BANKRUPTCY SALES: A BANKER'S GUIDE

KEITH CHARLES OWENS

As this article explains, there are certain risks lurking behind every sale of assets in bankruptcy that can affect the price payable for the assets and ultimately the distribution to banks and other creditors.

Lenders, other creditors, and investors have known for years that assets of insolvent companies, including companies in bankruptcy, can be obtained at bargain basement prices. Such deals have become highly publicized since the dot-com fallout of the late 1990s. For example, Singapore Technologies Telemedia Pte, Ltd recently bid $250 million to buy a 61.5% stake in the one-time, telecommunications darling, Global Crossing — only a fraction of the estimated $48.5 billion peak market value several years ago.[1]

Similarly, a year or so ago, a Florida-based pharmaceutical company, Vitacost.com, purchased a fully operational website founded by C. Everett Koop, President Reagan's former Surgeon General, for only $186,000. DrKoop.com, which attracted more than 900,000 visitors per month and had a database of more than two million registered users, was funded with more than $200 million. It reached a market capitalization of more than $1 billion before the Internet stock market crash.[2]

Despite the many lucrative deals that abound, however, there are certain risks lurking behind every sale that can affect the price payable for the assets and ultimately the distribution to banks and other creditors. This article dis-

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Mr. Owens serves as senior counsel at Foley & Lardner, Los Angeles, where he specializes in bankruptcy law and creditors' rights. He may be reached at kowens@foley.com.

cusses several risks commonly faced by purchasers of assets from a debtor or otherwise insolvent corporation, and explains how purchasers may seek to minimize these risks.

SECTION 363 SALES

Generally, there are two mechanisms for acquiring assets in a Chapter 11 bankruptcy case. First, all or substantially all of a debtor's assets can be administered through a Chapter 11 plan of reorganization. Second, the debtor's assets can be sold early on in a bankruptcy case through what has become known in bankruptcy parlance as a "Section 363 sale." This article discusses the procedural mechanism for accomplishing such sales under Section 363 of the Bankruptcy Code, which has become increasingly popular in recent years.

A bankruptcy trustee or debtor-in-possession may sell property of the bankruptcy estate outside the ordinary course of business after notice and a hearing.[3] The so-called "Section 363 Sale" is often characterized as having a "cleansing effect" on assets that might otherwise be subject to certain liens, encumbrances or interests.

Generally, bankruptcy assets may only be sold outside the ordinary course of business if any one of the following requirements are satisfied:

- applicable non-bankruptcy law permits such sale;
- an entity that holds a lien, encumbrance or interest against such assets consents to such sale;
- such interest is a lien and the price at which such property to be sold is greater than the aggregate value of all liens on such property;
- there is a bona-fide dispute concerning such interest; or
- such entity could be compelled to accept a money judgment in satisfaction of such interest.

If any one of these requirements are satisfied, Section 363(f) authorizes such sale "free and clear" of any interest in such property.

POTENTIAL RISKS TO ASSET PURCHASERS

There are three categories of potential risks when purchasing assets from a bankrupt or insolvent entity: (1) possible successor liability arising from certain unknown or future tort claims which, although arising pre-petition, do not become known until after the bankruptcy filing; (2) competitive bidding designed to encourage the highest and best bid for the bankruptcy estate; and (3) possible avoidance of pre-petition sales for less than fair market value.

Successor Liability Claims

Generally, "a corporation which acquires another corporate entity's assets does not assume the seller's liabilities unless (1) the buyer expressly assumes those liabilities; (2) the transaction constitutes a merger or consolidation; (3) the buyer is a mere extension of the seller; or (4) the transaction amounts to a fraudulent or collusive attempt to avoid the seller's liabilities."[4]

In the bankruptcy context, the "free and clear" language of Section 363(f) has proven to be troublesome in the area of successor liability. Several courts have held that the "free and clear" language only insulates property against which specific interests, such as liens, attach (*e.g., in rem* interests).[5] Other courts, however, ignore the distinction between *in rem* and *in personam* claims to allow tort claims to attach to specific property.[6]

The salient question in determining whether a successor-liability action can be discharged through a Section 363 Sale or through a Chapter 11 Plan is whether such liability is a "claim" as that term is defined by the Bankruptcy Code.[7] If the action is a pre-petition claim, some courts have held that the asset sale can be approved free and clear of that claim and the claim can be discharged through a Chapter 11 plan.[8] If the action is not a claim, the asset purchaser could be saddled with significant successor liability that would not be discharged. As an Illinois bankruptcy court has stated, "[d]espite the various permutations in fact patterns and reasoning, virtually all the cases conclude that unknown tort claims cannot be discharged and precluded from future recoveries unless their interests have been adequately represented within the bankruptcy proceeding."[9] Despite the strong legal arguments against the

imposition of successor liability for pre-petition tort claims, prospective asset purchasers are often advised to assume that a tort claim unknown at the time of the asset sale may be asserted against them after consummating the sale.

How Purchasers Cope With Potential Successor Liability Claims

The purchaser's best protection against successor liability is to carefully craft the asset purchase agreement to minimize such liability, and to insist that the sale order contain prophylactic provisions designed to insulate the purchaser from liability. For example, a purchaser will generally request that the asset purchase agreement and proposed sale order unambiguously state that the sale is free and clear of all claims against the debtor, whether known or unknown, liquidated or unliquidated, and releases or discharges the asset purchaser from any successor liability. Similarly, the asset purchase agreement and the proposed sale order may include very broad releases and provisions which unambiguously enjoin creditors or any other party from bringing any action or claim against the purchaser which arose prior to the purchaser's acquisition of the debtor's assets or business. In addition, the purchaser may demand that the asset purchase agreement, the sale order and the bankruptcy court's findings of fact and conclusions of law state unequivocally that purchaser is not a successor in interest of the debtor for any purpose, and thus, is not liable for any pre-acquisition successor liability claims. Finally, in order to minimize confusion and possible disputes in the future, the purchaser may seek to have the asset purchase agreement clearly identify all liabilities that the purchaser expressly seeks to assume, with all remaining liabilities to be rejected.

In addition to ensuring that the asset purchase agreement, sale order, and findings of fact and conclusions of law contain the appropriate prophylactic devices to protect the purchaser from successor liability, the purchaser also may take other steps to ensure that it does not, in fact, "appear" to be a successor in interest to the debtor's business. For example, the purchaser may not want to assume employee obligations or retain employees under existing contracts. Similarly, the purchaser may not want to employ the debtor's directors, officers or controlling shareholders unless absolutely necessary. If

the purchaser intends to operate in a manner substantially similar to the debtor's business, the purchaser also may close down operations for a while, operate from a different location, and use a different business name, letterhead and telephone numbers. Purchasers are advised that the fewer connections that the purchaser's business has with the debtor's business, the less likely that the purchaser will be subject to successor liability.

Reserve Fund And The Appointment Of A Representative For Unknown Claimants

If it is likely that substantial unknown claims exist, the asset purchaser may desire additional protection by having the debtor set aside a reserve to pay unknown tort claimants based upon certain historical assumptions about the company's business, and actuarial calculations of damages, injuries or deaths occurring in the same industry. For example, as part of the prospective purchaser's due diligence, the purchaser may desire to retain an expert to estimate the number of injuries or deaths per year that may occur as a result of the manufacture, use or sale of any given product manufactured or sold pre-petition. Based upon the expert's analysis, the proposed purchaser can demand that the debtor set aside a large enough reserve to pay such claims in full.

The reserve or trust fund device has been widely used in mass tort cases involving asbestosis, agent orange, the Dalcon Shield and silicone implants, where tort claimants often do not know that they have a claim against the debtor, or successor-in-interest, for years after the exposure.[10] In order to ensure that a claimant's due process rights are protected, the courts often appoint a representative to represent the unknown future claimants.[11] The reserve fund device may be especially desirable for purchasers if the acquired assets are located outside of the bankruptcy court's jurisdiction where an injunction would not be enforceable.

Discount

Frequently, a company that may have significant unknown claims against it may agree to discount its assets in an amount sufficient to cover potential successor liability claims.[12] However, it is often difficult to deter-

mine an accurate discount rate because any given year may have significantly more or less claims than might fall within the statistical average. Thus, an asset purchaser may get a windfall if fewer than expected successor liability claims are asserted against it. Conversely, an asset purchaser may be saddled with significant new debt that was unanticipated if greater than expected successor liability claims are asserted against it. Thus, any discount should only be used as one of the panoply of tools available to purchasers of assets in bankruptcy.

Conditional Offer

Finally, an offer to purchase assets from a debtor or insolvent company may be conditioned upon a bankruptcy court's approval of a purchase agreement which removes all claims, including unknown or future, pre-acquisition tort claims from assets to be acquired by the asset purchaser.[13] Thus, any claims asserted after acquisition can only be asserted against the debtor or assets of the bankruptcy estate, including the net sale proceeds. If the debtor or insolvent company does not obtain court approval of this condition, the asset purchaser can terminate the purchase agreement for cause.

In sum, purchasers of assets from a debtor or insolvent company have various tools at their disposal to minimize the impact of potential successor liability claims. This article is not exhaustive of the tools available, but is only intended to highlight possible risks and possible solutions to minimize these risks on which an asset purchaser may seek to rely.

Bidding Procedures and Incentives

Although a debtor-in-possession's decision to sell its assets outside the ordinary course of business is protected by the business judgment rule,[14] "the ultimate purpose [of such sale should be] to obtain the highest price for the property sold."[15] "In approving any sale outside the ordinary course of business, the court must...find [that the proposed sale]...is in the best interest of the estate, i.e. it is fair and reasonable, that it has been given adequate marketing, that it has been negotiated and proposed in good faith, that the purchaser is proceeding in good faith, and that it is an 'arms-length' transac-

tion."[16] To accomplish these objectives, courts generally require that the proposed sale be subject to overbids.

However, in order to incentivize the proposed purchaser to be the so-called "stalking horse," sellers are often required to give the buyer some protection should the proposed sale not be consummated. This is because buyers do not want to be used by the debtor to obtain higher bids or incur substantial costs in performing their due diligence. A "breakup fee" is often used to pay the potential buyer if the proposed sale is not consummated through no fault of the buyer. In large cases, the breakup fee can be substantial. Similarly, a "topping fee" may be used to pay the initial buyer a certain percentage of the difference between the buyer's initial bid, and the successful bid. These devices can be used separately or together, and are often approved by bankruptcy courts if they are reasonable and do not chill the bidding process.[17]

As part of the sale negotiations, the proposed buyer should try to negotiate a breakup fee and topping fee to compensate it for the time and expense incurred for agreeing to bring the first bid to the table, and as a hedge against the possibility that another party will be the successful bidder at a bankruptcy auction.

Possible Bankruptcy Court Disapproval Of Pre-Bankruptcy Sales

It is possible that a sale entered into between a proposed asset purchaser and an insolvent entity on the eve of bankruptcy may be unwound by the bankruptcy court if the court determines that the sale was not sufficiently exposed to the market place or the assets were acquired for inadequate consideration.[18] For example, in *In re United Healthcare System, Inc.*,[19] the bankruptcy court voided a pre-petition sale of an acute care hospital to an entity that agreed to maintain the legacy of the children's hospital on the basis that the debtor should have accepted higher and better competing bids. The district court reversed, stating that the bankruptcy court improperly focused its overwhelming attention on the monetary aspects of competing bids when the debtor's board of directors had a fiduciary duty to maintain the legacy of the children's hospital.

It is good practice for a proposed buyer to make sure that the assets that it seeks to obtain are exposed to the market place and subject to overbids. Otherwise, the transactions may be unwound by the bankruptcy court to afford the trustee or debtor-in-possession an opportunity to seek the best and highest bid. Alternatively, if the transaction cannot be unwound, it is possible that the buyer could be required to pay the difference between the purchase price and the fair market value of the asset as a fraudulent conveyance under 11 U.S.C. Sections 544 and 547.[20]

CONCLUSION

As banks and other creditors are or should be aware, investors who seek to acquire assets of an insolvent corporation or a corporation in bankruptcy can often do so at bargain basement prices. However, there are certain risks associated with such sales. Generally, it is in the asset purchaser's interest to make sure that a pre-bankruptcy sale is adequately exposed to the marketplace and is subject to overbids. Otherwise, the sale may be voided by the bankruptcy court or the investor may be ordered to disgorge the difference between the purchase price and the fair market value of the assets at the time of acquisition. In the post-bankruptcy context, the proposed buyer may try to negotiate break-up and topping fees to ensure that if the transaction fails through no fault of the purchaser, or the debtor's assets are sold to an overbidder, the buyer nevertheless is adequately compensated for such risks. Finally, a proposed buyer may minimize the risk of successor liability by (a) requiring the debtor to set aside a sufficient reserve to pay unknown or future claims, (b) obtaining a discount based upon estimated successor liability claims and/or (c) negotiating a provision in the purchase agreement which releases the purchaser from any successor liability claims.

NOTES

[1] *See* Neil McCartney, *A Tale of Misfortunes and Lost Fortunes, Where are They Now?,* The Financial Times, 2003 WL 652442683 (Oct. 13, 2003).

[2] *See Vitacost.com Acquires Dr.Koop.com for Cash,* Associated Press (July 16, 2002).

[3] 11 U.S.C. § 363.

[4] *In re Savage Indus., Inc.*, 43 F.3d 714, 717 n. 4 (1st Cir. 1994)(citing *Conway v. White Trucks*, 885 F.2d 90, 93 (3d Cir. 1989)(other citations omitted)). California, New Jersey and other states have adopted a "hybrid" exception known as "'product-line' liability" which precludes implied successor liability for products liability cases. *Id.* The seller must show the following: "(1) the total or virtual extinguishment of tort remedies against the seller as a consequence of an all-asset sale; (2) the buyer's continued manufacture of the same product lines under the same product names; (3) the buyer's continued use of the seller's corporate name and identity and trading on the seller's good will; and (4) the buyer's representation...to the public that it is an ongoing enterprise." *Id.* (citations omitted).

[5] *See, e.g., Fairchild Aircraft, Inc. v. Cambell*, 184 B.R. 910, 917 (Bankr. W.D. Tex. 1995)("[N]o one can seriously argue that *in personam* claims have, of themselves, an interest in such property."), *vacated on other grounds*, 220 B.R. 909 (Bankr. W.D. Tex 1998); *In re White Motor Credit Corp.*, 75 B.R. 944, 948, 951 (Bankr. N.D. Ohio 1987) (declining to impose successor liability on asset purchaser because "[t]he successor liability specter would chill and deleteriously affect sales of corporate assets, forcing debtors to accept less on sales to compensate for this potential liability"); *In re New England Fish Co.*, 19 B.R. 323, 326 (Bankr. W.D. Wash 1982).

[6] *See, e.g., Chicago Truck Drivers, Helpers & Warehouse Workers Union Pension Fund v. Tasemkin, Inc.*, 59 F.3d 48, 51 (7th Cir. 1995)(recognizing that the fact that creditors who possess successor liability claims may receive more than those who do not does not require an absolute prohibition on successor liability claims); *Zerand-Bernal Group, Inc. v. Cox*, 23 F.3d 159, 163 (7th Cir. 1994)(noting that extinguishing state law rights in order to increase the value of the debtors' property, "would not only...harm...third parties..., but [would provide an] incentive to enter bankruptcy for reasons that have nothing to do with bankruptcy law")(citation omitted); I*n re All American of Ashburn, Inc.*, 56 B.R. 186, 190 (Bankr. N.D. Ga. 1986)(reaffirming earlier decision that "the sale of the debtor's assets, approved by the Bankruptcy Court as free and clear of all claims, precludes the application of the successor doctrine against a purchase of those assets in a suit based on the debtor's alleged employment discrimination and violation of employees' civil rights"), *aff'd*, 805 F.2d 1515 (11th Cir. 1986). Courts have developed several tests to determine whether a claim can be asserted against a successor-in-interest:

A *Conduct Test*

Under the conduct test, a claim arises when conduct giving rise to the alleged liability occurred. *In re Kewanee Boiler Corp.*, 198 B.R. 519, 531 (Bankr. N.D. Ill. 1996)(citations omitted).

B *Pre-Petition Relationship Test*

The pre-petition relationship test requires that "potential future claimants

have entered into some kind of relationship with debtor at the time they were injured or earlier. Thus, if their injury occurs post-petition, only if they purchased, used, operated, or came in contact with debtor's defective product in their ordinary activity pre-petition, [are] they found to have a pre-petition claim." *Id.*

C *State Accrual Test*
The state accrual test focuses on state law to determine if and when a claim exists that may be addressed through the bankruptcy process. *Avellino Bienes v. M. Frenville Co.*, 744 F.2d 332, 335-36 (3d Cir. 1994).

D *Due Process Test*
In *Fairchild*, the court recognized the broadest possible relief available that does not "ride roughshod over due process and notions of fundamental fairness." *Fairchild*, 184 B.R. at 927. Thus, for example, a claim cannot be discharged if the claimant was not given notice and an opportunity to respond.

E *Fair Contemplation Test*
The Ninth Circuit Court of Appeals and other courts have adopted the "fair contemplation" test, at least in the context of CERCLA claims. *See In re Jensen*, 995 F.2d 925 (9th Cir. 1993). Under this test, a claim may only be deemed pre-petition if it is "based upon pre-petition conduct that can be fairly contemplated by the parties at the time of the debtors' bankruptcy." *Id.* at 930 (citation omitted).

[7] The term "claim" is broadly defined as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured..." 11 U.S.C. § 101(5).

[8] Of course, these courts ignore the distinction between *in rem* claims, which look to specific property for recovery, and *in personam* claims, which can be pursued against the entity. Arguably, products liability or tort claims are *in personam* claims that do not attach to specific property. Thus, the "free and clear" language should presumably not apply. Nevertheless, as discussed above, numerous courts have ignored this distinction.

[9] *In re UNR Indus., Inc.*, 224 B.R. 664, 672 (Bankr. N.D. Ill. 1998).

[10] *See, e.g., In re National Gypsum Co.*, 257 B.R. 184, 197 (Bankr. N.D. Tex. 2000)(trust established for estimating non-discharged asbestos disease claims over the next 40 years and retaining an expert to value those claims in the tort system), *cert. denied*, 532 U.S. 1075, 121 S. Ct. 2238, 150 L.Ed. 227 (2001); *see also In re UNR Indus., Inc.*, 224 B.R. 664, *passim* (Bankr. N.D. Ill. 1998)(and cases cited therein).

[11] *In re UNR Industries*, 224 B.R. 664 (Bankr. N.D. Ill. 1998); *Kewanee Boiler*, 198 B.R. at 528-29 (recognizing that the due process concern for ensuring that a creditor who had no way of knowing that it may have a claim against the debtor some time in the future may be adequately addressed by the establishment of a trust fund for future claimants and the appointment of a representative to articulate the interests of future claimants); *National Gypsum*, 257 B.R. at 187 (noting that the court previously appointed a legal representative "to advocate the interests of the unknown and future asbestos disease claimants").

[12] *See, e.g., City Environmental, Inc. v. U.S. Chemical Co.*, 814 F.Supp 624, 640-41 (E.D. Mich. 1993)(proposed buyer sought discount for assumption of CERCLA liability), *aff'd*, 43 F.3d 244 (6th Cir. 1994).

[13] *See In re Leckie Smokeless Coal Co.*, 99 F.3d 573, 577 (4th Cir. 1996)(proposed buyer insisting that it take property free and clear of all successor liabilities that might arise under the Coal Act), *cert. denied*, 520 U.S. 1118, 117 S.Ct. 1251, 137 L.Ed.2d 332 (1997).

[14] *In re Lionel Corp.*, 722 F.2d 1063, 1070 (2d Cir. 1983); *In re Plaza Family Partnership*, 95 B.R. 166, 173 (E.D. Cal. 1989).

[15] *In re Wilde Horse Enters., Inc.*, 136 B.R. 830, 841 (Bankr. C.D. Cal. 1991)(citing *In re Chung King, Inc.*, 753 F.2d 547 (7th Cir. 1985); (other citations omitted)).

[16] *Wilde Horse*, 136 B.R.. at 841-82 (citations omitted).

[17] *See, e.g., In re American West Airlines, Inc.*, 166 B.R. 908-12 (Bankr. D. Ariz. 1994).

[18] This is also consistent with the Bankruptcy Code's protection of the sale order from collateral attacks if the court makes a finding that the purchaser acquired estate assets in good faith and that the transaction was an "arms length" transaction not subject to collusion. *See, e.g.*, 11 U.S.C. §§ 363(m) and (n).

[19] 1997 LEXIS 5090, at *19-20 (D.N.J. 1997).

[20] *See, e.g., In re Morris Comm. NC, Inc.*, 914 F.2d 458 (4th Cir. 1990); *In re Maddalena*, 176 B.R. 551 (Bankr. C.D. Cal. 1995).