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Will **Section 363** Become A **New Chapter** of the Bankruptcy Code?

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During the volatile economic climate of recent years, expedited 363 sales have been favored over more traditional reorganizations under Chapter 11. The benefits of facilitating a quick sale under §363 of the Bankruptcy Code have often served as the impetus for many Chapter 11 case filings of large public companies. The use of expedited 363 sales prior to, or in place of, plan confirmation has generated much debate among the bankruptcy bench, bar and creditor groups. The competing tension at the heart of this debate is whether a fast track sale prior to the filing of a plan is justified in light of the resultant impact on well-established procedural and substantive rules

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designed to address stakeholder due process and bankruptcy protections in bankruptcy. Notwithstanding this debate, however, bankruptcy courts throughout the nation have approved these types of sales in light of competent evidence of deteriorating asset values.

Section 363 of the Bankruptcy Code originally was enacted as a tool to allow debtors to shed unnecessary or burdensome assets in furtherance of their reorganization effort[1] (although, at times, it did become a last resort for a failed struggling company). Following the 2008 financial crisis, many banks were reluctant or unwilling to provide post-petition financing, leaving many debtors with a lack of liquidity and few options other than a sale in Chapter 11—"free and clear of liens, claims and encumbrances" under §363 of the Bankruptcy Code. More recently, as the financial markets have begun to improve, debtors have been able to obtain post-petition financing; however, the terms have largely dictated the debtors' bankruptcy exit strategy and the use of 363 sales in Chapter 11 have continued to rise.

Historically, 363 sales in Chapter 11 would occur 90 to 120 days after filing. In recent years, however, the 363 sale timeline has been significantly truncated. The speed of the 363 sale process is largely attributable to aggressive lenders, deteriorating value, short post-petition loan terms to maturity and the desire for reduced administrative costs to closing. Additionally, the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Pub. L. 109-8, 119 Stat. 23, enacted April 20, 2005) (BAPCPA) aided in the compression of Chapter 11 time frames, generally. Specifically, the changes implemented to the key time frames and timelines for assumption or rejection of real estate leases as well as the limitations imposed on exclusivity periods have led to the need for an expedited decision-making process in the first several weeks of a case. 11 U.S.C. §§365(d)(4) & 1121(c). The creation of administrative priority status for vendor claims tied to goods sold within the 20 days prior to the bankruptcy filing under BAPCPA also had a tremendous influence on the ability of a company to survive and this additional administrative burden has caused many debtors to fail. 11 U.S.C. §503(b)(9). These amendments, along with the desire to reduce administrative costs in bankruptcy and achieve a quick closing and/or consummation of a plan of reorganization, have condensed the average time frame for Chapter 11 cases.[2]

Many of the recent Chapter 11 filings in which the debtor sought an expedited sale process are in the retail industry. For example, retailers such as *Loehmanns*, *Love Culture*, *Dots*, *Radio Shack* and *Coldwater Creek* each obtained relief under §363 of the Bankruptcy Code between 22 and 55 days of filing.[3] According to a recent study by AlixPartners advisory firm, 55 percent of all U.S. retailers that have filed for bankruptcy over the past 10 years have ended up in liquidation.[4] The conclusion ultimately reached is that, unlike other industries where 363 sales occur in less than one in 20 debtors, 363 sales in the retail sector occur much more frequently. The root cause was attributed in large part to the BAPCPA changes noted above, the "short runway" for retail sales and the liquid nature of the inventory.[5]

Critics of fast track 363 sales and proponents for change to the Bankruptcy Code argue that the process is too fast, due process rights of parties in interest are being compromised, and the sale process often begins and ends before parties in interest have had an opportunity to be fully informed and weigh in on the process. Additionally, these sales often determine the ultimate distributions to creditors, sidestep the plan process, and deprive creditors of their statutory right under §1129 of the Bankruptcy Code to vote (thereby eliminating the fair and equitable standard). Allowing parties in interest to slow down a fast track 363 sale process for reasons, such as inadequate marketing or a sale that will only benefit the senior secured creditor group, makes good sense.

It appears that even some bankruptcy judges are rethinking these expedited sale processes which have largely been approved to date. For example, the debtors in the *Digital Domain Media Group* bankruptcy sold their significant assets just 11 days after the petition date.[6] Although Judge Brendan Shannon allowed the highly expedited sale process and approved the resulting sale of the debtors' assets, at the hearing approving the sale, Shannon emphasized that he regretted allowing the sale process to proceed so quickly and cautioned that neither he nor his colleagues in the Delaware Bankruptcy Court would likely allow such a process to occur in the future.[7]

These concerns surrounding the use of fast track 363 sales were set forth in great detail in the ABI Commission Report.[8] The ABI Commission advocates for a new §363 entitled "363x" which would require a presumptive 60 day moratorium on sales (with some exceptions reverting back to the traditional *Lionel* standard). This presumption may be overcome by a showing by clear and convincing evidence that a quicker process (i.e., in the first 60 days of a case) is justified. The Commission further proposes that some—but not all—of the confirmation standards be incorporated in §363 (which, if enacted, may effectively make 363 its own chapter of title 11 for expedited sales outside a plan). One such requirement proposed would be to require that sale proceeds be reserved to satisfy all priority claims in full. The ABI Commission's proposal—if enacted into law—would curtail the use of structured dismissals after a sale and in lieu of plan confirmation. Structured dismissals are frequently approved by some courts in cases where the cost of doing a plan of liquidation cannot be justified.[9] In these cases there are provisions made for distributions to other creditor classes to balance the impact.[10]

In a recent report issued in October 2015 by the Loan Syndications and Trading Associations (LSTA), the LSTA responds to the ABI Commission Report.[11] The LSTA disagrees generally that reform of Chapter 11 is needed or appropriate and suggests that many of the proposals contained in the ABI Commission Report could have a potential harmful effect on the economy and financial markets. As to the proposed reform of 363 sales, the LSTA argues that the proposed 60-day moratorium on 363 sales could be affirmatively harmful to some debtors noting that "[l]engthening the time spent in bankruptcy before completing a sale will increase administrative expenses, including both the business's operating costs (and the costs of any related DIP financing) and the costs of the bankruptcy process itself, including the professional fees of the debtor and other parties in interest."[12] The LSTA also objects to the ABI Commission's proposed requirement that the debtor withhold sufficient proceeds from the sale to pay all administrative claims in full. Because typically a secured lender advocating a sale will negotiate with the debtor a carve-out from its collateral to pay the necessary and reasonable costs of the Chapter 11 sale process, the LSTA argues that the ABI Commission's proposal will remove the secured lender's choice and will give debtors a "blank check" to underwrite the cost of the process. This, like many of the proposals in the ABI Commission Report, the LSTA posits would adjust the lender's bargained for contractual rights and remedies entered into prior to the bankruptcy.

Most bankruptcy practitioners want to maintain the ability to formulate creative solutions for a company in financial and/or operational distress. While the recommendations of the ABI Commission Report seek to appropriately balance the rights of lenders with the rights of debtors in a Chapter 11 case, many of the recommendations upend secured creditors' bargained for rights and any room for debtor creativity. A "one size fits all" formulaic approach to 363 sales will not work. It cannot be disputed that a thorough marketing effort and adequate notice to parties in interest to evaluate the proposed transaction makes good sense and strikes a good compromise. To amend the Bankruptcy Code to dictate how a sale process should be run, or provide for involuntary and indeterminate carve-outs from a secured party's liens, appears far from striking a balance and contravenes a creditor's bargained for state law rights and remedies.

Whether or how Congress will address the proposals for the reform of Chapter 11 remains unclear. For now, however, given the continued rise in 363 sales (now in the retail sector), the concerns identified in the ABI Commission Report and the LSTA Response should be incorporated into the Chapter 11 advocacy process. Consideration of these concerns by courts may result in a more balanced approach to the "fire drills" imposed by these kinds of filings and expedited sales, and may more adequately address unsecured creditors' legitimate due process concerns and secured parties' contractual expectations.

1. The Bankruptcy Act of 1898 did not include any provision for an expedited sale, but instead overtime case law allowed for such sales to take place primarily where the assets were perishable or subject to rapid deterioration in value. See *In re Pedlow*, 209 F. 841, 842 (2d Cir. 1913). In 1978 with the enactment of the Bankruptcy Code, §363 was created but did not include any perishability or deterioration standard—in fact there was not even a requirement for cause to be shown to utilize the section. The current standard for approval of 363 sales was established in the landmark case of *Comm. of Equity Security Holders v. Lionel Corp. (In re Lionel)*, 722 F.2d 1063 (2d Cir. 1983). In the past 25 years "since *Lionel*, asset sales under §363 of the Bankruptcy Code have become the preferred method of monetizing the assets of the debtor, company." "The Seven Deadly Sins of §363 Sales," Am. Bank. Inst. J. June 2005, at 22 (citing *Ind. State Police Pension Trust v. Chrysler (In re Chrysler)*, 576 F.3d 108, 115 (2d Cir. 2009)).

2. Landmark examples of expeditious sales are *General Motors* and *Chrysler*, each of which involved a 363 sale of substantially all assets that was completed in approximately 41 days. See, e.g., *In re Gen. Motors,* 407 B.R. 463, 491-92 (Bankr. S.D.N.Y. 2009), aff'd sub nom. *In re Motors Liquidation Co.*, 430 B.R. 65 (S.D.N.Y. 2010); *In re Chrysler*, 405 B.R. 84, 96 (Bankr. S.D.N.Y. 2009). An example of an even quicker sale is *Lehman Brothers*. See *Lehman Bros. Holdings*, Case No. 08-13555 (Bankr. S.D.N.Y. 2008) (sale approved within seven days of Chapter 11 filing); "Section 363 Sales: Mooting Due Process," 29 Emory Bankr. Dev. L.J., Alla Rankin (2012) (although it should be recognized that tremendous public policy concerns existed for this process, so too in *Lehman* where the sale also occurred within one week).

3. See, e.g., *In re Loehmann's Holdings Inc., et al.*, Case No. 13-14050, [ECF Docket No. 200] (Bankr. S.D.N.Y. Jan. 7, 2014) (sale order entered 23 days from petition date); *In re Dots*, Case No. 14-11016, [ECF Docket No. 132] (Bankr. D. N.J. Feb. 27, 2014) (sale order entered 38 days from petition date); *In re Love Culture*, Case No. 14-24508, [ECF Docket No.157] (Bankr. D. N.J. Aug. 7, 2014) (sale order entered 21 days from petition date); *In re RadioShack, et al.*, Case No. 15-10197, [ECF Docket No. 1672] (Bankr. D. Del. April 1, 2015) (sale order entered 55 days from petition date); *In re Coldwater Creek*, Case No. 14-10867, [ECF Docket No. 439] (Bankr. D. Del. May 22, 2014) (sale order entered 41 days from petition date).

4. Holly Etlin and James Hogarth, ALIX PARTNERS RETAIL BANKRUPTCY STUDY, Insight, October 2015.

5. The downward trend in the retail market looks to continue as Macy's recently announced that it has had a "sluggish fall season" and that it would be going all out with holiday sales. See Hiroko Tabuchi, "Macy's Sounds a Holiday Alarm, and Retailers Brace for Heavy Discounting," N.Y. TIMES, Nov. 12, 2015, at B3. Other retailers' sales are also down significantly and their shares are dropping across the board.

6. See *In re Digital Domain Media Group*, No. 12-12568 (BLS) (Bankr. D. Del. Sept. 25, 2012) [Docket No. 223].

7. See Jacqueline Palank, "Judge Begrudgingly, Oks' Digital Domain Sale, Bankruptcy Beat," THE WALL STREET JOURNAL, Sept. 24, 2012.

8. See AMERICAN BANKRUPTCY INSTITUTE COMMISSION TO STUDY THE REFORM OF CHAPTER 11, 2012-2014 Final Report and Recommendations (the ABI Commission Report).

9. See, e.g., *In re LCI Holding Company*, No. 14-2709, 2015 U.S. App. LEXIS 16306 (3d Cir. Sept. 14, 2015) (upholding bankruptcy court order authorizing a sale that would result in significant capital gains tax liability for the estate and which would be left unpaid even though junior unsecured creditors would receive a distribution pursuant to a settlement agreement).

10. The cases tied to gifting and creditor carve-outs will not be addressed herein.

11. See The Trouble with Unneeded Bankruptcy Reform: The LSTA's Response to the ABI Chapter 11 Commission Report, October 2015.

12. See id. at p.51.