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Practical Issues Surrounding Section 363 Sales

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PRACTICAL ISSUES SURROUNDING SECTION 363 SALES

Harley E. Riedel[*] *& Edward Peterson*[**]

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I. INTRODUCTION

This Article explores several practical and recurring issues surrounding going concern sales of a Chapter 11 debtor's ongoing business operations pursuant to 11 U.S.C. § 363(b) (2006).[1] Section 363(f) of the Bankruptcy Code provides that such sales may be "free and clear" of "interest," as follows:

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1. Section 363(b) provides: (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, except that if the debtor in connection with offering a product or a service discloses to an individual a policy prohibiting the transfer of personally identifiable information about individuals to persons that are not affiliated with the debtor and if such policy is in effect on the date of the commencement of the case, then the trustee may not sell or lease personally identifiable information to any person unless—(A) such sale or such lease is consistent with such policy; or (B) after appointment of a consumer privacy ombudsman in accordance with section 332, and after notice and a hearing, the court approves such sale or such lease—(i) giving due consideration to the facts, circumstances, and conditions of such sale or such lease; and (ii) finding that no showing was made that such sale or such lease would violate applicable nonbankruptcy law.

> The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if--
> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
> (2) such entity consents;
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
> (4) such interest is in bona fide dispute; or
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.[2]

Specifically, this Article explores whether a sale in the context of a Chapter 11 case must result in a distribution to unsecured creditors, as opposed to secured creditors only. This Article further discusses the secured creditor's ability to transfer to unsecured creditors a portion of the proceeds to which the secured creditor would otherwise be entitled in order to obtain the support of the unsecured creditors for the sale.

In the case of solvent entities, good title to the assets of a business is ordinarily transferred by a combination of deeds, bills of sale, and assignment and assumption agreements. The release of secured claims is evidenced by written releases or satisfactions of all mortgages and liens on the transferred assets. Unsecured creditors are paid in full. Purchase agreements often contain indemnity provisions protecting the purchaser from undisclosed liabilities.

In the case of insolvent entities, if there is not enough money to pay in full the claims of all lien holders, then there is no practical way outside a Chapter 11 case to convey title to the encumbered assets free and clear of those claims unless each lien holder is willing to release its liens for an agreed upon payment. Even in circumstances where all secured claims are paid in full, purchasers may be concerned about their liability as successors to the seller for unsecured claims or of a post-sale involuntary bankruptcy in which the sale is challenged as a fraudulent conveyance. Finally, anti-assignment provisions in leases and executory contracts may create transfer problems as to those contracts or leases.

Thus, sellers and purchasers may find significant benefits from a sale transaction that is approved by a bankruptcy court on notice to all creditors. Secured creditors may also perceive benefits in using the

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2. 11 U.S.C. § 363(f) (2006).

bankruptcy process to expeditiously transfer assets subject to their liens. Secured creditors may acquire clear title to assets through use of state law remedies, such as judicial or non-judicial foreclosure proceedings, but these are often ill-suited to the sale of an ongoing business and the transfer of contracts and leases.

If a bankruptcy process is chosen, a going concern sale is effectively accomplished only in a Chapter 11 case, because business operations almost invariably cease in Chapter 7 cases.[3] Congress enacted Chapter 11 to allow, and indeed encourage, the rehabilitation rather than the piecemeal liquidation of financially distressed entities.[4] The theory is that everyone benefits if the reorganization is successful. Employees will retain their jobs, saving the government unemployment and other welfare payments. Employees also continue to earn paychecks, which allows them to spend these funds on other economic goods and services. The ongoing business will continue to form part of the tax base, contributing taxes to local, state and national governments. Finally, because the going concern value of assets is presumed to be greater than the piecemeal liquidation value of those assets, creditors will receive more than they would receive in a Chapter 7 liquidation case or following the dismemberment of the debtor under state foreclosure and creditors' rights laws. Going concern sales of the debtor's business operations may be accomplished by motion or through a Chapter 11 plan.[5]

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3. 11 U.S.C. § 721 does provide for the Chapter 7 trustee to operate the debtor's business for a limited period "if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate."

4. *See In re* Air Vectors Assocs., 53 B.R. 668, 686-87 (Bankr. S.D. 1985).

5. Some courts have restricted a debtor's ability to dispose of all or substantially all its assets by a motion filed under 363(b) of the Bankruptcy Code. These courts have concluded that such sales may require the disclosures and other protective procedures associated with a plan of reorganization rather than a simple motion. The leading circuit court case on this issue was *In re* Braniff Airways, Inc., 700 F.2d 935 (5th Cir. 1983). Braniff, the debtor obtained approval of a sale of its cash, airplanes and equipment, terminal and landing slots to another airline in exchange for travel scrip, unsecured notes and a profit participation in the purchaser's proposed airline operation. *Id.* at 939. Obviously, this consideration was much more difficult for a creditor to evaluate than an all-cash purchase price and would seem to require far more disclosure than a simple motion. To compound the problem, the distribution of this consideration was also established by the contract. For example, the travel scrip was largely allocated to employees of Braniff rather than to other creditors. For all of these reasons, the court determined that the sale in question required the protective features of a plan of reorganization. *Id.* at 940. Other courts have recognized that the Braniff case should not be held to preclude a sale of substantially all assets pursuant to a 363 motion as a matter of law. Two tests seem to have been adopted by various courts. The most lenient test simply requires that the debtor have an "articulated business justification, other than appeasement of major creditors"; to accomplish such a sale. *See In re* Lionel Corp., 722 F.2d 1063, 1070 (2d Cir. 1983); *see also In re* Chateaugay Corp., 973 F.2d 141, 143 (2d Cir. 1992); Stephens Indus., Inc. v. McClung, 789 F.2d 386, 389 (6th Cir. 1986). Other courts have indicated that

When given the choice between pursuing state court remedies that will result in a cessation of business operations or participating in a bankruptcy sale, secured creditors will prefer the bankruptcy process if they conclude that the business is worth more operating than defunct. Business operations may be maintained in Chapter 11 through new financing or the use of cash collateral, while the assets will be protected by the automatic stay. Anti-assignment clauses in leases and contracts will not be permitted to preclude transfer of those contracts or leases to a purchaser. In addition, certain protections from creditors can be afforded to purchasers.[6] For all of these reasons, secured creditors may conclude that the purchase price will be higher if the bankruptcy process is used. What follows is an analysis of practical and legal issues that arise in a section 363 sale under Chapter 11.

II. MUST THERE BE A CARVE-OUT FOR UNSECURED CREDITORS?

A motion to sell substantially all the assets of a debtor as a going concern often involves a complicated set of pleadings, because the purchaser will want to also become the assignee of valuable leases and unexpired contracts, which will require action under 11 U.S.C. § 365 (2006). Motions to sell are often filed early in a case, in which event it is likely that the contract was negotiated pre-filing, with a requirement by the purchaser that the sale be accomplished in Chapter 11 in order to obtain free and clear title to assets and in order to create a mechanism to assign leases and contracts with anti-assignment clauses. In other instances, the sale will follow unsuccessful efforts to return the business to a sufficient level of profitability to fund a "stand-alone" plan or obtain take-out financing. An unsecured creditors' committee faced with such a motion, and facing the prospect of no distribution on account of their unsecured claims, has a number of options. The committee may still have the right to object to the amount or validity of the secured creditor's claim, may have the right to seek leave to pursue avoidance actions against the secured creditor on account of pre-petition transfers to it, and has the right to file a motion to dismiss or convert the case to a Chapter 7 case.

Modern Chapter 11 represents a blending of provisions of chapters X, XI, and XII of the Bankruptcy Act of 1898. Under Chapter XI, secured

something akin to an emergency situation which requires a speedy liquidation is required before such a sale. *See In re* White Motor Credit Corp., 14 B.R. 584, 590 (Bankr. N.D. Ohio 1981).

6. Indeed, a carefully drafted order approving the sale will eliminate much of the risk of successor liability for the purchaser. By contrast, ordinary, non-bankruptcy foreclosure sales pursuant to the Uniform Commercial Code do not bar otherwise viable successor liability claims against the purchaser. *See* Cont'l Ins. Co. v. Schneider, 873 A.2d 1286, 1291 (Pa. 2005).

debts could not be affected, and the plan of arrangement could deal only with unsecured debt. Furthermore, there was some authority for the proposition that businesses should not be liquidated in Chapter XI, but rather that such liquidation must take place in straight bankruptcy proceedings.[7] In Chapter X, the majority view was that liquidation would be permitted under the guidance of a Chapter X trustee, although some cases suggested that such liquidation was more appropriate in straight (new Chapter 7) bankruptcy cases.

Chapter 11 contains no express requirement that unsecured creditors receive a distribution. Under § 1126(g), a creditor is deemed to have rejected a plan if the plan provides that it is not to receive or retain any property under the plan on account of its unsecured claim.[8] This implies, at least, that a plan could be confirmed without a distribution to unsecured creditors. Such a plan would have to comply with the "cramdown" provisions of § 1129(b), but, as a practical matter, as long as junior classes (equity interests) receive no distribution either, a plan with no distribution to unsecured creditors may meet the cramdown test imposed by § 1129(b)(2)(B)(ii). Because a debtor's assets may be sold under a plan pursuant to § 1123(b)(4), it would also seem to follow that the debtor could, with the secured creditor's consent and affirmative vote, sell all assets with no distribution to general unsecured creditors. Priority

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7. *In re* Sapolin Paints, Inc., 11 B.R. 930, 935 (Bankr. E.D.N.Y. 1981), the Court stated:

> Before considering the precise facts of the present proceeding, some consideration of the statutory framework in which it arises is appropriate. [The Debtors] filed their Chapter 11 proceeding under the most recent legislative revision of the bankruptcy laws of the United States, the Bankruptcy Code. Although Chapter 11 is captioned "Reorganization," and although the aim of the reorganization provisions of the Code is to facilitate a rehabilitation, the Code contemplates that a debtor corporation "may be liquidated in Chapter 11." Section 1123(b)(4) permits the reorganization plan to "provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among holders of claims or interests."
>
> This represents a change in the law. In In re Pure Penn Petroleum Co., 188 F.2d 851, 855 (2d Cir. 1951), the Court of Appeals for this Circuit held that an arrangement proposed under former chapter XI of the Bankruptcy Act "must comprehend something more than a mere surrender by the debtor of all his assets for liquidation and distribution to creditors." If a debtor under Chapter XI could sell all his assets, "a Chapter XI plan could bring about the same result as ordinary bankruptcy proceedings but minus the protective provisions whichare part of the latter, especially as to a sale of all the assets."

Id. (citations omitted).

8. 11 U.S.C. § 1126 (g).

creditors, however, must be paid in full unless they consent to different treatment.[9]

It is much more difficult to convince a court to approve a sale in the Chapter 11 context that results in no distribution to unsecured creditors. For instance, in *In re Encore Healthcare Associates*,[10] the debtor sought court approval to sell its sole asset for a sale price of $2,500,000.[11] According to the debtor's schedules, the property to be sold was subject to a secured claim of $8,401,259 held by Greenleaf.[12] The proceeds of the sale were to be used to pay for the cost of the sale and to partially pay the amounts owed to Greenleaf.[13] The sale agreement, which was entered pre-petition, required the debtor as seller to file a petition under Chapter 11 and file a motion seeking approval of the sale under section 363 of the Bankruptcy Code.[14] Although there were no objections filed to the sale motion, the court *sua sponte* questioned the propriety of a section 363 sale where the sole purpose is to liquidate assets for the benefit of the secured creditor.[15] The court's concerns were heightened after debtor's counsel acknowledged the intention to convert the Chapter 11 case to one under Chapter 7 following approval of the sale.[16]

Citing to *Committee of Equity Security Holders v. The Lionel Corporation* (*In re The Lionel Corporation*),[17] the court instructed that there must be some business justification for a sale, "other than appeasement of major creditors."[18] The court concluded that there was no business justification for the sale at issue because there would be no distribution to unsecured creditors and the sale would only benefit the secured creditor.[19]

Additionally, the court in *In re Fremont Batter Co.*,[20] applied the same reasoning. The court applied the *Lionel* business judgment test and concluded that there was no justification for the purposed section 363 sale.[21] The court reasoned as follows:

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9. *See* 11 U.S.C. § 1129(a)(9).
10. 312 B.R. 52 (Bankr. E.D. Penn. 2004).
11. *Id.* at 54.
12. *Id.*
13. *Id.*
14. *Id.*
15. *In re Encore Healthcare Assocs.*, 312 B.R. at 54.
16. *See id.*
17. 722 F.2d 1063 (2d Cir. 1983).
18. *In re Encore Healthcare Assocs.*, 312 B.R. at 55.
19. *Id.* at 58.
20. 73 B.R. 277 (Bankr. N.D. Ohio 1987).
21. *Id.* at 279.

> The proposed sale would not, as a whole benefit the [d]ebtor or creditors. In fact, if allowed, the sale would terminate [d]ebtor's existence. If [d]ebtor's proposed sale were authorized, the likelihood of reorganization would dissipate as there would remain no assets from which a plan could be proposed. Additionally, the proceeds from the proposed sale would, at most, benefit one creditor only. The sale would not create proceeds that would inure to the benefit of the unsecured creditors.[22]

Where sales outside the ordinary course have been approved, the facts are different. For example, in *In re Medical Software Solutions*,[23] the court found a sound business reason for a sale outside the ordinary course based on the lack of funds to continue operating and the narrow window for the sale before the assets began to decline in value.[24] Importantly, the sale also insured the payment of administrative claims and established a $100,000 fund for unsecured creditors.[25] Additionally, in *In re Channel One Communications, Inc.*,[26] The court approved a sale under circumstances where the debtor was securing post-petition loans to fund operating losses and needed to sell the assets quickly to maximize value for the estate.[27] Additionally, the consideration for the assets was in excess of all liens and encumbrances.[28]

In short, there is no absolute requirement under the Bankruptcy Code for there to be a distribution to unsecured creditors in the context of a section 363 sale. Perhaps that is because the benefits of going concern sales in Chapter 11 are far reaching, in terms of preservation of jobs, which in turn saves the government money. Nevertheless, although not required by the text of the Bankruptcy Code, depending upon the circumstances, many courts will not approve a section 363 sale unless there is some type of distribution to unsecured creditors. Sometimes, a carve-out to unsecured creditors is regarded as the "price of admission" for secured creditors wishing to benefit from the increased value that may attend a bankruptcy court's order approving a sale. This debate will

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22. *Id. See also In re* Mastercraft Interiors, Ltd., N.O. 06-12769, 2006 WL 4595946, at *14 (Bankr. D. Md. Aug. 10, 2006) (court approved a cash collateral motion in connection with a wind-up liquidation where, subject to certain conditions, the relief included a $400,000 reserve amount for payment to unsecured creditors).

23. 286 B.R. 431 (Bankr. D. Utah 2002).

24. *Id.* at 441.

25. *Id.* at 442.

26. 117 B.R. 493 (Bankr. E.D. Mo. 1990).

27. *Id.* at 496.

28. *Id.*

continue, and as discussed below, there are creative ways for secured creditors to appease dissenting unsecured creditors.

III. CAN A SECURED CREDITOR DESIGNATE A CARVE-OUT FOR UNSECURED CREDITORS WHEN THIS DESIGNATION MAY BE IN VIOLATION OF THE ABSOLUTE PRIORITY RULE?

An interesting question is whether a secured creditor can designate a portion of the sale proceeds to be paid to unsecured creditors even when there are administrative expense claims and priority claims that are unpaid. When there are allowed priority or administrative expense claims, allowing secured creditors in such a situation to "gift" a portion of the sale proceeds to unsecured creditors violates the priority scheme under section 507 of the Bankruptcy Code. Pursuant to the absolute priority rule, a junior class of creditors may not receive or retain property on account of such interest unless the senior class either consents or is paid in full.[29] This "absolute priority rule" is codified at 11 U.S.C. § 1129(b)(2)(B) as a definition of the "fair and equitable" standard for plan confirmation.[30] A secured creditor's gifting of a portion of its collateral to unsecured creditors, sometimes referred to as "reverse cramdown," finds its modern origins in *Official Unsecured Creditors' Committee v. Stern (In re SPM Manufacturing Corp.)*.[31]

SPM involved a Chapter 11 debtor whose creditors consisted of: (1) Citizen's Saving Bank (Citizens), owed approximately $9 million and secured by a perfected security interest on substantially all of *SPM*'s assets; (2) the IRS, owed priority withholding taxes of approximately $750,000; and (3) general unsecured creditors, owed approximately $5.5 million.[32] Citizens and the committee agreed that Citizens would share with the unsecured creditors any proceeds it received as a result of the

29. *See* 11 U.S.C. § 1129(b)(2)(B)(ii) (2006).

30. 11 U.S.C. § 1129(b) provides in pertinent part:

> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> . . . .
>
> (B) With respect to a class of unsecured claims-
>
> . . . .
>
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . . .

Id.

31. *See In re* SPM Mfg. Corp., 984 F.2d. 1305 (1st Cir. 1993).

32. *Id.* at 1307.

reorganization or liquidation of *SPM*.[33] Ultimately, *SPM*'s assets were sold for $5 million and the case was converted to a Chapter 7 case.[34]

The bankruptcy judge ruled that the distribution of the sale proceeds violated the priority scheme of the Bankruptcy Code.[35] The bankruptcy court ordered Citizens to pay the amount it had agreed to share with the committee to the Chapter 7 trustee to distribute to the priority tax claimants.[36] The First Circuit reversed, holding that "creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors."[37]

Other courts have followed suit. For example, in *In re MCorp. Financial Inc.*,[38] the U.S. District Court for the Southern District of Texas confirmed liquidating Chapter 11 plans that provided for distributions of a portion of the senior bondholders' potential recovery to the FDIC in settlement of complex litigation.[39] Additionally, in *In re Genesis Health Ventures*,[40] the U.S. Bankruptcy Court for the District of Delaware confirmed a Chapter 11 plan that provided for distributions of new common stock to existing management even though certain objecting parties had argued that such distributions were violative of the absolute priority rule.[41]

More recently, in *In re World Health Alternatives*,[42] the debtor filed a motion to approve a debtor in possession (DIP) financing order, bid procedures, and a sale of substantially all of its assets.[43] The bankruptcy court approved the DIP financing and bid procedures and scheduled an auction.[44] The committee reserved its rights to object to the sale.[45] Before the date of the auction, the committee and the secured creditor entered into an agreement under which the secured creditor agreed to cap its claim at $42.5 million, waive any deficiency claim and to carve out $1,625,000 of the secured creditor's collateral for the benefit of unsecured creditors after payment of the fees of the committee's professionals.[46] There was no

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33. *Id.* at 1308.
34. *Id.* at 1308-09.
35. *Id.* at 1309.
36. *In re SPM Mfg., Inc.*, 984 F.2d at 1309.
37. *Id.* at 1313.
38. 160 B.R. 941 (S.D. Tex. 1993).
39. *Id.* at 960-61.
40. 266 B.R. 591 (D. Del. 2001).
41. *Id.* at 616-18.
42. 344 B.R. 291 (Bankr. D. Del. 2006).
43. *Id.* at 293.
44. *Id.*
45. *Id.* at 294.
46. *Id.*

provision for payment of the priority tax claims.[47] The U.S. Trustee objected to the agreement on the grounds that payment of unsecured claims ahead of priority tax claims violated the policy underlying the absolute priority rule.[48] The bankruptcy court approved this settlement, on the basis that the payment to unsecured creditors ahead of priority tax claims was permissible because the payment was a carve-out of the secured creditor's collateral, and was not property of the estate.[49]

Other courts have not been as congenial towards such sharing arrangements. For example, in *In re OCA, Inc.*,[50] the bankruptcy court denied confirmation of a plan that provided that a secured creditor would extend participation rights to equity holders, even though unsecured creditors were not paid in full.[51] The court disagreed that *SPM* and *In re MCorp* controlled the outcome.[52] Specifically, the court distinguished *SPM* on the basis that the sharing arrangement in *SPM* was not part of a plan of reorganization.[53] Further, unlike in *OCA* where the sharing arrangement directly impacted the distribution process, the sharing arrangement in *SPM* occurred after all of the distributions had been made.[54] In distinguishing the *MCorp* case, the court in *OCA* instructed as follows:

> The difference between the *MCorp* holding and the instant case, as this court sees it, is that the *MCorp* court was approving a settlement of hotly contested litigation that had endured for over four years, and that settlement was funded by the senior bondholders to put an end to that litigation so that they could receive a distribution from the debtor's estate.[55]

The court further instructed that although it:

> agrees with the proposition that a creditor receiving a distribution from an estate may do whatever it likes with the money it receives *after* distribution, the court finds it troublesome when the creditor purports to share with other creditors or equity, over the objection

47. *In re World Health Alternatives*, 344 B.R. at 294-95.
48. *Id.* at 295.
49. *Id.* at 297.
50. 357 B.R. 72 (Bankr. E.D. La. 2006).
51. *Id.* at 92.
52. *Id.* at 85.
53. *Id.*
54. *Id.*
55. *In re OCA, Inc.*, 357 B.R. at 85.

> of an intermediate class, through the mechanism of a plan in a Chapter 11 that this court is called upon to confirm.[56]

Additionally, the District of Delaware in *In re Armstrong World Industries, Inc.*,[57] raised some questions about the validity of sharing arrangements between secured creditors and unsecured creditors.[58] In *Armstrong*, the debtors negotiated a plan of reorganization with the official committee of unsecured creditors.[59] The plan provided that the debtor would distribute $1.8 billion in value to a trust established pursuant to section 524(g) of the Code to satisfy claims of all present and future creditors.[60] General unsecured creditors would receive approximately 59.5% of the value of their claims.[61] Class Twelve, consisting of the debtor's parent, would receive $35 to $40 million in warrants to purchase equity in the reorganized debtor.[62] The committee argued that the plan violated the absolute priority rule because the plan proposed to distribute warrants to purchase common stock in the reorganized debtor to the junior class of equity interest holders, in apparent violation of section 1129(b)(2)(B)(ii) of the Bankruptcy Code.[63] The bankruptcy court approved the plan as proposed, based on the analysis provided by the courts in *MCorp, Genesis Health Ventures*, and *SPM*.[64] On appeal, the district court rejected the notion that a distribution-sharing exception to the absolute priority rule existed.[65] The Third Circuit affirmed, and distinguished those cases cited by the debtor for the proposition that a creditor class can transfer some of its recovery to a junior class without violating § 1129(b).[66] In making this decision, the court distinguished a number of scenarios which it considered inapposite, including *MCorp, Genesis Health Ventures*, and *SPM*.[67] The analysis therefore leaves open the possibility for a reverse cramdown plan in which a secured creditor agrees to a carve-out for lower priority unsecured creditors.

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56. *Id.* at 87.
57. 320 B.R. 523 (D. Del. 2005).
58. *See id.* at 537.
59. *Id.* at 525.
60. *Id.*
61. *Id.*
62. *In re Armstrong World Indus., Inc.*, 320 B.R. at 526.
63. *Id.* at 528.
64. *Id.* at 531.
65. *Id.* at 539.
66. *See In re* Armstrong World Indus., Inc., 432 F.3d 507, 518 (3d Cir. 2005).
67. *Id.* at 514.

Most recently, the rationale of the *SPM* progeny of cases was called into question by the Second Circuit Court of Appeals in *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating, LLC)*.[68] There, the creditors committee hired special counsel to investigate the validity of the prepetition secured creditors' liens. After an extensive investigation, the committee determined that the estate had several causes of action against the lenders.[69] The bankruptcy court authorized the committee to commence adversary proceedings against the lenders to challenge the validity and priority of their liens.[70] Additionally, the committee sought permission to pursue claims against Motorola, the debtor's former parent company.[71] Because the estate had limited resources, the committee decided to settle with the lenders and focus its efforts on pursuing Motorola.[72] Pursuant to the settlement, the parties stipulated that the lenders' liens were valid—a stipulation, however, that only became effective upon entry of the order approving the settlement.[73] For purposes of this analysis, the most controversial aspect of the settlement involved the transfer of cash upon which the lenders asserted liens to unsecured creditors ahead of priority claimants.[74] Motorola, an administrative expense creditor, objected to the settlement on the basis that it violated the absolute priority rule.[75] In discussing the application of *SPM*, the court instructed as follows:

> *SPM* stands for the proposition that in a Chapter 7 liquidation proceeding, an under-secured lender with a conclusively determined and uncontested "perfected, first security interest" in all of a debtor's assets may, through a settlement, "share" or "gift" some of those proceeds to a junior, unsecured creditor, even though a priority creditor will go unpaid. The Lenders and the Committee ask us to expand *SPM* to Chapter 11 settlements and then apply it here for the first time.[76]

The court declined to expand the reasoning of *SPM* where, until the settlement was approved, the lenders' liens were contested and the money

68. 478 F.3d 452 (2d Cir. 2007).
69. *Id.* at 458.
70. *Id.*
71. *Id.*
72. *Id.*
73. *In re Iridium Operating*, 478 F.3d at 459.
74. *Id.* at 462.
75. *Id.* at 465.
76. *Id.* at 460 (citation omitted).

held by the lenders was an asset of the estate.[77] Accordingly, in the court's opinion, *SPM* had no application because in *SPM* the creditor had an uncontested and perfected first priority security interest in all assets of the estate.[78]

The court next considered Motorola's argument that the settlement violated the "fair and equitable" standard under section 1129(b)(2)(B)(ii) of the Bankruptcy Code.[79] Because the settlement had not been proposed as part of a plan of reorganization, the court struggled with the issue of whether this standard should apply to settlements entered into by parties prior to consideration of a plan of reorganization.[80] The court acknowledged the holding of the Fifth Circuit Court of Appeals in *United States v. AWECO, Inc. (In re AWECO, Inc.)*[81] wherein the Fifth Circuit adopted a per se rule that pre-plan settlements must satisfy the absolute priority rule.[82] The court in *Iridium* rejected such a per se rule, instructing that "[i]n our view, a rigid *per se* rule cannot accommodate the dynamic status of some pre-plan bankruptcy settlements."[83] However, the court warned:

> Rejection of a *per se* rule has an unfortunate side effect, however: a heightened risk that the parties to a settlement may engage in improper collusion. Thus, whether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is "fair and equitable" under Rule 9019. The court must be certain that parties to a settlement have not employed a settlement as a means to avoid the priority strictures of the Bankruptcy Code.
>
> In the Chapter 11 context, whether a settlement's distribution plan complies with the Bankruptcy Code's priority scheme will often be the dispositive factor. *However, where the remaining factors weigh heavily in favor of approving a settlement, the bankruptcy court, in its discretion, could endorse a settlement that does not comply in some minor respects with the priority rule if the parties to the settlement justify, and the reviewing court clearly articulates the*

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77. *Id.*
78. *In re Iridium Operating*, 478 F.3d at 460.
79. *Id.* at 462-63.
80. *See id.* at 463.
81. 725 F.2d 293 (5th Cir. 1984).
82. *In re Iridium Operating*, 478 F.3d at 463.
83. *Id.* at 464.

> *reasons for approving, a settlement that deviates from the priority rule.*[84]

Because the committee did not provide a sufficient justification for the settlement's deviation from the absolute priority rule, the Second Circuit declined to approve the settlement and remanded the case for the bankruptcy court to assess the justifications for a departure from the absolute priority rule.[85]

Other courts, concerned with the use of the sharing arrangement as a way to gerrymander classes and manufacture votes in favor of a Chapter 11 plan, disagreed with the rationale of *SPM* and its progeny.[86] As the Fifth Circuit has instructed in the "one clear rule," "thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan."[87] In cases where gerrymandering is not an issue, the rationale of such cases appears to be misplaced.

There are some practical problems in implementing carve-out agreements. Generally, many of the Chapter 11 cases involving carve-out agreements ultimately convert to Chapter 7 cases. The question arises as to what entity will distribute funds after conversion of the Chapter 11 case to Chapter 7. There does not appear to be any case law authorizing or requiring a Chapter 7 trustee to do so. Indeed, in the case styled in *Matter of Xonics*, the bankruptcy court held that it has no jurisdiction over funds which are not property of the estate.[88] Additionally, Chapter 11 creditors' committees cease to exist after conversion of the case to Chapter 7. There are also problems with respect to distribution of carve-out funds pursuant to a Chapter 11 plan of reorganization. Under section 1129(a)(9) of the Bankruptcy Code, unless the holder of a priority claim has agreed to a different treatment, the plan must provide for payment in full to the holder of the priority claim.[89] Obviously, § 1129(a)(9) becomes difficult to satisfy under the scenario where there is a carve-out agreement that bypasses priority claimants. One potential way to satisfy § 1129(a)(9) is to convince the priority creditors to agree to share in the carve-out, on the theory that there is simply no more money to pay their claims. Similarly, in the Chapter 7 scenario, priority creditors may agree to share in the carve-out if they are convinced that they may not otherwise receive any distribution.

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84. *Id.* (emphasis added).

85. *Id.* at 466.

86. *See, e.g.*, *In re* Sentry Operating Co. of Texas, Inc., 264 B.R. 850, 866 (Bankr. S.D. Tex. 2001); *In re* CGE Shattuck, LLC, 254 B.R. 5, 13 (Bankr. D. N. H. 2000).

87. *In re* Greystone III Joint Venture, 995 F.2d 1274, 1279 (5th Cir. 1992).

88. *Matter of* Xonics, Inc., 815 F. 2d 127, 131-32 (7th Cir. 1997).

89. 11 U.S.C. § 1129(a)(9).

Such an arrangement may also necessitate the agreement of committee counsel because allowing the priority claimants to share in a carve-out will obviously result in a diminution of the recovery for unsecured creditors.

The majority rule continues to be that carve-out agreements are permissible where they involve a secured creditor with an undisputed lien voluntarily agreeing to a "gift" of its collateral for the benefit of unsecured creditors. Accordingly, unsecured creditors' committees are likely to continue to pursue carve-outs for the benefit of unsecured creditors. This prediction is especially true in cases where the debtor's assets are worth less than the amount of its secured claims. However, in light of the holding in *Iridium* discussed above, such carve-outs are more likely to be approved if the arrangement is made in a Chapter 11 case that contemplates conversion to Chapter 7.

IV. IS IT PERMISSIBLE FOR A SECURED CREDITOR TO PURCHASE A CLAIM OF A SECURED CREDITOR IN ORDER TO OBTAIN APPROVAL FOR A PROPOSED SALE?

Another alternative is for a secured creditor wishing to obtain approval of the sale to purchase the claims of an objecting unsecured creditor and vote them in favor of the sale. Prior to the amendments to Rule 3001(e) of the Federal Bankruptcy Procedure 1991, there was much more court supervision of claim trading. In 1991, Bankruptcy Rule 3001(e) was amended with the express intention of curtailing judicial oversight of claim trading.[90] Specifically, the amendments reduced the description of the trade to be filed with a court and eliminated third-party involvement.

The leading case after the amendment to Rule 3001(e) is *In re Olson*.[91] *In re Olson* was a Chapter 7 case in which the debtor's children first tried to buy the estate's assets.[92] When the trustee refused to sell to them, the children purchased all of the unsecured claims against the estate at a steep discount and then moved with the debtor to dismiss the case.[93] The bankruptcy court denied the dismissal motion and the trustee sold the assets to a third-party for a higher price than the children had been willing to pay.[94] The bankruptcy court also disallowed the claims transferred to the children above the amount of the discounted prices that had been paid.[95] On appeal, the Eighth Circuit Court of Appeals reversed because the

90. *See* Fed. R. Bankr. P. 3001(e).

91. *See generally In re* Olson, 120 F.3d 98 (8th Cir. 1997).

92. *Id.* at 100.

93. *Id.*

94. *Id.*

95. *Id.*

transferee had not objected to the assignment of the claim and therefore the circuit court lacked the power to intrude under amended Rule 3001(e).[96] The circuit court ruled this way even though it found that the children had special knowledge of the value of the assets and "obtained many of the claims from the creditors by providing them with false, misleading and incomplete information."[97] According to the Eighth Circuit, "the language of the rule is mandatory and directs the court to substitute the name of the transferee for that of the transferor in the absence of a timely objection from the transferor."[98]

The holding in *In re SPM Manufacturing*,[99] also supports the proposition that Rule 3001(e) applies a hands-off approach to claim trading even if it arguably infringes upon the Bankruptcy Code's other requirements.[100] The First Circuit equated the secured lender and committee agreement to a claim purchase, stating "[t]he circumstances in which claims transfers are expressly said to be invalid are limited."[101] As the First Circuit instructed, "[t]he bankruptcy court would have had no authority to prevent the general, unsecured creditors from transferring their claims" to the secured lender for the same amount they received under the agreement.[102]

The Third Circuit Court of Appeals took a different tact in *Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims*.[103] After the debtor filed a plan but before it filed a disclosure statement, Citicorp Venture Capital, which held a 20% ownership interest in the debtor, purchased a blocking position of unsecured claims but did not disclose to any of the selling creditors its identity as a buyer or its fiduciary status.[104] CVC then opposed confirmation of the debtor's plan and offered its own plan under which it proposed to acquire the debtor's assets.[105] Rather than focus on the rights of the transferors, as the *Olson* court did, the *Citicorp* court focused on the rights of the non-selling creditors and whether they suffered injury from *CVC*'s attempt to control the reorganization.[106] The bankruptcy court imposed a *per se* rule that

96. *In re Olson*, 120 F.3d at 102.
97. *Id.* at 101.
98. *Id.* at 102.
99. 984 F.2d. 1305 (1st Cir. 1993).
100. *See id.* at 1307.
101. *Id.* at 1314.
102. *Id.* at 1315.
103. *See* Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims, 160 F.3d 982 (3d Cir. 1998).
104. *Id.* at 985.
105. *Id.*
106. *Id.* at 990.

CVC's claim would be reduced to the aggregate amount of its claim purchase price.[107] On appeal, the Third Circuit reversed, holding that the imposition of a *per se* rule was improper.[108] Instead, the Third Circuit subordinated *CVC*'s claim under § 510(c) and limited its recovery to the purchase price of the notes.[109] The Third Circuit's ruling leaves open the possibility that an insider's claim will not be subordinated if the facts show that the non-purchasing creditors were protected.

More recently, in *In re Lynn*,[110] the Chapter 7 debtor objected to a claim assignment whereby the assignee acquired an unsecured claim in the amount of $177,107.50 for the payment of a mere $50.[111] The objection by the debtor was that the assignment allegedly violated the New York prohibition against champerty.[112] Although the debtor argued that the creditor's sole purpose in purchasing the claim was to harass the debtor, the bankruptcy court disagreed and found that the creditor's activity actually benefited the estate.[113] Focusing upon the plain language of Rule 3001(e), the bankruptcy court found that third parties, including the debtor, did not have standing to object to a claim assignment itself.[114] Citing *In re Olson*, the bankruptcy court instructed that "[t]he language of the Rule is mandatory and directs the court to substitute the name of the transferee for that of the transferor in the absence of a timely objection from the transferor."[115] The bankruptcy court did note that there are cases that take the position that a court has the power to regulate the attributes of an assigned claim if the assignee uses its claim improperly.[116] Thus, according to the bankruptcy court in *Lynn*, the purchasing creditor's conduct following the claim assignment could give the debtor standing to object to the claim assignment.[117] In such a context, the debtor's objection would be in the nature of a claim objection instead of a request to invalidate the assignment.[118] Even under that analysis, the bankruptcy court found that

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107. *Id.* at 986.

108. *Citicorp*, 160 F.3d at 990-91.

109. *Id.* at 991.

110. 285 B.R. 858 (Bankr. S.D.N.Y. 2002).

111. *Id.* at 859-60.

112. *Id.* at 859.

113. *Id.* at 860.

114. *Id.* at 862.

115. *In re Lynn*, 285 B.R. at 862 (quoting *In re* Olson, 120 F.3d 98, 102 (8th Cir. 1997)).

116. *Id.* (citing Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims, 160 F.3d 982, 991 (3d Cir. 1998)).

117. *Id.* at 863.

118. *Id.*

the purchasing creditor had not engaged in champerty under New York law.[119]

A related issue is whether a secured creditor who purchases the claims solely for the purpose of blocking confirmation is subject to the provisions of § 1126(e), which provides in relevant part: "On request of a party in interest . . . the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title."[120] In *In re Figter, Ltd.*,[121] the Ninth Circuit Court of Appeals became the first post-code circuit court to hold that claims purchased by creditors are voted in "good faith" even if they are purchased for the sole purpose of voting against the debtor's plan.[122] In *Figter*, the debtor owned a rental apartment complex and proposed a plan providing for conversion of the rental units to condominiums.[123] The secured creditor strongly opposed this plan because of the risk of being left with an undesirable mixture of apartments and condominiums.[124] To protect itself from the possibility of a cramdown, the secured creditor attempted to purchase the claims of the unsecured class in order to vote them against the plan.[125] The lender ultimately purchased more than half of the claims in the class and voted them against the plan.[126] The debtor argued that the secured creditor's votes should be disqualified because they were not purchased in good faith.[127] Alternatively, the debtor argued that even if those claims were purchased in good faith, the secured creditor was entitled to only one total vote for the claims that were purchased.[128]

The Ninth Circuit held that the secured creditor purchased the claims in good faith and was entitled to one vote for each claim it had purchased.[129] Of importance to the Ninth Circuit was the fact that the secured creditor had offered to purchase all of the claims and did not seek just to purchase a small number of claims for the purpose of blocking the plan, while injuring other creditors.[130] However, the fact that the debtor

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119. *Id.* at 864.
120. 11 U.S.C. § 1126(e).
121. 118 F.3d 635 (9th Cir. 1997).
122. *Id.* at 641.
123. *Id.* at 637.
124. *Id.*
125. *Id.*
126. *In re Figter, Ltd.*, 118 F.3d at 637.
127. *Id.* at 638.
128. *Id.*
129. *Id.* at 641.
130. *Id.* at 640.

was involved in litigation with the purchasing creditor was of no import to the circuit court.[131]

The most significant factor the courts consider in determining whether to designate a purchasing creditor's claims as being voted in bad faith is whether the purchasing creditor is a preexisting creditor as opposed to a voluntary creditor with its own plan to take control of the debtor. For example, in *In re Allegheny International, Inc.*,[132] a coalition of investment bankers who were not prepetition creditors purchased enough claims to block the debtor's plan.[133] The purchasing entity filed its own competing plan in which its purchased debt was converted to the controlling stock interest.[134] The bankruptcy court held that these votes rejecting the debtor's plan were cast in bad faith.[135] Additionally, in *In re Holly Knoll Partnership*,[136] a creditor that was not a preexisting creditor purchased claims of an inferior class.[137] While the bankruptcy court did not directly reach the § 1126(e) issue, the court did note that if it had reached the issue it would have found that the claim purchaser cast its votes in bad faith on the basis that "[c]learly [the claim purchaser] did not purchase the Class 2 claim to protect its rights as a creditor."[138]

As discussed above, under certain circumstances, the purchase of claims by a secured creditor appears to be a viable option for obtaining approval of a sale.

V. CONCLUSION

There is no clear answer as to whether there must be a distribution to unsecured creditors in the context of a section 363 sale. A distribution to unsecured creditors is not required by the Bankruptcy Code. However, the courts appear to be more willing to approve such sales where there is a distribution to unsecured creditors. There is authority for the approval of carve-out agreements that allow secured creditors with undisputed liens to gift a portion of their collateral to unsecured creditors, even in violation of the Bankruptcy Code's priority scheme. However, in light of the holding of *Iridium* discussed above, such carve-outs are most likely to be approved if the arrangement is made in a Chapter 11 case that contemplates a

131. *In re Figter, Ltd.*, 118 F.3d at 639.
132. 118 B.R. 282 (Bankr. W.D. Pa. 1999).
133. *Id.* at 287.
134. *Id.* at 286.
135. *Id.* at 290.
136. 167 B.R. 381 (Bankr. E.D. Pa. 1994).
137. *Id.* at 384.
138. *Id.* at 388.

conversion to Chapter 7. Finally, there are other creative options to obtain approval of a sale over objections, including a secured creditor's purchasing the claims of disgruntled unsecured creditors.