CHAPTER 18? IMAGINING FUTURE USES OF 11 U.S.C. § 363 TO ACCOMPLISH CHAPTER 7 LIQUIDATION GOALS IN CHAPTER 11 REORGANIZATIONS

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I. INTRODUCTION

In the early morning hours of September 15, 2008, Lehman Brothers Holdings, Inc. ("Lehman") filed a petition for protection under Chapter 11 of the United States Bankruptcy Code ("Code").[1] Lehman had survived panics, recessions, depressions, and wars, but it could not survive its own bad bets on the residential real estate market.[2] This action represented the largest bankruptcy filing in the history of the United States by a factor of more than six.[3]

Most participants in and commentators on the events of that mid-September weekend agreed that the federal government's refusal to provide support for a deal between Lehman and another Wall Street bank, as it had for J.P. Morgan acquisition of Bear Stearns & Co. in March, signaled the death knell of the oldest investment bank in the United States.[4] By Sunday evening, September 14, 2008, the final suitor, Barclays PLC ("Barclays"), had walked away from the

[1] Susanne Craig et al., *The Weekend That Wall Street Died—Ties That Long United Strongest Firms Unraveled as Lehman Sank Toward Failure*, WALL ST. J., Dec. 29, 2008, at A1.

[2] Deborah Solomon et al., *Ultimatum By Paulson Sparked Frantic End*, WALL ST. J., Sept. 15, 2008, at A1 ("The decline of Lehman—a storied, 158-year-old firm—occurred in slow motion this year. Heavily exposed to troubled real-estate investments, the firm tried to raise fresh capital, only to be thwarted.").

[3] Carrick Mollenkamp et al., *Lehman's Demise Triggered Cash Crunch Around Globe—Decision to Let Firm Fail Marked a Turning Point in Crisis*, WALL ST. J., Sept. 29, 2008, at A1 ("Lehman's total assets of more than $630 billion dwarf WorldCom's assets when the telecom company filed for bankruptcy in 2002 with assets of $104 billion.").

[4] *See generally* Craig et al., *supra* note 1 (offering a general background of the situation and a play-by-play analysis of the events of September 12-15, 2008).

negotiating table, and a Lehman bankruptcy filing was imminent.[5]

By the end of the week, however, Barclays managed to purchase the United States brokerage and investment-firm—the same assets it had declined to acquire days earlier—from the bankruptcy estate of Lehman for a fraction of the cost and risk it might have borne had the transaction been consummated outside of a bankruptcy court.[6] What could possibly have changed over the course of this short time period to encourage Barclays to go through with the acquisition they had side-stepped so recently? The answer lies in 11 U.S.C. § 363. Once Lehman entered bankruptcy protection, the full menu of the Code options became available to them and their creditors, and § 363 of the Code allows the bankruptcy trustee or the debtor-in-possession ("DIP") to make full use of the assets of the estate, including effectuating a sale of the business, in whole or in part, free and clear of all encumbering liabilities.[7] Making use of § 363(b) and (f) allowed Barclays to acquire the valuable assets of Lehman while shedding the risk of the liabilities associated with those assets which had frightened potential saviors outside of bankruptcy.[8]

[5] *Id.*

[6] Dionne Searcey & Chad Bray, *Crisis on Wall Street: In Lehman Bankruptcy, Judge Peck Packs a Punch—Recently Appointed Magistrate Who Approved a Speedy Deal Now Contends with Creditors*, WALL ST. J., Sept. 29, 2008, at C2 ("Lehman Brothers Holdings, Inc. . . . filed for bankruptcy protection on Sept. 15 . . . . Several days later, at the end of a packed marathon hearing, and over several objections from creditors, Judge Peck approved the sale of Lehman's U.S. brokerage-and-investment firm to Barclays PLC.").

[7] 11 U.S.C. § 363 (2008) (The relevant language of the statute includes "(b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . . ." and "(f) The trustee may sell property under subsection (b) . . . of this section free and clear of any interest in such property of an entity other than the estate, only if [certain conditions apply] . . . .").

[8] *See* Searcey & Bray, *supra* note 6 (noting this phenomenon and the objections of creditors to the speed of the transaction and the reduction of their interests in the assets sold).

Lehman and Barclays, of course, are not alone in their use of this section of the Code to divest of assets in bankruptcy to quickly raise cash for creditors instead of enduring a formal, and often lengthy, reorganization.[9] Asset sales under § 363 of the Code have become increasingly popular in recent decades.[10] In 2008 alone, the economic tumult sent many companies to bankruptcy court seeking liquidation of valuable assets in Chapter 11 reorganization filings.[11] The dramatic decrease in the availability of credit that occurred during 2007-2008 has affected more than the merger and acquisition market of healthy firms; it has virtually eliminated the ability of companies entering bankruptcy to acquire the operating capital they need to endure the restructuring process.[12] This momentum suggests that the important question to be asking is not whether the Code was intended to accomplish these transactions, but whether these transactions are being accomplished in an efficient manner that furthers the goals of the Code.

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[9] *See* Jacqueline Palank, *Tenor of Chapter 11 is Changing*, WALL ST. J., Oct. 15, 2008 ("Lenders are increasingly snuffing out their borrowers' hopes of reorganizing in Chapter 11 bankruptcy, instead seeking quick sales to ensure they recover as much of what they're owed as possible. And bankruptcy judges are letting them.").

[10] *See* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 170-71 (2005) (comparing three § 363 sales of large public companies in bankruptcy during the 1980s with thirteen § 363 sales in the 1990s and fifty-two § 363 sales of large public companies in bankruptcy from 2000-2003 alone).

[11] *See* Patrick Fitzgerald, *Mervyn's to Auction Leases*, WALL ST. J., Nov. 19, 2008 at B6B ("[Mervyn's] . . . blamed its financial woes on the 'state of the economy' and a difficult operating environment for retailers. A number of high profile retail chains, including Linens 'n Things, Steve and Barry's and Boscov's, have also sought Chapter 11 protection in recent months.").

[12] *See* Palank, *supra* note 9 ("This shift, years in the making, has come into sharper focus thanks to seized-up credit markets that have made it tougher for strong companies, let alone those on the verge of insolvency, to get cash.").

Bankruptcy law is intended to operate in the instances where other applicable laws break down.[13] In other words, it is a gap-filler that is not intended to disturb the natural order unless necessary to solve a problem.[14] More specifically, commentators generally acknowledge that the specific purpose of reorganization is to preserve the going-concern value of financially distressed firms.[15] Opponents of the use of § 363 of the Code to accomplish the Chapter 7 end of liquidation in Chapter 11 raise a host of complaints ranging from arguments that it represents an abuse of the reorganization process by secured creditors to systemic undervaluation of assets to concerns regarding the institutional competency of judges to effectively administer complicated auctions from the bench to contentions that this process fails the basic aim of Chapter 11 reorganization.[16] Recently, commentators have also raised the prospect that the self-interest of accountants, bankers, and lawyers involved in the reorganization may cloud the sale process

[13] *See generally* BARRY E. ADLER ET AL., BANKRUPTCY CASES, PROBLEMS, AND MATERIALS 1-3 (Foundation Press 2007) (1985) (discussing the need for bankruptcy law and writing "[i]ndividual rules of debt collection prevent a firm from readjusting its capital structure when its creditors are diverse. Bankruptcy gives the investors a way to act collectively. It enables investors to rearrange their rights to the firm and yet still respects the priority the investors enjoy relative to one another under nonbankruptcy law.").

[14] This idea is known as the Butner principle because it is derived from the Supreme Court case of *Butner v. United States*, 440 U.S. 48, 55 (1979). For a more complete discussion of the Butner principle, see generally DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 5-7 (Found. Press 2006) (1992).

[15] *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN L. REV. 751, 758 (2002) ("We have a going-concern surplus (the thing the law of corporate reorganizations exists to preserve) only to the extent that there are assets that are worth more if located within an existing firm."); Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's* The End of Bankruptcy, 56 STAN. L. REV. 645, 651 (2003) (endorsing the Baird-Rasmussen characterization of the purpose of corporate reorganization).

[16] *See* Jason Brege, *An Efficiency Model of Section 363(b) Sales*, 92 VA. L. REV. 1639, 1643-44 (2006) (summarizing this "cynical perspective" in an effective and coherent manner).

and deprive the estate of value.[17] Proponents of these sales counter the above complaints by pointing to the quick resolution of a complicated dispute and the economic benefits of a competitive bidding process as evidence for the superiority of asset sales to reorganization.[18]

The settlement of this argument and the reformation of the Code is beyond the scope of this Note; however, given the expected continuation of the uptick in Chapter 11 bankruptcy petition filings experienced in 2008, it will be useful to further investigate the current trends of § 363 uses while forecasting its future use in a time of constricting credit.[19] Part II of this Note explores the history of the uses of § 363 in bankruptcy proceedings while focusing on its increasing prevalence and popularity in recent years. The issues and concerns surrounding the current practices of § 363 usage, including the pitfalls and objections noted above, are to be examined in Part III. A consideration of proposed alternatives to pure asset sales in Chapter 11 reorganizations is discussed and evaluated in Part IV, while attempting to keep these suggestions in the context of the current economic climate. Ultimately, this Note concludes that asset sales in Chapter 11 under § 363 of the Code are too ingrained in the bankruptcy process to be turned back now. In fact, it is the position of this Note that the same credit market deficiencies that contributed to the rise in bankruptcy filings experienced in 2008 will also contribute to the cementing of § 363 asset sales as the preferred exit from Chapter 11. The issue that is left open for debate is how to effectively and efficiently administer the sale process within

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[17] *See* Lynn M. LoPucki & James W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 32-37 (2007) (discussing possible explanations for the failure of the asset sale market in bankruptcy).

[18] *See* Brege, *supra* note 16, at 1644 (summarizing this "less cynical story" in an effective and coherent manner).

[19] *See* Joann S. Lublin, *Recruiting Talent to Ailing Firms—How W.R. Grace Altered Hiring, Retention Practices While in Chapter 11*, WALL ST. J., Jan. 5, 2009, at B2 ("More than 64,000 businesses filed for bankruptcy during 2008, a higher number than in any year since Congress overhauled bankruptcy laws in 2005, according to the AACER bankruptcy-data service of Jupiter eSources LLC.").

bankruptcy in order to further the reorganization goal of maintaining going-concern value in financially distressed firms.

II. 11 U.S.C. § 363: ITS HISTORY, ITS USES, AND ITS PREVALENCE

The modern era of restructuring and reorganization began thirty years ago with the enactment of the Bankruptcy Reform Act of 1978.[20] Proponents of the Code praise it for preserving going-concern surplus of debtors while protecting the wide ranging interests of various creditors.[21] On the other hand, detractors criticize the Code for enabling well compensated advisors to pressure judges into using their Code-provided discretion to approve actions that favor too few creditors.[22] Among deficiencies cited by these skeptics, asset sales free and clear of the related interests and claims per § 363(f) subject to the judgment of the bankruptcy court are a frequent target of criticism.[23]

A. The Development of a Rule

The use of § 363 in this modern era arose only a few years after the enactment of the Code. Court decisions in cases such as *In re White Motor Credit Corp.*,[24] *In re Braniff Airways*,[25] and *In re Lionel Corp.*[26] demonstrate the rapid development of that section's applicability in Chapter 11 reorganization proceedings.[27] Though reticent initially to

[20] *See* George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 21 n.3 (2004) ("The bankruptcy laws of the United States underwent a wholesale revision culminating in 1978 with the enactment of the Bankruptcy Code.").

[21] *See id.* at 22.

[22] *See generally id.* at 22-28.

[23] *Id.*

[24] 14 B.R. 584 (Bankr. N.D. Ohio 1981).

[25] 700 F.2d 935 (5th Cir. 1983).

[26] 722 F.2d 1063 (2d Cir. 1983).

[27] As § 363 is located in Chapter 3, a generally applicable chapter of the Code, it can be used by debtor firms in either Chapter 7 or Chapter 11.

allow Chapter 11 proceedings to make use of § 363, the courts eventually settled on the corporate law concept of the business justification test to analyze proposed actions pursuant to this section.

The *White Motor* court made one of the first attempts to fully consider the place of a § 363 action in a Chapter 11 reorganization. [28] Surprisingly, perhaps to current practitioners, this court found that § 363(b) does not explicitly condone the types of asset sales now so commonplace in reorganization proceedings.[29] The *White Motor* court did, however, carve out an exception for an "emergency" situation which proved to be a crack in the dam of an otherwise clear and unambiguous holding.[30]

The *Braniff* court reached the same conclusion as the *White Motor* court—it did not allow a sale to proceed under § 363(b)—however, it followed a different path of reasoning in reaching this decision.[31] *In re Braniff Airways* involved a dispute over a plan to exchange Braniff company assets for "travel scrip, unsecured notes, and a profit participation" in the business of the proposed acquirer.[32] In this case, the court found the absence of an actual cash transfer to be dispositive and held that the proposed plan operated outside of the intended uses of § 363(b).[33] This early hesitation to make use of § 363 in Chapter 11 reorganization proceedings proved a red herring, however, as the Second Circuit followed the *Braniff* decision of the Fifth Circuit by issuing

[28] *See* Brege, *supra* note 16, at 1650 ("Troubled by the textual vacuity of a statute that would lead to unacceptable results, the bankruptcy court investigated [s]ection 363(b)'s legislative history to determine whether the debtor could sell substantially all of its assets to another corporation.").

[29] 14 B.R. at 590 ("It is clear . . . that in a [C]hapter 11 reorganization under the Bankruptcy Code, [s]ection 363(b) does not authorize sale of all or substantially all assets of the estate.").

[30] *Id.*

[31] *See* Brege, *supra* note 16, at 1651 ("In 1983, the result in White Motor was followed, but the 'emergency rule' reasoning was rejected by the Fifth and Second Circuits.").

[32] *In re* Braniff Airways, 700 F.2d 935, 939 (5th Cir. 1983).

[33] *Id.*

the textbook opinion on the limits of asset sales in bankruptcy.[34]

In re Lionel Corp. clearly established the permissibility of using § 363(b) to sell assets in a Chapter 11 reorganization.[35] The Lionel court established the business judgment test as the relevant standard for analyzing these transactions.[36] Observers explain the court's conception of its holding in noting that the "business justification" standard results in a case by case analysis by the court of factors arguing for and against the sale.[37] In the mind of the court, a bright-line rule was ineffective in this circumstance, and a flexible standard allowed judges to make proper use of the power delegated to them by the Code.[38] Though proposed as a limit on this activity, the standard has proven to be rather weak, and today, most estates seeking a sale of their assets under § 363(b) gain bankruptcy court approval with ease.[39]

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[34] *In re* Lionel Corp., 722 F.2d 1063 (2d Cir. 1983).

[35] *Id.*

[36] *Id.* at 1066.

[37] *See* Brege, *supra* note 16, at 1652 ("The 'business justification' standard means that certain reasons for a sale are impermissible . . . and the court will have to consider the ramification of a number of factors before approving a sale.").

[38] *See In re* Lionel Corp., 722 F.2d at 1071 ("Resolving the apparent conflict between Chapter 11 and § 363(b) does not require an all or nothing approach. Every sale under § 363(b) does not automatically short-circuit or side-step Chapter 11; nor are these two statutory provisions to be read as mutually exclusive. Instead, if a bankruptcy judge is to administer a business reorganization successfully under the Code, then—like the related yet independent tasks performed in modern production techniques to ensure good results—some play for the operation of both § 363(b) and Chapter 11 must be allowed for.").

[39] *See* BAIRD, *supra* note 14, at 249 ("One can always point to *some* reason for a sale now rather than later. The judge is poorly positioned to reject the debtor in possession's assertion that the terms of the proposed sale are favorable after the debtor has given multiple potential buyers the chance to bid. Far from limiting the debtor's ability to sell the business as a going concern, *Lionel* has become the authority one cites to permit such a sale to go forward.").

B. The Exception That Became the Rule

The regularity with which these asset sales are currently approved by bankruptcy courts has led some commentators to claim that corporate reorganizations have all but disappeared.[40] This claim is not beyond dispute, however.[41] Regardless of the definition used to capture corporate activity in Chapter 11, all involved in the process recognize that the process has morphed over time and that the corporate reorganizations of our time do not resemble corporate reorganizations of thirty years ago.[42]

Commenting on the original conception of Chapter 11, Professors Baird and Rasmussen identify three specific circumstances traditionally thought to be encountered by debtor firms as they enter bankruptcy.[43] These states are: (1) the ability to continue as a going concern but for certain financial distress, (2) the need for the cooperation offered by the Code, and (3) the inability to consummate a sale of the firm in the open market outside of bankruptcy.[44] Echoing

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[40] *See* Baird & Rasmussen, *supra* note 15, at 751 ("Giant corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use Chapter 11 merely to sell their assets and divide up the proceeds."). Writing in 2002, Baird and Rasmussen point to sales consummated in Chapter 11 by TWA and Enron because these transactions had just occurred at the beginning of this decade. However, the pair could effectively make the same claim today by pointing to several household names such as Linens 'n Things, Steve & Barry's, and Lehman that have made similar use of § 363(b) in the past year. *See generally* Palank, *supra* note 9.

[41] *See* LoPucki, *supra* note 15, at 646 ("The number of large, public firms reorganizing in 2002 was greater than in any prior year in history."). *But see* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 673-75 (2003) (disputing LoPucki's characterization of their initial claim and narrowing the definition of reorganization to traditional reorganization which excludes many Chapter 11 cases counted in LoPucki's study).

[42] *See generally* Palank, *supra* note 9.

[43] *See* Baird & Rasmussen, *supra* note 41, at 673-74.

[44] *Id.* ("The traditional account of corporate reorganizations assumes a financially distressed business faces three conditions simultaneously: (1) It has substantial value as a going concern; (2) its investors cannot sort out the financial distress through ordinary bargaining and instead require

part (1) of Baird and Rasmussen's above observation, Omar Tene writes that the Code succeeds where it forces a debtor firm to continue its operations when the value of its assets exceeds their liquidation value.[45] Even LoPucki, at odds with Baird and Rasmussen with respect to many topics of bankruptcy, agrees that the prime goal of reorganization is to preserve going-concern value of the debtor firm.[46]

For all the agreement regarding the underlying purposes of the Code, there is an equal amount of debate regarding the path most efficient in securing this going-concern surplus. Proponents of the Chapter 11 liquidation method into which § 363 has evolved extol the speed, efficiency, and competition involved in the sales as indications of its superiority over a more traditional reorganization.[47] Opponents of the increasing frequency of asset sales echo concerns expressed by the *White Motor* and *Braniff* courts while pointing to the developing issues of secured creditor control and the mixed motives of the participants in arguing for a retardation of these transactions.[48] These objections have begun to approach irrelevancy, however, with recent changes in the global economic environment. As noted, the volume of this type of disposition of reorganization

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Chapter 11's collective forum; and (3) the business cannot be readily sold in the market as a going concern. Remove any one of these conditions, and the standard account of corporate reorganization law falters.").

[45] Omar Tene, *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations*, 19 BANKR. DEV. J. 287, 295 (2003) ("Bankruptcy law generates a net gain for society if it prevents a debtor from selling its assets, where the going-concern value of the assets exceeds their piecemeal liquidation value. Bankruptcy reorganizations are premised on the existence of a surplus beyond the amount realizable by creditors in liquidation.") (citations omitted).

[46] *See* LoPucki, *supra* note 15, at 651. In fact, this going-concern focus is considered the traditional justification of corporate reorganizations simply because it is traditional. It has generally been agreed upon from the beginning. *See* ADLER ET AL., *supra* note 13, at 677 ("Chapter 11 is designed to ensure the survival of those firms in financial distress that are worth keeping intact as going concerns.").

[47] *See infra* Part II.C.

[48] *See infra* Part III.

proceedings has been increasing exponentially in recent years as the debtor firms have embraced this outcome and bankruptcy courts have become more comfortable with the mechanics of the transaction.[49] Also, the overwhelming majority of reorganization literature devoted to this topic praises this result in detailing the advantages of selling assets in bankruptcy.[50] Finally, the current economic climate will likely exacerbate two factors: creditor control of the reorganization process and lack of access to financing by debtor firms, which work to encourage § 363 asset sales.[51] Though empowered with pure motives and strong arguments, the sheer momentum and acceptance of the Chapter 11 liquidation process has most likely rendered opposition to the modern use of § 363 fruitless.[52]

C. The Advantages of Selling Assets in Bankruptcy

The use of the Code to effectuate asset sales offers many and various advantages to the purchaser over consummating these transactions outside of bankruptcy.[53] First, the speed and efficiency of sales that occur under the cover of reorganization are vastly superior to the experience outside

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[49] *See supra* note 10.

[50] *See infra* Part II.C.

[51] *See infra* Part IV.A.

[52] This opposition might accurately be analogized to the tilting at windmills exercise described in MIGUEL DE CERVANTES SAAVEDRA, THE ADVENTURES OF DON QUIXOTE, (J.M. Cohen trans., Penguin Books 1950) (1605). A more modern conceptualization of fighting a noble but losing battle is the characterization given the magazine, *The National Review*, when it first appeared in print. It was written that the magazine was "stand[ing] athwart history, yelling Stop, at a time when no one is inclined to do so . . . ." *See* William F. Buckley, Jr., *Publisher's Statement*, NAT'L REV., Nov. 19, 1955.

[53] The purchaser's vantage point is but one angle from which to perceive this process. Changing the view will likely change the opinion of these transactions. Advantages to one party may certainly become disadvantages to another party. This Note, however, is focused on the macroeconomic environment of Chapter 11 as opposed to the specific positions of each participant.

of bankruptcy.[54] Second, due to a history of generous statutory interpretation by bankruptcy judges, assets sold pursuant to § 363 are transferred without the associated, encumbering liabilities.[55] Third, sales transacted through Chapter 11 avoid certain inefficiencies and controls of state and federal law due to certain Code protections.[56] Finally, and perhaps the most interesting reason for an acquirer to prefer asset sales in bankruptcy, this structure permits the itemized selection of certain assets, leases, and contracts that would otherwise be impossible.[57] This separation is motivated by the debtor firm's need for cash, which allows the buyer to maintain significant bargaining power with respect to the desired assets.[58] It must be noted, however, that assets cannot be sliced so thinly as to separate a closely

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[54] *See* Rachael M. Jackson, *Responding to Threats of Bankruptcy Abuse in a Post-Enron World: Trusting the Bankruptcy Judge as the Guardian of Debtor Estates,* 2005 COLUM. BUS. L. REV. 451, 456 (2005).

[55] 11 U.S.C. § 363 (2008). *See also In re* Trans World Airlines, 322 F.3d 283 (3d Cir. 2003) (holding Chapter 11 debtor authorized to sell assets free and clear of employees' successor liability claims pursuant to 11 U.S.C. § 363(f)); George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process,* 76 AM. BANKR. L.J. 235, 236 (lamenting bankruptcy courts' broad application of the provision).

[56] *See* Neil Cummings, *A Time to Buy*, DAILY DEAL, May 16, 2002 (reviewing certain state laws that excuse transactions that are part of proposed reorganization plans and adding, "[t]hese state law provisions are bolstered by Section 1125 of the Bankruptcy Code, which says a company does not have to comply with the proxy rules or the going-private rules when it solicits approval of a plan of reorganization as part of the restructuring").

[57] *See* Corinne Ball & John M. Kane, *A Practical Guide to Distress M&A*, M&A LAW., NOS. 7-8, at 4 (2003). *But see* 11 U.S.C. §§ 544(b), 548 (2008) (delivering power to the trustee to recover assets "fraudulently transferred" by the debtor whether in actual fraud or constructive fraud).

[58] This bargaining power often translates itself into the form of a depressed price. *See generally* Leonard P. Goldberger & Harvey L. Tepner, *A Guide for Acquiring Businesses in Bankruptcy*, 10 J. BANKR. L. & PRAC. 521, 522-23 (2001) (noting that lower expectations, expectations of liquidation value, and an inefficient market contribute to lower prices in bankruptcy asset sales).

related package of assets.[59] Thus, the acquiring party is not rendered unlimited bargaining power by the Code.

Supporters of the asset sale process note the aforementioned benefits that accrue in the bankruptcy sale process, and point out additional benefits unique to § 363 asset sales as compared with bankruptcy sales administered through a reorganization plan.[60] First on the list of attributes mentioned is the speed at which these transactions occur.[61] This speed results in "reduce[d] . . . fees and costs associated with in-plan sales because the parties may settle matters more expeditiously amongst themselves."[62] The presumption is, of course, built on the idea that the market for debtor assets is robust enough to operate efficiently and produce a higher net present value for these quick sales relative to time-consuming restructurings.[63] Second, it can be difficult to explain why valuable assets must remain with the reorganizing firm in order to retain their value; they should be as valuable—if not more valuable—stripped of their encumbering liabilities and in the

[59] *In re* Exide Technologies, 340 B.R. 222, 228 (Bankr. D. Del. 2006) ("[A]ll of the contracts that comprise an integrated agreement must either be assumed or rejected, since they all make up one contract.").

[60] *See* Jackson, *supra* note 54, at 461.

[61] *See* George W. Kuney, *Let's Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy*, 40 HOUS. L. REV. 1265, 1273 (2004) ("By compartmentalizing these reorganization functions into two stages . . . the reorganization process is made more efficient: operating assets are returned to the nonbankruptcy world with lower transaction costs than under the reorganization by plan scenario."); Searcey & Bray, *supra* note 6 (noting the incredible one week timeframe within which Barclays purchased substantially all of the assets of Lehman).

[62] Jackson, *supra* note 54, at 462.

[63] *See* Baird & Rasmussen, *supra* note 15, at 756 ("Today, both small and large firms can be sold as going concerns, inside of bankruptcy and out. The ability to sell entire firms and division eliminates the need for a collective forum in which the different players must come to an agreement about what should happen to the assets."). Not all involved in the bankruptcy world share this conviction, however. *See infra* Part III.

hands of new owners and managers.[64] Finally, this camp notes that the track records of reorganized companies are unimpressive. This might lead one to believe that firms facing financial distress rarely possess any going concern value that is worth reorganizing.[65] As might be expected, opponents to this use of § 363 dispute the empirical evidence marshaled by its proponents and suggest that distressed firms' values are greater than the simple sum of their assets.

III. ISSUES AND CONCERNS SURROUNDING CURRENT USES OF § 363

A more cynical view of the § 363 process is that it allows sophisticated participants to make use of it as a loophole to shirk responsibilities, improperly dispose of assets, and line their own pockets at the expense of less well-represented creditors and stakeholders.[66] The lack of a plan confirmation proceeding is perceived by some as a glaring control deficiency that invites abuse.[67] Though notice and a hearing are prescribed by the Code, in practice the provision amounts

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[64] *See* Baird & Rasmussen, *supra* note 41, at 699 (arguing that teams—human capital—is the only true firm specific capital and noting that "[t]oday's businesses can be replicated with virtual businesses that organize production through the marketplace over the Internet. Any going-concern surplus can be captured for creditors via a sale.").

[65] *See In re* 26 Trumbull Street, 77 B.R. 374 (Bankr. D. Conn. 1987); Baird & Rasmussen, *supra* note 41, at 685-89 (describing the failed reorganization attempt of a restaurant in Hartford, Connecticut). Baird and Rasmussen trace the failure of the restaurant and its reorganization failure along with a succession of other failed restaurant concepts at the same location before an experienced restaurant family assumes control of the property and implements a successful concept in order to make the point that modern businesses do not retain value. People bring value to businesses. Selling assets to people with the talent to create value from those assets is more efficient than keeping the assets bound together in the original company.

[66] *See* Brege, *supra* note 16, at 1640 ("Section 363(b) appears to offer a side door to escape the rigors of the typical bankruptcy plan confirmation."); *see also* LoPucki & Doherty, *supra* note 17, at 32 (arguing that self-interest of participants clouds the outcome of the process).

[67] *See* Brege, *supra* note 16, at 1643.

to little more than token protection of a debtor firm's value.[68] Unfortunately, this potentially effective control on the process is mitigated by its requirement of an objection by a creditor who may not be sophisticated enough to understand that he should object.[69] Also, it has been posited that this control is lightly used simply because it is lightly enforced.[70] Simply put, the cynical view holds that DIP managers and secured creditors are often intimately involved in the asset sale plans, and that these groups lack the independence and oversight necessary to ensure decisions that maximize the value of the entire estate.[71]

A. Potential Undervaluation of Assets in § 363 Transactions

Despite the wholehearted support for the current use of § 363 in the reorganization process, some commentators have raised concerns about the value generated by asset

[68] *See* 11 U.S.C. § 363(b)(1) (2006); Brege, *supra* note 16, at 1643 n.15 ("The bankruptcy court will typically hold a hearing only if a party objects to the sale, hence the burden of producing evidence disfavoring the sale is on the various creditors who have incentives to object.").

[69] It may be helpful to consider creditors as three separate classes: secured, unsecured, and trade creditors. Secured creditors tend to hold the most sway over the reorganization proceedings. These creditors are typically banks or other large financial institutions. They hold interests in the property of the estate by way of their security interests, and they will be first in the collection line. Unsecured creditors are often also sophisticated financial institutions similar to the class of secured creditors, but they lack a security interest in any property of the estate. Their recoveries depend on the amount of estate property remaining after secured creditors satisfy their own claims. Trade creditors are the suppliers that carry on business with the debtor firm on a day-to-day basis. Their claims will vary in size but most likely be unsecured. They are thought to have only a small voice in the reorganization process. *See generally* ADLER ET AL., *supra* note 13, at 5-20.

[70] *See* LoPucki & Doherty, *supra* note 17, at 38-39 (detailing several reasons that a creditor may fail to object to a materially unfair § 363 asset sale).

[71] *See generally id.* at 31-44 (offering explanations for opined market failure § 363 asset sale process); Brege, *supra* note 16, at 1643-44.

sales in bankruptcy.[72] In the article *Bankruptcy Fire Sales*, Professors Lynn M. LoPucki and Joseph W. Doherty reveal the results of their empirical study, which suggests "reorganizations yield higher recovery ratios than going-concern sales . . . ."[73] The study included a sample of thirty § 363 asset sales and thirty reorganizations drawn from a database of all large public company bankruptcy filings after October 1, 1979, the effective date of the Code.[74] Startlingly, the results of the study "warrant the conclusion that, on average, companies sell for less than would be realized in their reorganizations."[75] Analyzing and dissecting the methods used by LoPucki and Doherty is beyond the scope of this Note, but the sheer discrepancy in returns discovered in their sample raises a red flag and points to the key dispute between those that argue for a return to true bargaining of the original restructuring process and those that argue for a continued liberal application of § 363.

The main question and key dispute concern the robustness of the market for debtor assets in bankruptcy proceedings. The camp favoring the current use of § 363 believes strongly in the ability of the debtor asset market to set efficient prices and ensure fair recoveries for all involved creditors.[76] The camp that favors a refocusing on traditional reorganization efforts believes that the debtor asset market is sufficiently thin to artificially suppress prices and reduce

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[72] *See* Richard E. Mendales, *Intensive Care for the Public Corporation: Securities Law, Corporate Governance, and the Reorganization Process*, 91 MARQ. L. REV. 979, 992 (2008) (citing research by LoPucki and Doherty and arguing that the Code itself facilitates their results); LoPucki & Doherty, *supra* note 17, at 15-31.

[73] *See* LoPucki & Doherty, *supra* note 17, at 31.

[74] *Id.* at 15-16.

[75] *Id.* at 44 (noting that the reorganizations studies produced returns greater than sales by up to 56% of book value). *But see* James J. White, *Bankruptcy Noir*, 106 MICH. L. REV. 691, 702-04 (taking issue with the sample of the LoPucki and Doherty study and arguing that selection bias influenced their results).

[76] *See* Baird & Rasmussen, *supra* note 15, at 756; *see also supra* Part II.C.

recoveries for certain creditors.[77] This Note does not intend to expound on the efficiencies, or lack thereof, of the debtor asset market, but it is worth considering how the current economic climate might affect the operation of all markets. As liquidity vanishes, so too does the ability of potential purchasers to take advantage of any buying opportunity. Less competition for the same assets generally creates an expectation of a lower sale price, and there is no reason to believe that the debtor asset market will behave differently. Traditional cash purchases of debtor assets will likely not offer the highest and best recovery for creditors in the current market environment.[78]

B. Mixed Motives and Conflicts of Interest

1. Managers

In an effort to explain the perceived market failure noted above, LoPucki and Doherty offer up DIP managers as a potential scapegoat, noting that the CEO and other high-level executives often have compensation tied directly to bankruptcy sale transactions.[79] In cases where a sale does not trigger a management payday, the executives of the debtor may have promises to be hired by the acquirer upon a sale or hopes to enter lucrative consulting contracts upon separation from the debtor.[80] Critics of the LoPucki and Doherty position have offered the reasonable response that the mere presence of incentives cannot be assumed to influence the behavior of principled professionals.[81] After all,

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[77] *See* LoPucki & Doherty, *supra* note 17, at 41-42. This thin market for debtor assets might be used by insiders to undermine the sale process and increase their own payout. *See infra* Part III.B.

[78] *See infra* Part IV.C.

[79] *See* LoPucki & Doherty, *supra* note 17, at 32 (highlighting eleven of the thirty cases studied in which CEOs directly and tangibly benefitted from the sale in the form of severance payments tied to the transaction).

[80] *Id.*

[81] *See* White, *supra* note 75, at 705 (disputing the inferences drawn in the LoPucki and Doherty study).

despite the occasionally wayward executive, no evidence exists to suggest an epidemic of unscrupulous executives using their positions to improperly influence the reorganization process.[82] Acknowledging this deficiency in their argument, LoPucki and Doherty respond memorably by invoking Bart Simpson and noting that the absence of proof is not itself proof.[83] The point is well taken. While the mere presence of incentives cannot condemn management, the motivation and the opportunity to do mischief exists. The cynic will assume the worst.[84]

2. Professional Advisors

Traditionally, a debtor firm must hire teams of accountants, bankers, and lawyers for financial and legal advice in navigating the complex maze of restructuring and reorganization.[85] Interestingly, a recent study indicates that fees paid to financial advisors—accountants and bankers—dwarf fees awarded to legal advisors.[86] Regardless of where the money flows, the sheer size of the revenue available—up to $18,000/hour in some cases[87]—indicates the potential for

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[82] *See* LoPucki & Doherty, *supra* note 17, at 33-34 (describing an embarrassing episode during the reorganization proceeding of Polaroid). *But see* White, *supra* note 75, at 705 (disputing the inferences drawn in the LoPucki and Doherty study).

[83] *See* Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Vérité*, 106 MICH. L. REV. 721, 737 ("The principal problem with that defense is that if those actors didn't do it, no explanation remains at all for the massive failure of a four-times redundant system.").

[84] *See id.* at 737 ("When, as in large public company bankruptcies today, no innocent explanations remain plausible, we conclude that corruption exists.").

[85] *See* Lynn M. LoPucki & Joseph W. Doherty, *Rise of the Financial Advisors: An Empirical Study of the Division of Professional Fees in Large Bankruptcies*, 82 AM. BANKR. L.J. 141, 141-42 ("Parties the estate subsidizes can afford to collect more information, purchase more and better advice, and litigate more issues more thoroughly.").

[86] *See id.* at 141-43 (describing the methods of the study and reviewing the results).

[87] *Id.* at 170.

self-interested action on the part of the advisors.[88] Legal fees are often hourly based which provides a set of incentives that does not reward the advisor for ensuring an efficient process, as it encourages attorneys to draw out their efforts and potentially pass up fair opportunities for resolution. Financial advisor fees are often based on the sale transaction, which can encourage an advisor to consummate a deal quickly in order to move on to the next potential fee rather than diligently work for the best outcome for all interested parties.[89] They can be arranged as either flat percentages, contingent upon a successful transaction, or arranged in some other like manner.[90] No matter the fee structure, the current methods are generally unable to deliver the proper incentives to the participants to ensure the maximum recovery for the estate.[91]

These negative views are countered with the reasonable idea that despite their love of money and detachment from the debtor firm, professional advisors must still take care to protect their reputations and abide by relevant ethical codes.[92] It seems a stretch to impugn the integrity of an entire industry—in fact, most of the legal profession earns revenue through hourly billing—for the simple reason that short-term gains are possible. Professional advisors must generally value a long term practice and repeat business over the temptation of a one-time windfall if they wish to sustain their revenue models. Given the events of 2008, perhaps it is not wise to argue that these advisors always act in an ethical—or even logical—manner, but White's

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[88] *See* LoPucki & Doherty, *supra* note 17, at 34 ("The investment bankers who arrange the sales are not an effective check on sale prices either.").

[89] *See id.* at 35.

[90] *Id.*

[91] *Id.* ("The investment bankers have little reason to curry favor with the sellers who hired them; the companies are going out of business . . . .").

[92] *See* White, *supra* note 75, at 706 ("[The advisors] have contractual and fiduciary duties to represent their principals, the debtor firms. To suggest that they will casually disregard this duty in order to pursue a richer interest elsewhere is unfair and illogical.").

argument is fair in stating self-serving incentives do not necessarily indicate systemic failure of the Chapter 11 reorganization process with respect to § 363 asset sales.[93]

3. The Bankruptcy Courts

To fully understand the role of the bankruptcy courts in this process, it is necessary to remember that an action with respect to a § 363 sale transaction by a bankruptcy court is not reviewable by any other court but is final.[94] As noted above, bankruptcy courts generally approve sales proposed by debtor firms.[95] This eagerness to approve sales and cater to debtors is explained by some as a result of competition among the various bankruptcy courts for business.[96] The view one takes of this empirical evidence depends on whether this competition is explained as a race to the top[97] or a race to the bottom.[98]

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[93] *Id.* This argument is similar to the argument also raised by White with respect to LoPucki and Doherty's claims regarding executives of the debtor. *Cf.* White, *supra* note 75, at 705.

[94] 11 U.S.C. § 363(m) ("The reversal or modification on appeal of an authorization under subsection (b) and (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 . . . unless such authorization and such sale or lease were stayed pending appeal."). The embedded good faith requirement in the above Code section ensures that no fraud will operate upon a court's decision. *See In re* Rock Indus. Mach. Corp., 572 F.2d 1195, 1198 (7th Cir. 1978) ("The requirement that a purchaser act in good faith, of course, speaks to the integrity of his conduct in the course of the sale proceedings. Typically, the misconduct that would destroy a purchaser's good faith status at a judicial sale involves fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders.").

[95] *See* LoPucki & Doherty, *supra* note 17, at 40 ("[W]e know of no modern case in which a large public company debtor proposed a sale and the court refused to approve it.").

[96] *Id.* ("[The] cases produce[] billions of dollars in fees for local bankruptcy professionals and substantial industries in [the cities in which the courts are located].").

[97] This term is used to describe the competition as fruitful in identifying the bankruptcy judges and professionals with the greatest skill

Evidence to support either theory is in short supply,[99] but, once again, simply raising the prospect of this control deficiency should give even the most ardent supporters of § 363 asset sales pause to consider the effectiveness and efficiency of the system currently in use. To suggest that the bankruptcy courts pose a control deficiency is not to endorse the idea that the courts are acting improperly in approving these sales. Such an accusation is potentially dangerous, in fact, because once faith in the impartiality of the court system is lost, the collective action problem that the Code seeks to remedy may return in full force.[100] Acknowledging this line of argument is simply meant to highlight holes in the current system that must be adequately addressed in the future.

C. Disparate Power Across Creditor Classes

Another issue which has been raised in recent scholarship that merits attention and identifies a potential downside to the freewheeling use of § 363 to effectuate asset sales in bankruptcy is creditor control of the process.[101] This control

in navigating the Code and reaching the best result for both the debtor firm and its creditors.

[98] This term is used to describe the competition as detrimental to the reorganization process as bankruptcy judges and professionals in certain districts signal a playing field tilted in the direction of the debtor firm at the expense of its creditors.

[99] *See* White, *supra* note 75, at 707 (pointing out the lack of evidence for the assertions made by LoPucki and Doherty with respect to the behavior of the bankruptcy courts).

[100] *See* ADLER ET AL., *supra* note 13, at 2 ("Bankruptcy law . . . responds to this collective action problem, a problem akin to the one that exists when individuals, pursuing their own interest, graze too many cattle in a common pasture."). This phenomenon is also commonly described as the tragedy of the commons.

[101] *See* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11* 4 (Colum. Univ. Ctr. for Law & Econ., Research Paper No. 321 and Nw. Univ. Law Sch. Law & Econ. Research Paper Series, Paper No. 08-16, 2008), *available at* http://ssrn.com/abstract=1081661 ("During the past decade, creditors with senior, secured claims have come to dominate the Chapter 11 process.").

is often made possible through debtor-in-possession ("DIP") financing arrangements that render control to the lender—often an existing creditor—by placing the debtor under restrictive covenants and reducing the availability of cash.[102] The question of the value of this creditor control will be determined by the circumstances of the person answering the question.[103] This control has a tendency to expedite sale processes, and advocates of § 363 asset sales are much more comfortable with its existence than are those who believe in a return to traditional reorganizations.[104] Justified or not, the phenomenon of creditor control is made possible through the Code and through tradition.[105]

In analyzing creditor control, the focus is on secured creditors as opposed to unsecured creditors. Unsecured creditors may contribute to conflict among the creditor classes, but without a tool of control such as an interest in collateral or a loan covenant, they will have little influence with the debtor.[106] The interesting question is not whether

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[102] DIP financing is a form of postpetition borrowing by the debtor. The lender may be a new creditor, but often, the financing is arranged with a prepetition creditor. *See* ADLER ET AL., *supra* note 13, at 477; David A. Skeel, *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905, 1918 (2004) (describing the mechanics of DIP financing and the various mechanisms used to secured control of the debtor).

[103] *See* Chad P. Pugatch, Craig A. Pugatch & Travis Vaughan, *The Lost Art of Chapter 11 Reorganization*, 19 U. FLA. J.L. & PUB. POL'Y 39, 72 (2008).

[104] *Id.* at 72-73 ("[I]f the insolvency process is designed to provide a maximum return to creditors, then creditor control that advances the current trend is justified. Conversely, if one desires . . . true bargaining . . . with the goal of saving companies through restructuring debt, it may not be justified.").

[105] *See* Ayotte & Morrison, *supra* note 101, at 26 ("Chapter 11 gives senior lenders, unsecured creditors, and equity holders leverage over resource allocation issues."); Skeel, *supra* note 102, at 1905 (tracing the origins of the DIP financing statutes of the Code to the common law equity receiverships of the nineteenth century).

[106] *See* Ayotte & Morrison, *supra* note 101, at 26 ("Creditors dictate the dynamics of the reorganization process. Senior lenders exercise significant control through stringent covenants contained in DIP loans.

the control exists but how the control affects the outcome of the bankruptcy process. Professors Kenneth M. Ayotte and Edward R. Morrison addressed this question in a recent paper and came to the conclusion that the actions of the creditors involved in the bankruptcy process will be driven by the extent to which they are either undersecured[107] or oversecured[108] with respect to their collateral.[109]

The Ayotte and Morrison paper notes a finding of a "statistically significant, non-monotonic relationship between the ratio of secured debt-to-assets and the resolution of the case."[110] In other words, when debtor assets are sufficient to fully protect a secured creditor's claim, that creditor loses his incentive to participate in a lengthy reorganization; he simply desires to collect on his claim by converting the debtor assets into cash as soon as possible.[111]

The preferred method of accomplishing this conversion in recent years has been the § 363 asset sale.[112] Although this development is not necessarily cause for concern in and of itself, the finding of creditor control raises another potential breakdown in a process provided by the Code and generally blessed with a cursory glance by the bankruptcy courts. A very real possibility exists that the liberal use of § 363 in the Chapter 11 reorganization process can lead to a situation in which secured creditors force the liquidation of debtor firms with going concern value.[113] As noted, other interest classes

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Unsecured creditors gain leverage through objections and other court motions.")

[107] *See* ADLER ET AL., *supra* note 13, at 36 (defining an undersecured creditor as a creditor holding an interest in collateral that has a value less than the creditor's claim).

[108] *Id.* (defining an oversecured creditor as a creditor holding an interest in collateral that has a value greater than the creditor's claim).

[109] *See* Ayotte & Morrison, *supra* note 101, at 26.

[110] *Id.* at 6.

[111] *Id.*

[112] *See* Brege, *supra* note 16, at 1648 (noting that the widespread use of § 363 may be the signal of a shift in bankruptcy theory and practice).

[113] *See* Kuney, *supra* note 20, at 28 ("Once secured creditor control has been established and the debtor's agents critical to this control has been

(e.g., junior secured creditors, unsecured creditors, trade creditors, and equity holders) may make use of court objections to contest these decisions, but these objections are rarely made and even more rarely granted for reasons discussed earlier in this Note.[114] Also, it must be recognized that these junior classes operate at a significant power deficiency to the senior secured creditor—usually the DIP lender.[115]

Much like the systematic undervaluation of assets in § 363 sales and the opportunity for self-serving action among the participants in the process, the specter of creditor control cannot automatically be labeled detrimental to the reorganization process. The purpose of flagging these issues is to remind the bankruptcy community that the favored practice of § 363 asset sales is open to abuse.[116] Ultimately, the goal of the Chapter 11 procedure, including the use of § 363, is to achieve the greatest recovery possible for creditors either by reorganizing a firm to capture a going-concern surplus or selling it, in whole or in part, to provide cash settlements.[117]

IV. SECTION 363 ASSET SALES GOING FORWARD: THE NEW ECONOMIC REALITY

The year just ended, 2008, will most likely be remembered by future generations as the year that the world

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taken care of, there is little real incentive on the part of those with the power to do so to realize value for those with lower priority.").

[114] *See* LoPucki & Doherty, *supra* note 17, at 37-39 (describing why creditors fail to object to § 363 asset sales); *supra* Part III.A.

[115] *See* LoPucki & Doherty, *supra* note 85, at 141 ("[P]ower follows money.").

[116] *See* Kuney, *supra* note 55, at 235 (explaining how the misapplication of § 363(f) can be a tool of mischief for savvy participants in the reorganization process).

[117] *See generally* Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199, 1203-07 (2005) (describing modern bankruptcy theory).

of finance changed forever.[118] Credit markets began tightening during the summer of 2007, and Bear Stearns toppled early in 2008. The full brunt of the crisis was not fully recognized, however, until September 2008 when Lehman failed, American International Group teetered on the brink of collapse, and the United States government was forced to respond with a $700 billion rescue bill.[119] Change has come, and it would be foolhardy to think that the bankruptcy process would be impervious to these same forces. As described earlier in this Note, the number of bankruptcy filings in 2008 was higher than any other year on record, and many experts expect to see a similar result in 2009.[120] The question is not whether the reorganization process will change but rather how it will change and what debtor firms will experience in Chapter 11.

First, consider the issue of creditor control and conflict identified by Ayotte and Morrison and discussed earlier in this Note.[121] It stands to reason that as the supply of credit to healthy firms dries up,[122] the supply of credit to firms in bankruptcy will suffer at least as much, if not more. Contemplate this observation:

> Over the course of 2008, the credit crisis that began with securities backed by home loans engulfed virtually every market that could be tapped by borrowers—individuals, corporations and investors. Although there have been some signs of improvement in recent weeks, such as in the market for interbank lending, the cost of borrowing by even the most highly regarded companies remains unusually high.

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[118] *See* Annelena Lobb, *Few Bright Lights Amid the Gloom*, WALL ST. J., Jan. 2, 2009, at R2 (reviewing the headline making events of the year).

[119] *See id.*; *see also* Greg Ip & Jon E. Hilsenrath, *Seeds of Excess: How Credit Got So Easy and Why It's Tightening*, WALL ST. J., Aug. 7, 2007, at A1.

[120] *See* Lublin, *supra* note 19.

[121] *See* Ayotte & Morrison, *supra* note 101, at 4; *see also supra* Part III.C.

[122] *See* Ip & Hilsenrath, *supra* note 119.

> For borrowers without pristine credit, the credit markets are nearly closed.[123]

The more difficulty debtor firms experience in obtaining DIP financing, the greater the bargaining power experienced by the DIP lenders will be as the lenders gain the leverage needed to negotiate more stringent terms. Debtor firms find themselves truly desperate for cash as they enter Chapter 11 because the only real alternative to adequate DIP financing is an organized liquidation. As such, the control currently exercised over debtor firms by their secured creditors may increase substantially.[124]

Second, consider how the senior secured creditors may make use of their newly acquired leverage. Some research suggests that traditional Chapter 11 reorganizations have been disappearing for at least a decade.[125] A dramatic increase in the ability of secured creditors to control the reorganization process could result in the virtual elimination of the reorganization option in certain circumstances.[126] Though a § 363 asset sale will not necessarily kill a reorganization effort (i.e., one can imagine a debtor firm using § 363 to sell a small division for much needed operating capital while proceeding with a larger reorganization effort), the prevalent use of § 363 is to sell the entire company.[127]

Finally, consider that though § 363 asset sales may be permanently ingrained as part of the reorganization process, the procedures by which they are accomplished may not remain static. Indeed, they may even become the exception that swallows the rule.[128] The auction process favored by

[123] Tom Lauricella, *Foundation of New World Order Is Uncertainty*, WALL ST. J., Jan. 2, 2009, at R1.

[124] *See* Ayotte & Morrison, *supra* note 101, at 4.

[125] *See* Baird & Rasmussen, *supra* note 15, at 751.

[126] *See* Ayotte & Morrison, *supra* note 101, at 18 (concluding that the oversecured creditor will always favor an immediate sale of the debtor assets).

[127] *See* Palank, *supra* note 9; *see also* LOPUCKI, *supra* note 10, at 170-71.

[128] *See supra* Part II.B.

bankruptcy judges may change fundamentally to rely less on cash bids and more on creative financing arrangements in order to increase interest and improve the sale price—and resulting creditor recovery—for the debtor's assets.[129] Some debtor firms may choose to avoid Chapter 11 altogether in order to accomplish § 363 ends outside of bankruptcy as some courts have exhibited resistance to any alteration of the current scheme.[130] These imagined changes are not certain. In fact, they are mere speculation; but this speculation could prove valuable preparation in this time of great financial and economic uncertainty.

A. Projecting the Effect of Increasing Creditor Control

The idea that creditor control will increase in a time of constricting access to financing assumes that this control existed in measurable quantities during times of easy access to financing.[131] With credit markets tightening—or perhaps, not even functioning—businesses that are good credit risks will experience difficulty in arranging financing.[132] Businesses that are poor credit risks may have those avenues closed off to them completely.[133] The silver lining for debtor firms in bankruptcy is that the Code provides some incentive for lenders, especially prepetition lenders, to extend credit to the debtor firms.[134]

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[129] *See generally* Matthew Rhodes-Kropf & S. Viswanathan, *Corporate Reorganizations and Non-Cash Auctions*, 55 J. FIN. 1807 (2000) (describing the mechanics of a traditional non-cash auction and how it might operate in the reorganization context).

[130] *See infra* Part IV.D.

[131] *See* Ayotte & Morrison, *supra* note 101, at 11 (describing the method of the study as "collecting data on all corporate bankruptcies . . . during the latter half of 2001"); *see also* Ip & Hilsenrath, *supra* note 119 (noting the slashing of interest rates by the federal reserve during the 2000-2001 time period in order to avoid an economic downturn in the wake of the technology stock bubble burst). The sample of bankruptcies used in the Ayotte & Morrison study came from a time of artificially cheap money.

[132] *See* Lauricella, *supra* note 123.

[133] *Id.*

[134] *See* ADLER ET AL., *supra* note 13, at 475 (explaining the Code presumption of administrative expense priority, noting §§ 364 and 503 of

While a firm in bankruptcy may not be a good credit risk, it is usually able to find some source of financing due to the special priority afforded these claims.[135] In other words, lenders will generally make credit available to debtor firms in the Chapter 11 reorganization process because the Code provides assurances that they will be able to extract that money from the estate at some point in the future.[136] In most cases the DIP lender is also a prepetition creditor.[137] There is comfort and familiarity between the debtor and an existing lender that allows for speed in arranging these loans when time is of the essence.[138] Also, the DIP lender has a vested interest in intimately involving itself in the reorganization process, and the cost of extending credit usually encompasses more than the rate of interest charged; these lenders want control of the debtor businesses in order to protect their investment and their collateral.[139]

It is a general tenet of economic theory that as an asset becomes scarcer, its price will rise in relevant proportion, all else being equal. It then stands to reason that as the credit markets dry up and remain dysfunctional, the cost of this credit for debtor firms (i.e., control of the reorganization) will rise substantially. Given the level of control currently permitted by bankruptcy courts, the reorganization process could conceivably reach a point where the DIP management acts as nothing more than a puppet of the DIP lender.[140] In fact, two cases from the modern bankruptcy era illustrate

the Code govern bankruptcy finance, and explaining that extensions of credit to the debtor receive administrative expense priority which means the debt will be paid back before any other prepetition claims).

[135] *Id.*

[136] *See* BAIRD, *supra* note 14, at 242 ("The rule is necessary to ensure that people do business with the debtor . . . .").

[137] *See* Skeel, *supra* note 102, at 1917 ("[T]he most likely source of debtor-in-possession financing is the company's existing lenders.").

[138] *Id.* at 1918.

[139] *See* BAIRD, *supra* note 14, at 246 ("The typical debtor-in-possession . . . loan grants the lender virtually complete control over the reorganization process.").

[140] *See generally In re* Clark Pipe & Supply Co., Inc., 893 F.2d 693 (5th Cir. 1990).

where the current line of control has been drawn while unintentionally providing advice to DIP lenders on exercising extreme control of the debtor while avoiding court censure.[141]

In *In re American Lumber*, the bankruptcy court subordinated the claims of the DIP lender on the finding that the lender actually controlled the debtor's business activity through such actions as terminating employees, hiring its own staff to conduct a liquidation of the debtor, and selectively making good on the debtor's payables for the lender's own benefit.[142] This decision was distinguished in *In re Clark Pipe* despite a rather overt admission of ill intentions by an employee of the lender facing scrutiny.[143] According to the court, the difference between the *Clark Pipe* circumstances and the activities in *American Lumber* was the fact that the lender in the *Clark Pipe* case had a contract with the debtor explicitly allowing it to take the actions in question.[144] If contractual provisions define permissible activity between lenders and debtors in times of financial distress, a reduction in bargaining power caused by a lack of credit in the DIP financing market could carry significant consequences as debtors may be required to submit to draconian loan covenants in order to acquire enough cash to continue daily operations in their attempts to reorganize.[145]

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[141] *See generally id.*; *In re* American Lumber Co., 5 B.R. 470 (D. Minn. 1980).

[142] *See generally American Lumber*, 5 B.R. 470. This process is known as equitable subordination or judicial subordination. Courts generally make use of it to alter the claims of an overreaching insider that would otherwise enjoy administrative expense priority. *See* ADLER ET AL., *supra* note 13, at 538-39.

[143] *See Clark Pipe*, 893 F.2d at 700 (describing the testimony of the loan officer in which he stated that his only motivation was to extract the greatest amount of money from the debtor prior to the filing of a bankruptcy petition).

[144] *Id.* at 702 ("Associates' control over Clark's finances, admittedly powerful and ultimately severe, was based solely on the exercise of powers found in the loan agreement.").

[145] Note that the *Clark Pipe* court also paid special attention to the fact that the contract in question was entered into prior to financial

The mere presence of creditor influence or control in a reorganization proceeding is not in and of itself an evil that must be cured. However, it must be recognized that the current economic climate will likely increase the ability of certain creditors to direct debtors' actions during bankruptcy. As the control of creditors to date has not definitively resulted in an efficient allocation of debtor's assets, there is little reason to believe that the actions taken by creditors once they enjoy greater control will result in higher recoveries for the participants of a Chapter 11 reorganization action.[146] In fact, as this discussion has endeavored to illuminate, there is some reason to believe precisely the opposite.

B. Imagining an End of the Reorganization Option

It is entirely possible that the increase of creditor control over the reorganization process described above may not actually alter the current trajectory of Chapter 11 practice. As has been noted, some existing research suggests that traditional reorganizations have been on the decline for years while concurrent research suggests precisely the opposite—indicating that debtor firms emerge from Chapter 11 as reorganized entities at a significant rate.[147] Despite conflicting characterizations about the current viability of Chapter 11, most commentators are in agreement that the relative number of bankruptcy proceedings that result in liquidation is increasing.[148] As also noted above, the available evidence strongly indicates that when creditors

distress developing at the debtor. *Id.* at 700. Perhaps a bankruptcy court would find a similar contract entered into on the eve of a reorganization proceeding to be unconscionable and cause for subordination of claims.

[146] *See* Baird & Rasmussen, *supra* note 15, at 751 (announcing the end of traditional reorganizations due to the efficient market for debtor assets). *But see* LoPucki & Doherty, *supra* note 17, at 1 (questioning the efficiency of § 363 asset sales in maximizing creditor recoveries).

[147] *See* Baird & Rasmussen, *supra* note 15, at 751 ("Corporate reorganizations have all but disappeared."). *But see* LoPucki, *supra* note 15, at 646 ("Corporate reorganizations are booming.").

[148] *See supra* Part II.B.

capture the ability to control a debtor firm's fate in reorganization, the creditors are likely to consummate a sale of the firm.[149] Therefore, it does not seem a stretch to conclude that a dramatic rise in the level of control enjoyed by a single, secured lender (i.e., a prepetition lender that agrees to become the DIP lender) could result in a significant rise in the number of § 363 asset sales (Chapter 11 liquidations) and the effective cessation of Chapter 11 reorganizations.[150]

Time has always been of the essence in Chapter 11 reorganization proceedings, and restricted access to credit will likely only exacerbate the exigency of this situation.[151] The absolute importance of cash flow to debtor firms on the verge of failure leads many of them to seek out DIP financing arrangements prior to actually entering bankruptcy protection.[152] If a firm is forced into bankruptcy without securing DIP financing, it is more likely to liquidate

[149] *See* Ayotte & Morrison, *supra* note 101, at 26 (concluding that sales are most likely to happen when senior creditors are oversecured but also noting that creditor control does not make a § 363 sale a foregone conclusion). It must also be noted, however, that asset sales are not limited to situations in which oversecured creditors control the outcome. Undersecured creditors might be tempted to act as DIP lenders in order to gain administrative expense priority with the hopes of recovering most, or perhaps all, of their claim by driving a hard bargain and fetching a high sale price. This phenomenon is most likely to develop when all of the creditors are undersecured, and it might create competition between creditors resulting in more favorable financing terms for the debtor.

[150] *See* ADLER ET AL., *supra* note 13, at 477 (noting that DIP financing is often arranged with a prepetition, secured lender for reasons of convenience and easy access to necessary information).

[151] *See* Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 528-29 (1983) ("The strain of extended financial stress results in lost sales when customers seek a more secure supply source, in consumption of valuable management time spent resolving financial difficulties, and in forgone opportunities to obtain new projects.").

[152] *See* Skeel, *supra* note 102, at 1917 ("By the time a corporate debtor files for bankruptcy, its DIP financing arrangement is usually securely in place, awaiting only the initial approval of a bankruptcy court in connection with the debtor's so-called first day orders.").

pursuant to Chapter 7 of the Code.[153] The piecemeal liquidation process of Chapter 7 is certainly the most inefficient option in bankruptcy, and it is favored by few, if any, commentators.[154] It appears, then, that a drawn out period of scarce credit could leave debtor firms considering bankruptcy protection a choice between two unappealing alternatives: (1) arrange DIP financing with a lender, if one can be found, and effectively cede control of the reorganization process or (2) forgo DIP financing and face the reasonable certainty of enduring liquidation of assets at steeply discounted prices. Despite this potentially gloomy outlook, the Code itself seems to suggest that neither option is necessarily unfavorable. To fully understand this position, it must be remembered that the Code exists as a gap-filling device that should not alter the contours of applicable state law except where necessary to correct failures.[155]

The Best Interests Test ("BIT") is drawn from 11 U.S.C. § 1129(a)(7), and it states that "creditors who [do] not vote in favor of the plan [of reorganization have] to receive as much [under the plan] as they would receive in an orderly liquidation of the business."[156] Essentially, this section of the Code establishes the Chapter 7 liquidation value of the debtor firm as the baseline for judging the fairness of a payout scheme to various creditors in a reorganization proceeding. Though this test is intended to operate within the context of the approval process of a reorganization plan, its aim may be adopted to evaluate the Code's ability to accomplish its goals in a period of scarce credit. If a debtor firm is faced with the unappealing choice of forgoing DIP financing and liquidating or entering into a DIP financing

[153] *See* Ayotte & Morrison, *supra* note 101, at 8 (reviewing the results of several studies concerning the effects of DIP financing and noting the results of one which suggested a relationship between lack of DIP financing arrangements and Chapter 7 liquidation proceedings).

[154] *See* LoPucki & Doherty, *supra* note 17, at 5 ("Scholars and policymakers are in agreement that piecemeal sales are the least desirable alternative because they provide the lowest values." (citations omitted)).

[155] *See* BAIRD, *supra* note 14, at 5-7 (describing the Butner principle).

[156] 11 U.S.C. § 1129(a)(7) (2008); *see also* BAIRD, *supra* note 14, at 75.

arrangement that effectively cedes control and assures a quick sale by the controlling creditor, the Code can still play an effective role by ensuring the sale price is equal to or greater than the liquidation value.[157] Thus, the elimination of the reorganization option will not render the Code ineffective because the Code still allows the prevailing economic conditions to determine the fate of the debtor firm.[158]

The purpose of the Code is not to ensure that all creditors are paid in full but to provide a way for all creditors to act in a collective fashion to ensure the maximum recovery possible for the bankruptcy estate.[159] Given this understanding, the elimination of the reorganization option will not necessarily affect the Code's ability to function as an effective tool in administering the debtor's estate and distributing proceeds to creditors. However, the current method of executing § 363 transactions—the auction—will have to change to suit the new economic climate.[160] The same lack of credit that this Note posits will accelerate the decline of the traditional Chapter 11 reorganization will certainly affect the ability of purchasing companies to construct their bids for debtor firms. In order to continue producing the highest possible recoveries for creditors, § 363 asset sales will need to employ a non-cash component in the auction process.

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[157] While conceding that this value may be uncomfortably low, it is arguable that a floor—at whatever level—is advantageous to the process because it provides a starting point and a frame of reference from which the bankruptcy court may begin its analysis. Also, the liquidation value is easily calculable since it is nothing more than the asset values less the encumbering liabilities.

[158] *See* BAIRD, *supra* note 14, at 5-7. The Butner principle requires the Code to allow state law—and by extension, general economic conditions—to operate without interference when possible.

[159] *See* ADLER ET AL., *supra* note 13, at 1-3 (describing the general function of bankruptcy law).

[160] *See infra* Part IV.C.

C. An Alternative to Tradition

Working under the assumption that scarce credit will severely shrink, if not eliminate completely, the market for traditional corporate reorganization proceedings, it makes sense to focus on the concept of bankruptcy as a liquidation device.[161] Those that conceive of bankruptcy as such a vehicle have long argued that an auction is the most efficient method of obtaining a true and maximum price for a distressed firm.[162] The key to the proper functioning of an auction, however, is access to cash.[163] If traditional cash auctions function questionably under normal credit circumstances, they certainly cannot be expected to achieve their goals in times of scarce capital. Given the well documented tightening of the credit markets over the past eighteen months, it makes sense to explore the contours of an alternative to the traditional cash auction that may prove more effective in raising bids and improving returns to creditors of debtor firms in this changed environment.[164]

A non-cash auction is mechanically very similar to a traditional cash auction.[165] Yet, especially in times of financial distress, the non-cash method may enjoy significant advantages over the cash model.[166] In other words, it is

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[161] *See supra* Part IV.A–B.

[162] *See* Rhodes-Kropf & Viswanathan, *supra* note 129, at 1807 (summarizing key works of Baird, Jackson, and Jensen and explaining the rationale behind their pro-auction position).

[163] *See* Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J. L. ECON. & ORG. 523, 527 (1992) ("Auctions work well if raising cash for bids is easy and there is plenty of competition among bidders. However, even in the most advanced Western economies, these conditions are unlikely to be met . . . .").

[164] *See* Ip & Hilsenrath, *supra* note 119.

[165] *See* Aghion et al., *supra* note 163, at 533 (comparing the components of a hypothetical cash and non-cash auction bid). The main difference between cash auctions and non-cash auctions is that non-cash auctions allow for creativity in bid constructions. Instead of purchasing a firm for cash, a non-cash bid may be composed of a cash component, a debt component, an equity component, or some combination of the above.

[166] *See* David Hahn, *When Bankruptcy Meets Antitrust: The Case for Non-Cash Auctions in Concentrated Banking Markets*, 11 STAN. J.L. BUS.

believed that non-cash auctions may provide for greater flexibility in structuring bids for debtor firms that will allow bidders to exercise a certain degree of independence from the traditional suppliers of financing, large banks. In a time when great concern is focused on the control delivered to the banks that are creditors of the debtor firms, an opportunity to reduce any one creditor's ability to solely determine the fate of a debtor firm should be a welcome development. The overriding question, of course, is whether non-cash auctions can deliver on their inherent promise.

In the book, *Firms, Contracts, and Financial Structure,* Oliver Hart identifies four alternative bidding structures that might be used in a non-cash auction.[167] These examples are described as:

> (1) The old managers propose to keep their jobs, and offer claimants a share in the post-bankruptcy company; (2) The same financial arrangement might be offered by a new management team; (3) The managers of another company might propose to buy the bankrupt company, offering shares in their company as payment; (4) Management (old or new) might induce some debt in the company's capital structure.[168]

Despite the rosy theoretical treatment afforded non-cash auctions over the past decades, these few examples help identify the flaws that exist in this alternative model. First, the valuation difficulties presented by a non-cash structure are evident.[169] As with all exercises in valuation, divining

& FIN. 28, 32 (2005) ("Non-cash auctions enjoy the benefit of relying on market-based valuations of the firm. Yet, in departing from cash payments, this proposed bankruptcy model may reduce the dependency of the various actors, most notably potential bidders, on the dominating banks' financing.").

[167] *See* OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 171 (1995).

[168] *Id.* (emphasis omitted).

[169] *See* Rhodes-Kropf & Viswanathan, *supra* note 129, at 1809 ("Auctions with non-cash (securities) bids create a valuation problem for the seller because the seller has to value the bids to rank which is the highest.").

the most valuable structure proposed will involve a certain element of fortunetelling on the part of the DIP or trustee. The certainty of a cash bid proves a distinct advantage for traditional auctions in the arena of valuation.[170]

Despite certain deficiencies, these alternative bidding structures are not preferred only in theory. Studies suggest that the valuation difficulties lamented above can actually benefit the process by increasing the overall value of the bids due to bidders' desires to indicate the strength of their offer.[171] In fact, the results of the Rhodes-Kropf–Viswanathan study indicate that non-cash auctions generate greater revenue than traditional cash auctions.[172] Though non-cash auctions may not be as promising as earlier theoretical articles had hoped, their contributions to the reorganization process can be substantial under the proper economic circumstances.[173]

Professor David Hahn argues that these proper economic conditions can be found in markets of tight credit, pointing to the fact that they are reliably present in concentrated banking environments.[174] The oligopolistic structure of a

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[170] *Id.* at 1810 ("The most critical drawback of a non-cash auction is that some securities will not separate the bidders."). The authors go on to note the dangers of artificial bidding devices used to create stratification of the non-cash options by explaining that they often reduce the effective number of bidders through a process of clustering. Any value added to the process by increasing the number of bids for the DIP or trustee to review could be immediately surrendered if all of the bids arrange together around the same value which limits the range of choice.

[171] *Id.* at 1809 ("[The signaling effect] increases the bids and may increase the seller's expected revenue.").

[172] *Id.* at 1842 ("[A] non-cash auction is revenue superior because the use of securities introduces a valuation problem and hence the securities that are bid must correctly 'signal' the expected value of the firm.").

[173] *Id.* at 1843 (acknowledging the loss of efficiency inherent in the use of non-cash bidding structures); *see also* Hahn, *supra* note 166, at 32 (discounting the effectiveness of traditional "market-based mechanisms"—cash auctions—in the absence of easy access to capital).

[174] Hahn, *supra* note 166, at 32 ("[T]he approach I suggest herein is to adopt non-cash bankruptcy auctions as the model for concentrated banking economies."). A concentrated banking economy is one in which "a

concentrated banking economy destroys the efficiencies of a traditional cash auction because the centralized control at the financing institution means that bidders are dependent on banks for cash and allows the bank to fully control the valuation process and, thus, the outcome of the auction.[175] Hahn believes that opening up the auction process to creative bidding arrangements allows a return of the competition that was missing in these concentrated banking economies, which may result in greater returns.[176]

This discussion of non-cash auctions and concentrated banking economies is relevant to a consideration of the world of scarce financing because the two environments resemble each other in that both suffer from a lack of options. If the use of non-cash auctions in less developed economies with a dearth of financing options can increase competition and improve returns for seller firms, the theory should also be applicable to bankruptcy auctions in Chapter 11 reorganizations when DIP financing becomes a tool of creditor control due to the scarcity of funds.[177] In recent years, concrete examples of these non-cash arrangements have begun to appear in bankruptcy courts. The adjudication of two specific cases seems to suggest practical boundaries for the application of this concept to real world Chapter 11 reorganizations.[178]

few financial institutions dominate the supply of finance to the entire local market." *Id.* at 44.

[175] *See* Aghion et al., *supra* note 163, at 539.

[176] *See* Hahn, *supra* note 166, at 66 ("The non-cash auction bankruptcy regime, on the other hand, would facilitate the introduction of . . . competing [bid structures] . . . in every corporate bankruptcy case.").

[177] *See id.* at 32, 44; *see also* Rhodes-Kropf & Viswanathan, *supra* note 129, at 1843.

[178] *See* Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30 (Bankr. S.D.N.Y. 2005); *In re* ACG Holdings, Inc., No. 08-11467 (Bankr. D. De. July 15, 2008); *In re* Vertis Holdings Inc., No. 08-11460 (Bankr. D. De. July 15, 2008).

D. Limits to the Use of Non-Cash Auctions in Chapter 11 Reorganizations

The real world application of non-cash auctions is still in its infancy as debtors and creditors endeavor to understand what is permissible under the Code and as courts begin to define the boundaries of this process. Much like *In re White Motor Credit Corp.* and *In re Braniff Airways* illustrate the bankruptcy courts' early conceptualization of the § 363 asset sale doctrine, two recent cases have provided a glimpse into the practical uses of non-cash structures in accomplishing reorganization goals.[179] The disposition of *In re Westpoint Stevens* suggested an outer boundary to the use of a non-traditional auction process in a Chapter 11 reorganization while the prepackage plan of reorganization concerning American Color Graphics, Inc. ("ACG") and Vertis, Inc. ("Vertis") indicates a place for these alternative arrangements as long as certain requirements of the Code are observed.[180]

WestPoint Stevens, Inc. ("WestPoint Stevens"), a textile maker, entered Chapter 11 in 2003 and emerged from the reorganization proceedings in 2005 after conducting an auction to sell itself while still in bankruptcy.[181] The company valued the winning bid at $703 million and the losing bid at $632 million, but both offers included cash and non-cash components.[182] Though the bankruptcy court in the Southern District of New York ("SDNY") approved of this sale, a junior class of creditors objected to the transaction as a sub rosa plan of reorganization and challenged the decision

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[179] *See In re* Westpoint Stevens, 333 B.R. 30 (Bankr. S.D.N.Y. 2005); *In re* ACG Holdingsm, No. 08-11467 (Bankr. D. De. July 15, 2008); *In re* Vertis Holdings, No. 08-11460 (Bankr. D. De. July 15, 2008); *see also supra* Part II.A.

[180] *See In re* Westpoint Stevens, 333 B.R. 30 (Bankr. S.D.N.Y. 2005); *In re* ACG Holdingsm, No. 08-11467 (Bankr. D. De. July 15, 2008); *In re* Vertis Holdings, No. 08-11460 (Bankr. D. De. July 15, 2008).

[181] *Icahn Wins Bidding War for Textile Maker*, N.Y. TIMES, June 25, 2005, at C13.

[182] *Id.*

of the bankruptcy court in the district court for the SDNY.[183] The district court agreed with this challenge and reversed certain portions of the sale order that appeared to resemble too closely a proposed plan of reorganization.[184] Essentially, the district court believed that orchestrators of this non-cash auction, the management of WestPoint Stevens and the first lien creditors, used § 363 in such a way that the consummated transaction effected an end-run around the Chapter 11 control of the plan confirmation requirement rather than a true sale of debtor assets. Thus, a limitation on the practical use of this non-traditional method emerged from the decision. Non-cash auctions cannot result in ownership structures that resemble equity based plans of reorganization in the absence of unanimous support among the various creditor and equity classes.[185]

The trepidation expressed by the *Westpoint Stevens* court at the use of non-cash bidding structures is not the end of the story for alternative disposition of debtor assets through § 363. In the summer of 2008, American Color Graphics, Inc. and Vertis, Inc. made use of a prepackaged reorganization approved by a vote of their creditors prior to making Chapter 11 filings.[186] Though not the result of an actual auction process, the transaction resulted in an entity that had shed more than $1 billion in prepetition debt through a recapitalization effort involving both equity and debt—as

[183] *In re* Westpoint Stevens, 333 B.R. at 54. A sub rosa plan of reorganization is simply an attempt to make an end run around the confirmation procedures of the Code. Using non-cash bidding in the § 363 process can lead to a situation in which a debtor firm's finances are restructured in a way that resembles a traditional reorganization. However, § 363 does not require a formal plan of reorganization or creditor approval. The court seems to suspect an attempt by DIP management to reorganize the firm without submitting to the strictures of the Code.

[184] *Id.*"The Bankruptcy Court's utilization of sections 363(b) and 105(a) to overcome Appellants' anticipated objections to an attempt to cram down an equity-based plan of reorganization must be rejected.").

[185] *Id.*

[186] Bill Rochelle, *Quaker, Stratus, Vertis, Asarco: Bankruptcy (Update1)*, BLOOMBERG, July 17, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aK3BE.n0DUsg.

opposed to cash—issued in satisfaction of creditors' claims.[187] Contrary to the *Westpoint Stevens* court, the bankruptcy judge in this transaction fully supported the combination of these two firms through use of the contours of the Code and complimented the efficiency of the entire process.[188] In fact, this merger represented the first recorded instance of two firms using the bankruptcy process to complete a union.[189] The distinguishing factor that led to the approval of this consolidation and to the reversal in the *Westpoint Stevens* situation seems to be the agreement of the various creditor classes.[190] Bankruptcy courts do not wish to stand in the way of innovation as long as the boundaries of the Code are adhered to and respected. Courts are wary, however, of new structures that appear to accomplish forbidden actions through traditionally permissive avenues.[191]

Though the door has by no means been closed to non-cash auctions in the reorganization context, the reticence of bankruptcy courts to fully acquiesce to this new process has led some debtor firms to pursue private workouts with their creditors.[192] The recent trend in out–of–court negotiations has been debt exchange offers.[193] Much like the specter of

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[187] *Id.*

[188] Dawn McCarty, *Vertis, American Color Win Approval of Exit Plans (Update3)*, BLOOMBERG, Aug. 26, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a_4vXbN9CYwA.

[189] *Id.*

[190] *See In re Westpoint Stevens*, 333 B.R. 30 (Bankr. S.D.N.Y. 2005); *In re* ACG Holdingsm, No. 08-11467 (Bankr. D. De. July 15, 2008); *In re* Vertis Holdings, No. 08-11460 (Bankr. D. De. July 15, 2008).

[191] *See In re* Westpoint Stevens, 333 B.R. at 54.

[192] *See* Michael Aneiro & Aparajita Saha-Bubna, *GMAC Bondholders Balk at Debt Swap*, WALL ST. J., Dec. 11, 2008, at C2 (describing the GMAC proposal as offering to exchange existing debt for new debt with a lower face value and preferred stock); *Crisis on Wall Street*, WALL ST. J., Nov. 15, 2008, at B6 ("Realogy Corp., the parent company to real-estate brokers Century 21 and Coldwell Banker, warned . . . that it may have to default on part of its credit line. Realogy is offering creditors the opportunity to swap their bonds at a discount for as much as $500 million in principal of new second lien loans . . . .").

[193] *See* Aneiro & Saha-Bubna, *supra* note 192 (noting several firms other than GMAC LLC that are offering debt exchanges to creditors). A

non-cash auctions, however, this creative strategy is not without its drawbacks. Courts may not be initially involved in the exchange offer, but often the proposals end up in court through the actions of disgruntled secured creditors who stand to fall a rung on the ladder of bankruptcy priority.[194] Given this resistance, the viability of the exchange offer model is uncertain at this point in time. Some firms have backed away from proposals on encountering resistance from certain classes of creditors while other firms have successfully navigated the process.[195] Whether by alternative bankruptcy auction processes, private negotiations, or other creative financing arrangements, the current economic climate has forced both debtors and creditors to reevaluate the function of the Code in accomplishing corporate reorganizations.

The current use of § 363 did not win instant approval with bankruptcy judges or practitioners.[196] Over time, though, the newly proposed uses of § 363 to accomplish traditional reorganization goals found favor in the bankruptcy courts as the advantages of the process became evident.[197] As economic conditions force the reorganization process to change once again, new non-traditional methods of efficiently accomplishing bankruptcy goals must emerge and

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typical debt exchange involves trading unsecured debt for secured debt with a lower face value. The debtor firm obtains breathing room in the form of lower interest payments, and the creditor obtains the satisfaction of securing a portion of its outstanding loan and ensuring some recovery if the debtor eventually falls into bankruptcy.

[194] *See id.* ("GMAC LLC is facing opposition as it tries to persuade investors to swap bonds for lesser-valued debt."); Zachery Kouwe, *Ichan Sues Over Realogy's Debt-Swap Plan*, N.Y. TIMES, Dec. 3, 2008, at B5 ("Mr. Icahn is seeking to prevent . . . Realogy . . . from refinancing $1.1 billion of debt, claiming the move would hurt certain Realogy bondholders.").

[195] *See* Randall Smith, *Year-End Review of Markets & Finance 2008*, WALL ST. J., Jan. 2, 2009, at R13 (describing the results of exchange offer proposals from Harrah's Entertainment Inc., Station Casinos Inc., and GMAC LLC).

[196] *See In re* White Motor Credit Corp., 14 B.R. 584 (Bankr. N.D. Ohio 1981).

[197] *See supra* Part II.A.

prove themselves to be workable. The application of non-cash auctions to § 363 asset sales and the use of private workouts to avoid bankruptcy altogether, while not silver bullets or perfectly efficient solutions for settling valuation debates, may very well become the favored tools of courts, creditors, and debtors alike in the future as all seek a means of maximizing the asset values of a firm in bankruptcy when a traditional Chapter 11 reorganization is no longer feasible.[198]

V. CONCLUSION

The year ended December 31, 2008, will be remembered for a long time to come. September 2008 will likely take a place beside October 1929 and October 1987 as an iconic month reminding this nation of the fragility of its financial system. The collapse of the credit markets and the loss of confidence in the economy contributed to a sharp rise in bankruptcy filings and a renewed debate concerning the use of a small provision of the Code.[199] Many bankruptcy experts believe asset sales pursuant to § 363 of the Code to be the most efficient disposition of the estate of a debtor firm in Chapter 11 reorganization.[200] However, some research suggests that this process robs creditors of a proper recovery by forgoing a traditional reorganization and selling distressed assets at bargain prices.[201] Additional research indicates that secured creditors have come to control the reorganization process through the use of the DIP financing provisions of the Code and effectuate these asset sales to cover their own claims without seeking to maximize the value of the estate for all creditors.[202] The loss of access to credit experienced this past year will provide an opportunity for these creditors to extract greater control as DIP lenders and presents the possibility of the absolute extinction of

[198] *See supra* Part IV.B.

[199] *See supra* Part I.

[200] *See supra* Part II.C.

[201] *See supra* Part III.A.

[202] *See supra* Part III.C.

traditional Chapter 11 reorganizations.[203] Though the use of alternative methods of accomplishing these asset sales, such as non-cash auctions, has been theorized as a way of mitigating creditor power and increasing recovery to the entire population of creditors, the prevailing economic conditions seem to indicate a final shift in the fundamental transformation of the reorganization process.[204] The operative question no longer appears to be whether these asset sales produce as much value as traditional reorganizations but rather how to harness this new regime to ensure its efficient operation and maximum recovery for all creditor classes.

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[203] *See supra* Part IV.A–B.

[204] *See supra* Part IV.C.