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Valuing Bids in Bankruptcy Auctions

By Adam L. Rosen and Sheryl P. Giugliano

Bids in bankruptcy auctions can be divided into two broad categories: all-cash bids; and non-cash and credit bids. This article discusses some important issues raised by non-cash bids.

Background

Bankruptcy auctions are designed to provide the highest possible value for the estate. But, how does the estate determine the highest value when a bid includes non-cash consideration? Too often, bidders are discouraged or confused because they do not know the operative value of the stalking-horse bid. By "operative value," we mean the aggregate cash value of a bid for purposes of comparing it to other competing bids at an auction. We think that confusion about operative value can adversely affect the success of bankruptcy auctions.

The estate is entitled to use its broad business judgment to determine which bid is the "highest and best," but sometimes valuing non-cash and credit bids can be fraught with subjectivity and uncertainty. Auction procedure orders usually provide estates with wide latitude to determine the operative value of bids. However, when auctions are not held in the presence of a bankruptcy judge, then there is no efficient and immediate method of resolving disputes with a sense of finality regarding the operative values of bids.

In re Financial News Network Inc.

Certainly as a result of the challenges in valuing non-cash consideration, there is greater need for flexibility in auctions involving non-cash bids. *See, e.g.*, *Consumer News and Business Channel Partnership v. Financial News Network Inc.* (*In re Financial News Network Inc.*), 134 B.R. 737 (1991), aff'd 980 F.2d 165 (2d Cir. 1992) (*FNN*). In *FNN*, one bidder, Dow Jones submitted a bid that included $125 million in cash, a share of the business' future revenues (which it valued at $32.8 million), and assumed liabilities valued at $9.3 million.

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Third Circuit Sheds Some Light on Evoloving Practices

By Adam H. Friedman and Jonathan T. Koevary

Corporate restructuring practice has dramatically evolved in the nearly 40 years since enactment of the 1978 Bankruptcy Code. Since *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983), one of the more significant changes to Chapter 11 practice has been the use of section 363 to sell the assets of a debtor, prior to confirmation of a plan, as a means to restructure and maximize value. This transactional use of the Bankruptcy Code has, by necessity, changed how cases are administered. With more frequent under-water balance sheets and ever evolving, more complex capital structures, many modern cases have required flexible approaches. Practitioners and bankruptcy courts have been forced to adapt. Two recent precedential decisions from the U.S. Court of Appeals for the Third Circuit provided a much-needed stamp of approval on these flexible and pragmatic approaches to modern restructuring practice.

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The other bidder, CNBC, offered $135 million in cash. During the auction, which was held before the bankruptcy judge, CNBC asked the bankruptcy court to value the non-cash component of Dow's bid so that CNBC could make an informed decision with respect to its bidding strategy. The bankruptcy court refused to do so, and CNBC increased its bid to $140 million in cash, plus assumption of liabilities valued at $6.1 million. *In re Financial News Network Inc*., 134 B.R. at 738. At this point it was unclear which bid was best for the estate.

Bankruptcy Judge Francis G. Conrad closed the bidding and then took testimony with respect to the value of the future revenue stream, which was a component of Dow Jones' bid. *Id*. After the close of the testimony, the parties increased their bids. *Id*. The estate and the creditor's committee did not agree on which bid should be the winning bidder and the bankruptcy court did not make an immediate decision. *Id*. at 739.

The next day, the estate asked the bankruptcy court to delay its ruling in order to consider new evidence, namely a $17 million offer by an investment bank to purchase the future revenue stream included in Dow's bid. *Id*. Judge Conrad viewed the new evidence as relevant in providing a more definitive value of the future revenue stream. *Id*. After a conference call with the parties, Judge Conrad considered the new evidence and reopened bidding to allow both parties to again revise their bids. *Id*. CNBC objected, but ultimately increased its bid to $145 in million cash, and a share of the revenue stream. Dow declined to increase its bid, and Judge Conrad determined that CNBC was the successful bidder. *Id*. at 739-40.

Both the district court and the U.S. Court of Appeals for the Second Circuit upheld the bankruptcy court's decision to receive post-auction evidence regarding the value of the future revenue stream, which Judge Conrad determined to be critical in establishing the operative value of the future revenue stream. *Id*. at 738. On appeal, CNBC argued that the bankruptcy court should not have considered the additional evidence, or reopened the bidding, and that CNBC should only be required to pay the amount of its offer, rather than the increased offer made as a result of the reopened bidding. *Id*. The Second Circuit agreed with Judge Conrad's approach, and declined to require a refund to CNBC. *FNN*, 980 F.2d 165 (2d Cir. 1992).

Additionally, the district court and the Second Circuit in *FNN* discussed the issue of how to value non-cash auction bids. The district court agreed that the bankruptcy court acted appropriately in hearing post-auction evidence on the value of the non-cash components of bids stating:

> Here, the two contending bids were structured differently and accordingly were difficult to compare. The May 7 hearing had been aimed primarily at determining the value of Dow's bid, which was uncertain because of its contingent revenue component … [The new offer] simply was newly available evidence obtained from a third party which gave a clear answer to what at the close of the May 7 hearing appeared to be a vexing problem for the court, and was properly admitted.

FNN, 134 B.R. 737, 741-42 (S.D.N.Y. 1991).

The district court noted the need for flexibility in bankruptcy auctions, stating:

> The situation was highly unusual and appears unlikely to recur frequently. In the event similar circumstances arise, bankruptcy courts retain considerable

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> discretion to prevent manipulation or undermining of their sale procedures, an authority which the approach taken in this case has not diminished.

Id. at 743.

Although the facts in FNN were unusual, as a general proposition, we are not sure that the problem of valuing non-cash bids is so unusual, and one reason for this is the popularity and importance of credit bids.

Credit Bidding As a Non-Cash Bid

The now infamous *Fisker Automotive* decision may be viewed as a decision that determined the "operative value" of a credit bid for purposes of an auction. *In re Fisker Automotive Holdings, Inc*., 510 B.R. 55 (Bankr. D.Del. 2014). In *Fisker Automotive*, the court relied on section 363(k), which provides that "unless the court for cause orders otherwise the holder of [a claim secured by the property for sale] may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." 11 U.S.C. § 363(k).

Among other issues Judge Gross had with the validity of the credit bid in *Fisker*, part of what he decided was that limiting the operative value of the credit bid was justified, at least in part, because it was unclear what portion of the bidder's claim was a valid secured claim. *See In re Fisker Automotive Holdings, Inc*., 510 B.R. at 61 ("The law leaves no doubt that the holder of a lien the validity of which has not been determined, as here, may not bid its lien." (citing *In re Dau fuskie Isl. Props., LLC*, 441 B.R. 60 (Bankr. S.D.C. 2010)). Judge Gross' decision was based on the established principle that the disputed portion of a secured claim cannot be used to credit bid. *See, e.g. In re RML Development, Inc*., 528 B.R. 150, 155 (Bankr. W.D. Tenn. 2014) (holding that secured creditor may credit bid the uncontested portion of its allowed secured claim but not the contested portion).

Other Examples of Non-Cash Consideration

Sometimes the operative value of a bid is affected by considerations such as the risk of a delayed closing, or the risk of no closing. Also, the views of affected parties, like landlords and other contract parties whose views are relevant to the sale process should affect the operative value of a bid. Or, litigation concerns might affect the value of an offer. Or, public policy concerns like continuation of the work of a not for profit organization. *See, e.g., In re United Healthcare System, Inc*., 1997 WL 176574 (D.N.J. March 26, 1997) ("When analyzing an articulated business reason for the sale, the bankruptcy court must also take into consideration the fact that a debtor is a charitable institution.") (citing *In the Matter of Brethren Care of South Bend, Inc*., 98 B.R. 927, 935 (N.D. Ind. 1989) ("[C]ontinuing satisfaction and ongoing beneficial treatment of the residence of the St. Paul's [retirement and nursing] facility is a good business reason for the sale of [its] assets as scheduled.").

But, should the estate be required to provide its value of non-cash components of a bid in order to encourage competitive bidding? Certainly, estates should do so with respect to stalking horse bids that contain significant non-cash components. Perhaps fewer auctions would be cancelled due to a lack of interest if potentially interested bidders were able to determine the operative value of non-cash components of an offer. There are many recent examples of cancelled auctions. *In re Kior, Inc*., Case No. 14-12514 (CSS) (Bankr. D.Del.) (ECF Doc. No. 196); *In re Cold Holding Company LLC*, 15-11296 (LSS) (Bankr. D.Del.) (ECF Doc. No. 607); *In re Grubb & Ellis Company*, Case No. 12-10685 (MG) (Bankr. S.D.N.Y.) (ECF Doc. No. 720).

Often, complex auctions drag on for hours or days because, at least in part, there are disagreements regarding the valuation of non-cash components of bids. In some cases with sophisticated financial advisers, these questions are resolved at the auction, but in many cases the operative value of non-cash bids remains a gray area, which makes bankruptcy auctions less attractive to potential competing bidders.

The Bankruptcy Court's Role

Conducting the auction in the presence of a bankruptcy judge certainly is a good practice in these circumstances. Bankruptcy courts recognize that non-cash components of a bid are a part of determining the highest and best bid. *See, e.g., In re After Six, Inc*., 154 B.R. 876, 882 (Bankr. E.D.Pa. 1993) (stating in *dicta* that in appropriate circumstances non-cash components of a bid might justifiably cause an estate to choose a "lower" bid as the winning bidder). For example, if a bid contains a waiver of claims against the estate, and those claims are unlikely to be paid in full then the operative value of the bid should reflect that fact. *Id*. at 883.

Courts understandably are hesitant to substitute their own business judgment for the estate's judgment. *See, e.g., In re Diplomat Construction, Inc*., 481 B.R. 215 (Bankr. N.D. Ga. 2012) (holding trustee's selection of second highest bidder as successful bidder was a reasonable exercise of business judgment, because "the [t]rustee is afforded great judicial deference in deciding which bid to accept as the best and highest bid. Even though the discretion is not without limit, the Court should not step in and assume a role and responsibility properly placed in the hands of the [t]rustee under these facts") (citations omitted).

On Dec. 1, 2015, the Bankruptcy Division of the District Court of the Virgin Islands approved a sale of assets after an auction involving substantial non-cash consideration. *See In re Hovensa, L.L.C.*, Case No. 15-10003 (MFW) (ECF Doc. No. 394). The declarations filed with the court by the Government for the Virgin Islands, and the estate's financial adviser, demonstrate that the estate made

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an effort to determine the cash value of certain tax concession agreements with the Government for the Virgin Islands. Ultimately, the stalking-horse bidder was selected, due in part to the substantial value attributed to the non-cash consideration offered (a negotiated agreement with the Government, and certainty as to allocation of sale proceeds between the Government and the estate).

Reopening Auctions

When courts do intervene in auctions, that decision and the results are often controversial. For example, whether to reopen an auction to consider a new bid, which is always dependent on the facts of the case.

Bankruptcy courts generally will not reopen an auction "simply because one of the parties who participated … now wants to make a higher offer." *In re Bigler, LP*, 443 B.R. 101, 102, 109 (Bankr. S.D.Tex. 2010) (declining to reopen auction based upon U.S. Court of Appeals for the First Circuit precedent that it is important to instill "public confidence in the regularity of judicial sales" absent something unusual about the auction or some other circumstance warranting reopening the auction as a matter of equity) (quoting *In re Gil Bern Industries, Inc.*, 526 F.2d 627, 629 (1st Cir. 1975)).

But, where a higher offer is made after the close of the auction, only if "the price [accepted at the auction] is so grossly inadequate as to shock the conscience," then some courts will consider reopening the bidding, or even invalidating the sale. *See, e.g., First Nat'l Bank v. M/V Lightning Power*, 776 F.2d 1258, 1259 (5th Cir. 1985) (voiding sale where party was unable to bid because it did not have the required documents demonstrating its financial wherewithal, enabling the bank to successfully bid $5,000 for a vessel valued at $900,000); *In re Family Christian, LLC*, 533 B.R. 600 (Bankr. W.D. Mich. 2015) (holding that auction was flawed because, among other reasons, the sale to the high bidder included releases of potential estate claims against insiders which had not been accounted for in valuing the bid).

Courts may even consider reopening an auction without a showing that the "initial bids were grossly inadequate or that the original bidding was tainted by fraud or some other irregularity," where a late bid is submitted prior to entry of a sale order, and it "would not unduly frustrate the reasonable expectations of the participants or compromise the integrity of the process," but rather, would result in a financial gain for the estate and its creditors. *See Corporate Assets, Inc. v. Paloian*, 368 F.3d 761 (7th Cir. 2004) (affirming district court and bankruptcy court decisions to reopen auction to consider new bid that was 9% higher based on a flaw in the auction process concerning the debtor's failure to communicate certain information to all parties during the auction) (citing *FNN*, 980 F.2d at 170; *In re Food Barn Stores, Inc.*, 107 F.3d 558, 565 (8th Cir. 1997)).

Another reason to reopen an auction is to hear evidence concerning the value of non-cash components of a bid. *FNN*, 134 B.R. 737, 742 (S.D.N.Y. 1991) (holding bankruptcy court appropriately reopened bidding, especially where earlier proceeding "had seen considerable 'ebb and flow'… which suggest[ed] that both parties understood that the proceeding was not constrained by rigid procedural requirements").

In *FNN*, the Second Circuit supported the reopening of the auction, holding that:

> [T]he involved and somewhat speculative nature of the assets being sold required the bankruptcy court to adopt a fluid bidding process that allowed both parties at various times to amend their offers in an attempt to arrive at a fair valuation of the assets. There was, according to the bankruptcy court, an 'ebb and flow' throughout the auction, which 'required each participant to tack with the change of the wind.' In [the Second Circuit's] view, this process best balanced the competing considerations of finality in the bidding process and fairness to the bidders against the interests of creditors in securing the highest sales price. There are cases where the bankruptcy court's discretion must be sufficiently broad so that in making its decision it can compass these competing considerations as best it can.

In re Financial News Network Inc., 980 F.2d 165, 170 (2d Cir. 1992).

Even though it would be helpful to bidders, "there is no requirement that competing purchasers be given precise valuations of the non-dollar components of their bids." *In re Bakalis*, 220 B.R. 525 (Bankr. E.D.N.Y. 1998) (citing *In re Financial News Network Inc.*, 134 B.R. 737 (S.D.N.Y. 1991), aff'd 980 F.2d 165 (2d Cir. 1992)).

Practice Tips

In cases where bids include significant non-cash consideration or a disputed secured claim, the estate should consider conducting the auction in the presence of the bankruptcy judge, or seek pre-auction direction from the court to ensure auction participants understand the operative value of bids, and bid terms. *See, e.g., In re Bigler, LP*, 443 B.R. 101, 116 (Bankr. S.D.Tex. 2010) (suggesting "that the most appropriate approach to maximizing value for the estate — and also the soundest method of maintaining confidence in the system — is to hold auctions in the courtroom, on the record, with the [c]ourt serving as auctioneer"). This allows competing bidders to bid on an "apples to apples" basis. It also encourages bidders to participate in auctions because it increases transparency and valuation consistency.

Bidders should also consider raising valuation issues before the auction procedures are approved, or during the auction, whether or not the auction is held before the court. In the end, bankruptcy judges want to bring value into the estate, and will use their equitable powers to do so where appropriate and justifiable.

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Bankruptcy Code Section 1113 Trumps NLRA

By Francis J. Lawall, Henry J. Jaffe and Michael J. Custer

A significant problem confronting many debtors seeking to reorganize through Chapter 11 involves the resolution of labor contract issues. A recent decision from the U.S. Court of Appeals for the Third Circuit will likely impact how that problem is solved by debtors teetering on the brink of, or already in, Chapter 11 where their operative collective bargaining agreement has or soon will expire. Deciding an issue of first impression, the Third Circuit in *In re Trump Entertainment Resorts*, 2016 U.S. App. LEXIS 672 (3d Cir. Jan. 15, 2016), affirmed a bankruptcy court's determination that Section 1113 of the Bankruptcy Code allows a debtor to reject the continuing terms and conditions of an expired Collective Bargaining Agreement (CBA). In so holding, the court effectively determined that the policies and goals underlying Section 1113 override the countervailing requirements of the National Labor Relations Act (NLRA), which otherwise prohibit an employer from unilaterally changing the terms and conditions of a CBA, even after expiration.

The Case

The facts in *Trump* tell the familiar story of the crisis conditions that have enveloped many Atlantic City, NJ, casinos. The debtors own and operate the Trump Taj Mahal, which has nearly 1,500 unionized employees, most of whom are represented by the appellant, Unite Here Local 54. The union and the Taj Mahal were parties to a CBA, the term of which initially went through Sept. 14, 2014, but thereafter continued on a year-to-year basis unless either party gave 60 days' notice of its intent to terminate, modify or amend. In early 2014, the debtors sought to renegotiate the CBA due to the casino's deteriorating financial condition. Those negotiations failed to result in a modified contract prior to the debtors' September 2014 bankruptcy. Immediately after filing, the debtors requested an extension of the CBA's term, which the union refused, resulting in the CBA's expiration a few days later.

Thereafter, the debtors filed a motion pursuant to Section 1113 of the U.S. Bankruptcy Code to reject the CBA and implement the terms of the debtors' last proposal to the union. Section 1113 governs the procedures by which a debtor may assume, reject or modify a CBA, providing that a debtor may reject a CBA if the bankruptcy court determines that: 1) the debtor has made a proposal that provides for modifications necessary to permit the reorganization; 2) the employees' authorized representative has refused to accept the proposal without good cause; and 3) the balance of the equities clearly favors rejection of the agreement.

The bankruptcy court granted the debtors' motion to reject and implement, finding that the debtors satisfied the requirements of Section 1113. The court noted the uncontroverted evidence that the debtors would have to liquidate if the relief was not granted, and concluded that the union was clearly not focused on reaching agreement. Most importantly, the bankruptcy court held that while Section 1113's text does not explicitly grant the court authority to implement the terms of the debtors' last proposal to the union, a debtor-in-possession is authorized to implement changes to the terms and conditions of employment that are included in the Section 1113 proposal approved by the bankruptcy court.

The Appeal

On direct appeal to the Third Circuit, the union challenged whether a bankruptcy court may permit rejection of an expired CBA under Section 1113. The Third Circuit recognized that the statutory schemes of both the Bankruptcy Code and the NLRA were implicated. Turning first to the plain language of Section 1113, the court observed that it does not mention the continuing obligations imposed by the NLRA, nor does it restrict its prescription to executory or unexpired CBAs. The court rejected the union's argument that the plain meaning of the term "collective bargaining agreement" as used in Section 1113 is a contract between an employer and a labor union, and because the CBA had expired, there was no "contract" to be rejected. The court declined to engage in what it called "a hyper-technical parsing of the words and phrases that comprise Section 1113."

The Third Circuit then turned to the context in which Section 1113 was enacted. The court noted that it was enacted in response to the U.S. Supreme Court's decision in *National Labor Relations Board v. Bildisco & Bildisco*, 465 U.S. 513 (1984), in which it was held that it was not an unfair labor practice for an employer to unilaterally change the terms of a CBA after filing for bankruptcy but before the court approved the rejection of the CBA. According to the Third Circuit, Congress passed Section 1113 in response to *Bildisco* to prohibit unilateral changes in debtors' CBAs without bankruptcy court approval. Section 1113, the court stated, "balances the concerns of economically-stressed debtors in avoiding liquidation and the unions' goals of preserving labor agreements and maintaining influence in the reorganization process." Unlike Section 365 of the Bankruptcy Code, which does not constrain a debtor's rejection of burdensome executory contracts, Section 1113 prescribes strict procedural and substantive requirements before a CBA can be rejected. The section was designed to

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foreclose all but the essential modifications integral to a successful reorganization, and in requiring compliance, its strict requirements, the court reasoned, "Congress sought to ensure that, when the NLRA yields to the Bankruptcy Code, it does so only for reasons that will permit the debtor to stay in business."

Addressing the facts of the debtors' case, the court concluded that rejection of the debtors' continuing labor obligations under the expired CBA was necessary to permit reorganization. To avoid liquidation, the debtors moved to reject the CBA, and their proposed modification of the CBA included over $14.5 million in annual savings. In response, the court noted, "instead of negotiating with the debtors, the union stalled the bargaining session, engaged in picketing, and attempted to harm the debtors' business." The court also observed that the debtors' plan of reorganization was contingent on rejection of the CBA.

The court concluded that the intent of Congress was to incorporate expired CBAs in the language of Section 1113, and when the debtor's statutory obligations to maintain the status quo under the terms of an expired CBA will undermine the debtor's ability to reorganize and remain in business, the bankruptcy court must review and decide on the necessity of a proposed modification. The court rejected the union's argument that because a debtor cannot assume or reject an expired contract under Section 365 of the Bankruptcy Code, it cannot reject an expired CBA under Section 1113. The court concluded that there is an important distinction between a CBA and any other executory contract: the key terms and conditions of a CBA continue to burden the debtor after the agreement's expiration.

The court reasoned that allowing a debtor to reject its continuing obligations under an expired CBA is consistent with the Bankruptcy Code's purpose of giving debtors latitude to restructure their affairs. According to the court, Section 1113 furthers the Code's rehabilitative policies by permitting debtors to restructure their labor obligations, and to hold that expired CBAs cannot be rejected under it would impede the Code's overriding goal. Under the policies of bankruptcy law, the court further noted that it is preferable to preserve jobs through the rejection of a CBA, as opposed to losing the positions permanently by requiring the debtor to comply with the continuing obligations set out by the CBA. The court found that in light of Chapter 11's overarching purposes and the exigencies the debtors faced, the bankruptcy court did not err in granting the debtors' motion to reject the CBA.

Conclusion

The Third Circuit's decision in *Trump* is certain to have an impact on negotiations between debtors and labor unions where their CBA is likely to expire post-petition. With the Third Circuit's determination that such expiration does not preclude a debtor's ability to reject the agreement's continuing obligations under a CBA, and impose the terms of its last offer, debtor-employers appear to have gained some additional leverage in seeking modification of a CBA's terms from labor unions.

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Structured Dismissals

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Business Credit Inc. (*In re Jevic Holding Corp.*), 787 F.3d 173 (3d Cir. 2015), prepetition, Sun purchased Jevic, a trucking company, through a leverage buy-out funded by CIT. On the eve of filing for Chapter 11, Jevic ceased its operations and gave termination notices to its employees. As of the petition date in 2008, Jevic owed $53 million to CIT and SUN as secured creditors, and over $20 million to taxing authorities and general unsecured creditors. Two lawsuits were filed during the bankruptcy case. One was from a group of truck drivers against Jevic and Sun. alleging violations of the Worker Adjustment and Retraining Notification Act (WARN) for failure to provide adequate termination notice. The truck drivers wanted $12.4 million in damages, $8.3 million of which they asserted was entitled to priority under section 507(a)(4) of the Bankruptcy Code (for wages, subject to a cap per employee, earned within 180 days prior to the petition date). The other was from the official creditors' committee, on behalf of Jevic's estate, against Sun and CIT seeking to avoid the leverage buyout transactions.

In March 2012, Jevic, CIT, Sun and the creditors' committee negotiated and sought court approval of a settlement under Bankruptcy Rule 9019. Critically, at that time the only assets remaining in Jevic's estate was $1.7 million in cash subject to Sun's lien and the creditors' committee's avoidance action. The settlement provided:

- For a full exchange of releases among the settlement parties.
- That CIT would pay $2 million into an account to pay Jevic's and the Committee's legal fees and other expenses.
- That Sun would assign its $1.7 million lien to a trust that would pay tax and administrative creditors and then general unsecured creditors (who would receive a 4% recovery) on a priority basis.
- For dismissal of the case, which was structured insofar as it implemented the settlement.

The drivers objected on two primary grounds. They argued that the

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settlement constituted a "structured" dismissal ("structured" as it provided for the distribution of assets and resolution of certain issues), which were not authorized by the Bankruptcy Code. Moreover, the dismissal distributed assets to junior general unsecured creditors, even though the drivers' senior priority claims would go unpaid.

The bankruptcy court approved the settlement and structured dismissal and the district court affirmed on appeal. The drivers appealed again to the Third Circuit. The court affirmed (on a 2-1 vote) and issued a detailed opinion.

The Third Circuit noted that there was no dispute that a court could dismiss a Chapter 11 case for cause under section 1112(b)(1) of the Bankruptcy Code. Rather, the issue was whether dismissals could be "structured," "at least to the extent that they deviate from the priority system of the Bankruptcy Code in distributing estate assets." *Jevic*, 787 F.3d at 180. The court held that "bankruptcy courts may, in rare instances like this one, approve structured dismissals that do not strictly adhere to the Bankruptcy Code's priority scheme." *Id.* In upholding the dismissal of the case, the Third Circuit observed that the Bankruptcy Code prohibited a structured dismissal when there is a "showing that a structured dismissal has been contrived to evade the procedural protections and safeguards of the plan confirmation or conversion [to Chapter 7] process." *Id.* at 181.

Next, the court analyzed settlement principles under Bankruptcy Rule 9019 in determining whether the structured dismissal could go outside the Bankruptcy Code's priority scheme. The court held that settlements must be "fair and equitable," which does not mean that the Bankruptcy Code and the Bankruptcy Rules "extend the absolute priority rule to settlements in bankruptcy." Yet, the underlying policy of the rule "ensuring the evenhanded and predictable treatment of creditors — applies in the settlement context." *Id.* at 184. The Third Circuit thus held that bankruptcy courts could deviate from the priority scheme of section 507 of the Bankruptcy Code, only with "specific and credible grounds to justify [the] deviation." *Id.* (quoting *In re Iridium Operating LLC*, 478 F.3d 452, 466 (2d Cir. 2007). *Id.* Although a "close call," the deviation was justified because there was no prospect of plan confirmation and the alternative would have been a conversion to Chapter 7 and the secured creditors taking the remaining assets in "short order." *Id.* In that situation, the drivers would have received nothing, and as found by the bankruptcy court, there was "no realistic prospect" of a meaningful distribution to unsecured creditors. Thus, the settlement and the structured dismissal "remained the least bad alternative." *Id.* at 185.

Credit Bidder's Settlement Payment Not Property of The Estate

LifeCare Holdings, Inc.(n/k/a ICL) filed for Chapter 11 protection as a struggling operator of long-term acute care hospitals. It had roughly $484 million in debt, of which $355 million was secured and was in need of capital. In an attempt to sell its business, it received seven bids. The highest came in at approximately 80%-85% of the secured debt. Because there was no suitable buyer, the secured lender issued a credit bid of $320 million, and agreed pay LifeCare's's legal, accounting wind-down fees, and creditors' committee fees. The lenders directed cash funds totaling $1.8 million (the "Escrow Funds") into escrow accounts to cover the fees, with the excess amounts to be returned to the lender.

The creditors' committee objected on the grounds that the transaction was a "veiled foreclosure." The United States government objected because the sale would have given rise to an estimated $24 million capital gains tax liability, as an administrative expense claims that would go unpaid, even though other administrative expense claims (professional fees) would be paid.

The lender resolved the creditors' committee objection by agreeing to deposit $3.5 million in trust (the "Settlement Proceeds") for the benefit of general unsecured creditors. The settlement gave rise to an additional government objection: that creditors would receive distributions on account of general unsecured claims that were lower in priority than the government's unpaid tax claim. The bankruptcy court approved the sale and committee settlement over the government's objection.

The Third Circuit affirmed in *In re ICL Holding Company, Inc.*, 802 F.3d 547 (3d Cir. 2015). The government's primary argument was that the Escrow Funds and the Settlement Proceeds were property of the estate that were being distributed outside of the plan. The court disagreed, observing that the Settlement Proceeds were not property of the estate, proceeds of the liens, or lender collateral. The Settlement Proceeds were not given as consideration for the assets, but were paid by the secured lender to withdraw the objection as an obstacle to completing the transaction. As for the Escrow Funds, the government took the position that it constituted the cash paid to LifeCare. But the court noted that LifeCare transferred its cash to the lender under the purchase agreement, and that excess amounts would be returned to the lenders. *ICL*, 802 F.3d at 556. Because the Escrow Funds were funded by purchaser's property with its own funds, the payments were not property of the estate. In *dicta*, the Third Circuit indicated that the government may have had an argument that the Escrow Funds were estate property if they were a carve-out of collateral rather than lender property.

What This Means

Taken together, the *Jevic* and *ICL* decisions approve flexibility based on the circumstances and needs of

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Structured Dismissals

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a case. Where a Chapter 11 plan is unlikely to be confirmed or beneficial, say where the senior secured creditor is out of the money as in *ICL*, these circuit-level decisions clear paths to allow for structured dismissals and distribution of the secured lender's purchase and settlement proceeds outside of the Bankruptcy Code's priority scheme and provide room at the table to unsecured creditors who may otherwise be out of the money.

In the early days of the Bankruptcy Code, parties generally presumed that a reorganization through Chapter 11 plan was the "gold standard" to achieve in a case. The plan process was preferred and carried the hallmarks of a fair outcome: a priority scheme, a best interests of creditors test, and, most importantly, an opportunity to vote on the plan transaction and distributions with supermajority rules. A section 363 sale promised none of those things. Instead, a party could merely object to a proposed transaction and if that objection was overruled, the transaction moved forward and proceeds came into the estate. Because a section 363 sale resolved *the debtor's business issues* and liquidated estate proceeds outside of a plan, parties generally viewed section 363 sales as illegal *sub-rosa* plans.

Then came *In re Lionel Corp*. In *Lionel*, the U.S. Court of Appeals for the Second Circuit held that a debtor could undertake a section 363 sale, where it could demonstrate that it exercised sound "business judgment." The Second Circuit provided a non-exhaustive list of considerations, including the likelihood reorganization, the elapsed time since the filing and the effect of the proposed disposition on future plans of reorganization.

Over time, it became regular practice for getting transctions done in many cases. As the *ICL* opinion properly and succinctly observes, "[i]n modern bankruptcy practice [a section 363 sale] *is the tool of choice* to put a quick close to a bankruptcy case. It avoids the time, expense, and, some would say, the Bankruptcy Code's unbending rules." *ICL*, 802 F.3d at 549. (emphasis added).

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The Chapter 11 plan process remains the ideal, but it simply cannot work for many situations. The voting process invites minority or special interest stakeholders to hold up transactions that might be beneficial for creditors of a whole. Lenders will not advance DIP financing or consent to cash collateral unless they have assurances that a process will run on a tight timeline, with a tight budget and strict milestones. The 2005 amendments to the Bankruptcy Code reduced to 210 days the time in which one can assume and assign a commercial real property lease without landlord consent. Moreover, when a secured lender is out of the money, there may not be the funds necessary to meet the Chapter 11 plan requirements, such as payment of administrative claims.

What are the options? On one hand, strict adherence to the Chapter 11 formality has the benefit of ensuring that creditors will be treated according to anticipated priorities. On the other, few are prepared to fund the plan process and more practically, many cases simply cannot confirm a plan.

Official (and even unofficial) committees have become increasingly important to the process so that there is some form of "check" on the process and so there is a party to investigate and if advisable negotiate and settle, which are hallmarks of the Chapter 11 process.

Bankruptcy judges are often faced with a decision: consider a post-section 363 sale structured dismissal, Rule 9019 settlement, or direction of purchaser proceeds to go forward — or to strictly adhere to the principles of the Code. In some jurisdictions, they have recognized that the latter can be a hollow victory. Perfection often becomes the enemy of the good: Insistence on a Chapter 11 plan can mean destroying a deal, with no value to creditors and, often, the risk of termination of employees.

Through *ICL* and *Jevic*, the Third Circuit has shown that it understands this conundrum that practitioners and bankruptcy courts often face and provides pathways for dealing with these issues. The *Jevic* decision relied significantly on the Second Circuit's *Iridium* opinion and rejected a decades-old decision from the U.S. Court of Appeals for the Fifth Circuit: *In re AWECO, Inc*., 725 F2d 293 (5th Cir. 1984). In *AWECO*, the Fifth Circuit rejected a settlement as not "fair and equitable" that would have transferred assets outside of the Code's priority scheme. Questions remain as to what extent other circuits follow *Jevic* and whether the Fifth Circuit revisits its decision.

Questions also remain whether proposed changes to the Bankruptcy Code will allow it. The ABI Chapter 11 Commission Report envisions a so-called section 363(x) sale, which would incorporate certain creditor protections of a plan into sale process. Only time will tell how these issues continue to evolve.

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