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Feature

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Rounding the Square Peg

Clarifying the Jurisprudence of the Sale Model of Chapter 11

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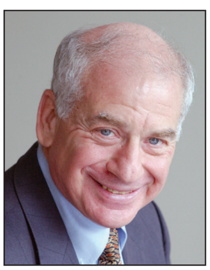

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A number of commentators, including the authors, have noted how the typical chapter 11 case of an operating business has transformed over time. Chapter 11 was designed to give businesses a chance to resolve operational and financial issues while temporarily protecting them from creditors' actions, with an overall resolution that was driven by legal principles and effectuated through a reorganization plan. The right to appeal a plan-confirmation order was limited in order to encourage finality, but § 1129 of the Bankruptcy Code includes numerous protections for all stakeholders in a case.

How things have changed: Chapter 11 has morphed via so-called § 363 sales into an efficient, numbers-driven means of transferring value from existing owners to creditors.[1] The § 363 sale is now "the tool of choice to put a quick close to a bankruptcy case. It avoids time, expenses and, some would say, the Bankruptcy Code's unbending rules."[2] Speedy resolution of an entire case following a sale has been furthered by the liberal use of § 363(m) and general doctrines of mootness to limit appeal.

The "off-label" use of § 363 has led to many issues, not the least among them being the "mission creep." Over time, parties began asking bankruptcy judges to sign off on sale-approval orders that included provisions that the Code contemplated would be included in reorganization plans, *e.g.*, terms governing validity of secured claims, distributions of proceeds and priority and payment of creditors, application of the absolute priority rule, executory contracts, employee issues, releases, settlements, post-sale administration, litigation claims and other matters.[3]

When confronted with an appeal relating to one of these "363 on steroids" sale orders, district courts tended to use the broader, § 1129-type concept of mootness instead of the more limited § 363 version. In turn, this resulted in cases being resolved on a global basis, largely impervious to appeal, without consideration of any of the distribution, operational and other fairness tests embedded in § 1129. Until recently, there were very few appellate decisions as to the limits, if any, of § 363, and how far mootness protections can go. This dearth of appellate authority has led to uncertainty, which has begun to abate as a result of a number of recent decisions by the Third Circuit. This article discusses these developments.

Equitable Mootness

While both §§ 363 and 1129 contain provisions designed to promote finality of transactions and render appeals moot, the protections afforded by § 363(m) apply only to the purchaser, whereas those contained in § 1129 cover the entire transaction and the parties involved. This makes sense because § 363 was never intended to function as a road map for the overall resolution of a chapter 11 case; that is § 1129's job. In recent years, courts have begun to focus on both the broad dimensions of the concepts of equitable mootness and on how far sale orders can really go to limit appellate review. Thus, the Third Circuit has "reversed findings of equitable mootness or declined to dismiss appeals as equitably moot no less than seven times since the Continental Airlines mootness decision."[4]

1 *See, e.g.*, J. Landers, "The Changing Face of Chapter 11 for Large Operating Businesses," 8 *Pratt's J. of Bankruptcy Law* 99 (2012). *See also* Written Statement of Kathryn Coleman, TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 6-7, (Nov. 3, 2012), *available at* commission.abi.org.

2 *In re ICL Holding Co.*, 802 F.3d 548, 549 (3d Cir. 2015).

3 The Final Report and Recommendations of the ABI Commission to Study the Reform of Chapter 11 (the "ABI Commission Report") sets forth the Commissioners' extensive discussions of the development of § 363 sale practice. The Commission's concerns about the rushed timing of many such sales, together with the lack of protections that are mandatory in the plan confirmation context, resulted in the Commission's recommendation that sales of substantially all of a debtor's assets be subject to a moratorium lasting 60 days from filing. ABI Commission Report at 83-87.

4 *See One2One Commc'ns LLC*, 805 F.3d 428, 436 (3d Cir. 2015); *id.* at 439, 445, 446-47 (Krause, J. concurring).

Two cases in particular are worthy of mention as standing in the way of the steamroller of mootness. In the *One2One* case, the Third Circuit tackled the view that appellate mootness precludes review of a transaction that is substantially consummated and concluded that it does not, unless granting the relief would "fatally scramble the plan and/or significantly harm third parties who have justifiably relied on the plan's confirmation."[5] Although the opinion did not set forth a set of specific factors in applying this standard, it suggests that reviewing courts should conduct a detailed analysis of the likely impact of a successful appeal and not rely on generalities and legal argument.[6] Indeed, the appellate court even had a moralistic component — *i.e.*, the case was simple and straightforward, there was minimal third-party reliance, the debtor may have manipulated the process to invoke equitable mootness, and the plan did not involve "intricate transactions but those that transpired in 'almost any bankruptcy' where there was no stay."[7]

In the *ICL Holdings* case, the Third Circuit took on the super-sized sale order. The court noted that § 363(m) only protects the sanctity of the transfer to a good-faith purchaser. It does not moot review of "'every term that might be included in a sale agreement,' even if each is technically 'integral to that transaction.'" Finality and predictability also do not prevent review "at all costs and certainly not for non-purchasers."[8] This clearly opens the door to widespread review of many aspects of § 363 sales. The prospect of meaningful appellate review was the only effective antidote to overly inclusive sale orders, because without such review, courts' attempts to limit the scope of sale orders were met by purchasers' statements that absent broad protections, they simply would not participate.

Clarifying the availability of appellate review has had several important consequences. For one, it has, at least in part, removed a nagging *Stern v. Marshall* issue as to whether any bankruptcy order can be final without parties' having the right to seek review by an Article III judge.[9] For another, it mandates more-nuanced analysis of § 363(m) and equitable-mootness arguments on a case-by-case basis. However, the main consequence has been generally to validate the § 363 sale process as it has evolved, to discourage overreaching to resolve some very troublesome issues and to offer a primer for future cases. By providing the backup of appellate review of most provisions of the sale order, these decisions have also taken considerable pressure off bankruptcy judges, which is big news.

Recent Developments

The Absolute Priority Rule

The absolute priority rule has virtually unassailable status in bankruptcy law, and many courts — including the Second and Third Circuits — have policed plans to present evasion, even when the debtor was insolvent, senior secured creditors were undersecured and had liens on all assets, and no funds were available to junior creditors. In so doing, they have rejected the "no harm/no foul" rule in favor of legal purity.[10] However, the reality of many bankruptcy cases is that (1) there are possible grounds to attack the claims of the senior lenders; (2) junior creditors and creditors' committees have substantial nuisance-making power; and (3) there are no free funds available to pay junior creditors what is euphemistically called "a tip."

Section 363 is being used in ways never contemplated by the drafters of the Bankruptcy Code.

In plan-confirmation cases, the resulting logjam might be broken by proposing payments to junior creditors to be approved by class votes of the affected creditors, but in § 363 sales, such procedures are not available. In the *ICL* case, the Third Circuit not only solved the problem, but gave the parties some helpful hints.[11] An undersecured creditor with a security interest in all of the debtor's assets bought the operating business by a credit bid in a § 363 sale and, as part of a settlement, set up separate funds, held in escrow, to pay certain administrative expenses and general creditors. The U.S., as a creditor objected, claimed an administrative tax with priority over the general creditors' fund. Despite counsel for the creditors' committee stating that the purpose of the settlement was to allocate sale proceeds — which, of course, would be property of the estate — the court declined to elevate form over substance, found that the escrowed funds were not property of the estate, and praised the settlement as facilitating a smooth post-sale transition. The message is clear: Even in a cashless credit bid sale, it is possible to not comply with the absolute priority rule — if you do it right.

Dismissal of a Case

Most of the activity in a typical § 363 sale case involves the sale, and once it is done, there is not much left to do (and little or no money left to do it with). The obvious solution is to dismiss the case, but the Bankruptcy Code seems to require a liquidating plan. In *In re Jevic Holding Corp.*,[12] the secured creditor had a security interest in all of the debtor's assets, and virtually all assets were liquidated except for a litigation claim against the lender and there were no funds to prosecute it. The solution was a "structured dismissal" — a dismissal of the case together with an agreement to settle various issues, and the establishment of a fund to pay certain administrative claims and unsecured creditors. Alas, there was to be no distribution on account of a union's claims under the Worker Adjustment and Retraining Notification Act, which were entitled to either priority or equal treatment with other unsecured creditors (obviously not permitted in either a chapter 11 plan or a chapter 7 liquidation). The court held that (1) the structured settlement was permitted (even though this was a "rare" instance) and a liquidating plan not required; (2) the payment to unsecured creditors was permit-

5 *See In re Semcrude LP*, 728 F.3d 314 (3d Cir 2013); *In re Tribune Media Co.*, 799 F.3d 272 (3d Cir. 2015); *One2One*, *supra* n.3.

6 *One2One*, *supra* n.3, at 434, 437, 439, 453. The opinions in n.5 strongly imply that only true third parties, persons providing real new money, or situations requiring a massive undoing of the reorganization are required, and simply disappointed expectations are not enough.

7 *Id.* at 436-37; *id.* at 445-47 ("encourages" opportunistic plan proponents to prevent any review of confirmation order) (Krause, J., concurring).

8 *ICL Holdings*, *supra* n.2, at 554.

9 *Compare* the majority and concurring opinions in *One2One*, 805 F.3d at 433, 444-45.

10 *See In re Armstrong World Indus. Inc.*, 432 F.3d 507 (3d Cir. 2005) (equity recovery not permitted); *In re DBSD N. Am. Inc.*, 634 F.3d 79 (2d Cir. 2011) (junior creditor recovery not permitted).

11 *ICL Holdings*, *supra* n.2.

12 787 F.3d 173 (3d Cir. 2015).

ted because it was part of a settlement, and settlements are not subject to the absolute priority rule; and (3) there was no other choice. A dissent by Judge Anthony Scirica noted that the sale was tied to a settlement of claims against the purchaser (secured creditors of Jevic) and that this claim was property of the estate.[13] In short, a § 363 sale, followed by a structured dismissal because the estate lacks funds, is now a permitted practice.

Classification and Equal Treatment

The *Jevic* case involved another feature common in § 363 sales: different classification and treatment of similarly situated creditors. The court discussed whether a settlement must comply with Code priority rules and the potential for abuse, and said that although settlements ordinarily should comply with Code priorities, this is not absolutely required, and that *Jevic* was a "close call" since there was no alternative. The sharp dissent from Judge Scirica disagreed because the purchaser refused to permit the union to participate in the settlement, a practice that priority and classification rules were designed to prevent.

In her concurrence in *One2One*, Judge Cheryl Ann Krause expressed great concern with the equitable-mootness rule in situations involving agreed discrimination. Again, these kinds of special deals are a common feature of § 363 sales and have now been sanctioned. In addition, the notion that a settlement can facilitate transactions not otherwise permitted in a reorganization plan is somewhat troubling, and using a settlement approval to circumvent other provisions of chapter 11 is a potential loophole wide enough to drive a truck through.[14] In short, coupling the § 363 sale power with the settlement authority grants extremely broad power to the bankruptcy court to allow and sanction the adoption of rules and procedures that are sharply at variance with the bankruptcy law.

Releases

A typical § 363 sale involves participation by existing lenders who are undersecured and often have "everything," a debtor in possession by or with the consent of the existing lenders, and the debtor's management. These parties have substantial control over the terms of the price and sale, especially, as in *Jevic*, where despite an active sale process, the obtainable price is well below the amount of the secured debt. But also commonly, there is pending or threatened litigation by committees or individual creditors against the lenders, shareholders and management on various avoidance, breach of fiduciary duty and other grounds.

As part of a § 363 sale, as in *Jevic*, the lender/buyer, shareholder and management seek to settle such issues and obtain a release. To do so, even though the lenders have liens on everything, they often provide funds for administrative expenses and something for unsecured creditors, and obtain the release. If everyone agrees, this does not present an issue. However, such transactions involve considerable potential for abuse, especially when the release is a third-party release, which prevents creditors and others from seeking remedies against third parties. Moreover, even if creditors are receiving equal treatment, the release may have disparate effects on the rights of such creditors.

Courts have always been uncomfortable with the issues implicated by releases, especially of insiders and co-obligors. First, does the court have the power to approve them at all? In *In re Millennium Lab Holdings II LLC*,[15] the court approved a prepackaged plan with such releases, noted a split of authority in Delaware on this very issue and certified the issue for direct appeal. This is obviously a crucial element of § 363 sales, which might now be clarified and resolved. Second, how much diligence must the parties and the court exercise prior to approving such releases? In *Jevic*, the court cited settlement-approval cases and the process of approval, but the authors believe that the process is often perfunctory. Courts' willingness to approve releases that might not be approved in the plan-confirmation context is another example of the way that sale power, coupled with settlement authority, deals with a critical loose end.

Conclusion

Section 363 is being used in ways never contemplated by the drafters of the Bankruptcy Code. To the extent that the result is lower costs and greater efficiency, that is all to the good — but those benefits should not be at the expense of the carefully crafted protections inherent in plan confirmation. abi

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13 The parties to the *Jevic* case have filed a *writ of certiorari* to the U.S. Supreme Court, which is pending.

14 In a non-precedential decision in the Third Circuit, the court held that a tender offer conducted in the *Energy Future* case, which would not have passed muster outside of the bankruptcy context, was appropriately sent to stakeholders even prior to the bankruptcy court's approval, and that both the lack of prior approval and the fact that identically situated classes were treated differently were acceptable in the context of a settlement. *Delaware Trust v. Energy Future Holdings Corp. (In re Energy Future Holdings Corp.)*, 15-1591 (3d Cir. May 4, 2016). *See In re Covenant Partners LP*, 541 B.R. 804 (Bankr. E.D. Pa. 2015) (Securities and Exchange Commission settlement permits payments to shareholders); *In re Age Refining Inc.*, 801 F.3d 530 (5th Cir. 2015) (settlement without considering possible sale price of assets); *In re LPN Healthcare Facility Inc.*, 531 B.R. 730 (Bankr. S.D. Ohio 2015) (settlement did not comply with absolute priority rule).

15 2016 WL 155500 (Bankr. D. Del. 2016).