Cir. 2003) (en banc) (noting that bankruptcy courts are "able to craft flexible remedies that, while not expressly authorized by the Code, effect the result the Code was designed to obtain").

72 *See Law v. Siegel*, 134 S. Ct. 1188, 1194 (2014) ("It is hornbook law that § 105(a) 'does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code.'") (citation omitted); *United States v. Pepperman*, 976 F.2d 123, 130-32 (3d Cir. 1992) (reversing order under § 105 because relief did not further appropriate bankruptcy purpose).

73 *See, e.g.*, *New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc. (In re Dairy Mart Convenience Stores, Inc.)*, 351 F.3d 86, 92 (2d Cir. 2003) (Section 105(a) does not provide independent source of relief); *Joubert v. ABN AMRO Mortg. Grp., Inc. (In re Joubert)*, 411 F.3d 452, 455 (3d Cir. 2005) ("Section 105(a) empowers bankruptcy courts and district courts sitting in bankruptcy to fashion orders in furtherance of Bankruptcy Code provisions.").

B. Property Rights In Bankruptcy

1. Property rights in bankruptcy are determined according to applicable non-bankruptcy law.[74] Section 105 is not a substantive source of rights.[75]

2. Absent federal preemption, bankruptcy courts incorporate and rely upon applicable state law for determining property rights.[76]

   (a) E.g., fiduciary duty law,[77] mechanics and other liens law,[78] real property law.[79]

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[74] *See, e.g.*, *In re Flintkote Co.*, 486 B.R. 99, 120 (Bankr. D. Del. 2012), *aff'd*, 526 B.R. 515 (D. Del. 2014) (confirming plan and noting that whether an alter ego claim is property of the estate "turns on state law" and that conflicts of law issues were implicated because "courts in different jurisdictions have come to different conclusions").

[75] *See In re Combustion Eng'g Inc.*, 391 F.3d 190, 236 (3d Cir. 2004) (Section 105(a) "'does not "authorize the bankruptcy courts to create substantive rights . . . ."'") (citations omitted); *Butner v. United States*, 440 U.S. 48, 54-55 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."); *In re Brannon*, 476 F.3d 170, 176 (3d Cir. 2007) ("[W]e generally turn to state law for the 'determination of property rights in the assets of a bankrupt's estate.'") (citation omitted).

[76] *See Slobodian v. IRS* (*In re Net Pay Sols., Inc.*), 822 F.3d 144, 158 n.13 (3d Cir. 2016) (citing *Butner*, 440 U.S. at 54-55).

[77] *See In re Hercules Offshore, Inc.*, 565 B.R. 732, 757-60 (Bankr. D. Del. 2016) (applying Delaware fiduciary duty law).

[78] *See In re Ryckman Creek Res., LLC*, No. 16-10292 (KJC), 2017 WL 1330309, at *2 (Bankr. D. Del. Apr. 10, 2017) (applying Wyoming lien law).

[79] *See In re Brannon*, 476 F.3d at 176 (applying Pennsylvania property real law).