Going, Going, Gone: Increased Use of Chapter 11 to Quickly Sell Business Assets

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Increasingly, struggling businesses are opting to use Chapter 11 bankruptcy as a vehicle to sell substantially all of their assets. This is because Chapter 11 debtors can sell assets under uniquely buyer-friendly conditions. The last several years have revealed a clear trend in favor of quick liquidation by sale motion. As businesses continue to falter and fail due to the continuing financial crisis, it is likely that liquidations by Chapter 11 sale motion will continue to gain popularity. This article examines the increased use of bankruptcy sales as a means to quickly liquidate a debtor's assets.

Why Bankruptcy?

In today's strained economic conditions, many businesses can no longer operate profitably and are unable to obtain financing to cover operating shortfalls. The only viable options are a going-concern sale of all of the company's assets or shutdown followed by liquidation.

Chapter 11 creates a unique opportunity for buyers and sellers of business assets. Some of the benefits are:

- the automatic bankruptcy stay can operate as a shield against creditors pending approval of the sale
- ability to preserve the "going-concern" value of the business pending the sale
- protections are available to lenders willing to fund postpetition operations pending a sale
- transferred assets can be free and clear of liens, claims and encumbrances – a powerful incentive for potential buyers
- possibility that initial bidder can receive court approved expense reimbursement and a break-up fee in the event that that buyer is outbid by a competing bidder

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- purchase of assets can happen without fear of fraudulent transfer claims following the sale

As referenced above, one of the most attractive reasons to buy and sell assets via Chapter 11 bankruptcy is the fact that the Bankruptcy Code permits buyers to purchase assets free and clear of liens, claims and encumbrances so long as certain conditions are met. The authority for "free and clear" bankruptcy sales is found at §363 of the Bankruptcy Code.

The Shift From Plan to Motion

Chapter 11 asset sales can happen by motion or by reorganization plan. Sale motions were traditionally used for the sale of discreet assets while the sale of all assets of a debtor was accomplished by reorganization plan. In recent years, sale of all assets by motion has steadily been gaining popularity among debtors and buyers.

In the Sixth Circuit, the Court paved the way for §363 sales of all of the debtor's assets in *Stephens Industries, Inc. v. McClung*, 789 F.2d 386 (6th Cir. 1986). In *Stephens Industries*, the Court concluded that a bankruptcy court may authorize the sale of all of the debtor's assets under §363(b)(1) so long as the sale is justified by a "sound business purpose." *Id.* at 390.

Speed is the primary reason for this trend. When the debtor's business is in extreme distress it may not be able to survive long enough to enable the sale to happen via plan whereas a sale by motion can happen fast. In addition, the lengthy timeframe and potential for expense and uncertainty inherent in the plan process may scare away otherwise interested buyers.

The rise in the use of sale motions to sell all of the debtor's assets in Chapter 11 may also be attributable in part to the fact that the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) makes it more difficult to confirm a Chapter 11 plan. In particular, BAPCPA contains more rigid timeframes for confirmation and lease rejection. It also creates a new administrative claim for suppliers of goods during the 20 days prior to the petition date and those claims can make it impossible for some debtor's to satisfy their administrative expense obligations.

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Thus, under BAPCPA many debtors will simply be unable to survive long enough to make it to plan confirmation and must turn to faster methods to accomplish the sale of assets.

How It Works

Motions to sell all or substantially all of the debtor's assets are met with heightened scrutiny because the sale will end the debtor's postpetition income stream and dispose of the most valuable assets. A sale motion will typically ask the court to establish procedures for the sale that will be approved before the sale itself is conducted. The complexity of the procedures will vary depending on the nature of the assets to be sold, and the sale itself might happen by private sale or public auction.

When sale procedures are established, the procedures typically allow a specified timeframe for notice to potential buyers and marketing efforts aimed at generating buyers. The procedures will also govern the method by which interested parties may bid on the assets. If competing bids are timely and properly received, the debtor will choose the highest and best offer based on the pre-approved sale procedures. The debtor will return to the court to present the highest and best offer and to seek approval of the sale to that buyer. Even when sales happen on shortened notice, the foregoing procedures are generally followed.

When Quick Is Not Quick Enough

When time is truly of the essence, the sale must happen on an expedited basis. Expedited sale motions are often necessary because the debtor is (or soon will be) unable to meet its operating expenses. Commentators agree that as the economic crisis continues, more and more debtors will seek to sell all assets quickly in the early days of the Chapter 11 case.

Expedited sales can create tension between the parties in interest. The debtor – often in conjunction with the buyer and the senior secured lender – will argue that the sale must happen quickly in order to minimize costs to the estate and to maximize the value of the assets. Sometimes, the debtor can demonstrate that its

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operating cash is rapidly dwindling and that it will be unable to continue to operate long enough to allow the sale to proceed on a non-expedited timeframe. That argument, if true, can be difficult to rebut. Other creditors, including the Official Committee of Unsecured Creditors (the "Committee"), may have an incentive to slow down the process in order to make certain that the sale is, indeed, in everyone's best interest.

Even under the most pressing expedited conditions, the debtor must give careful consideration to establishing a record before the court that clearly supports the debtor's position that 1) the sale is in the reasonable business judgment of the debtor, 2) the prepetition and postpetition marketing efforts were thorough and adequate, 3) that the offer is the best possible offer available, 4) that the proposed sale is an arm's length transaction and 5) that all due process and noticing requirements have been met.

The Bankruptcy Court for the Middle District of Tennessee recently relied on the *Stephens Industries* "sound business purpose" test in denying a debtor's expedited sale motion. *In re Barnhill's Buffet, Inc.,* 2008 WL 4489687 (Bankr. M.D. Tenn. Feb. 13, 2008).

In *Barnhills*, the court listed the following factors commonly considered in connection with the "sound business purpose" test:

- a sound business reason or emergency justifies a pre-confirmation sale
- adequate and reasonable notice of the sale was provided to interested parties
- the sale has been proposed in good faith
- the purchase price is fair and reasonable

Id. at *2; *see also, In re Titusville Country Club*, 128 B.R. 396 (Bankr. W.D. Pa. 1991). The *Barnhills* motion failed because the debtor was unable to meet its burden in establishing that a sound business purpose justified the sale. In that case, the Court also found that the debtor failed to prove that notice was adequate and that the sale price was fair and reasonable. Ultimately, the *Barnhills* debtor filed a renewed sale motion that was granted following testimony related to additional marketing efforts and value. *In re Barnhill's Buffet, Inc.,* 07-08948, slip op. at 2-3 (Bankr. M.D. Tenn. Feb. 28,

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2008).

Even the fact that the case will convert to Chapter 7 if the sale is not approved is not always enough to justify the quick sale. The debtor still must to introduce adequate proof as to price, notice and marketing. *See, In re Exaeris, Inc.,* 380 B.R. 741 (Bankr. D. Del. 2008) (Delaware bankruptcy court denied expedited sale of substantially all assets even though the denial would likely result in a conversion to Chapter 7).

Even in light of the proof and notice requirements, expedited sale motions can happen incredibly quickly. Such was the case with the September 2008 sale by Lehman Brothers Holdings, Inc. of assets valued at $47.4 Billion. The Lehman Brothers sale was approved just five days after the Chapter 11 petition was filed. While not a sale of all assets, the Lehman Brothers sale is a good example of how quickly sales can happen so long as the debtor meets its burden of proof.

In short, while imminent shutdown and other exigent circumstances can be factors that weigh heavily in favor of shortened notice for sale motions, the debtor still must demonstrate that the sale meets the applicable factors for sale approval.

Conclusion

As the economy continues to fluctuate and business owners search for exit strategies for their companies, it is likely that more Chapter 11 cases will be filed as a vehicle to quickly accomplish the sale of all assets. Even so, debtors and buyers should be mindful that while Courts are generally more receptive to quick sales of all assets than they were in the past, the debtor still bears the burden of proof that a quick sale is justified under the circumstances.

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