

# Defending the Current State of Section 363 Sales

by

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*Notwithstanding the priority-based controversy following the Chrysler and GM § 363(b) sales, value is the central dispute dominating the asset sale debate. Given the mounting data purporting to show that sales harm junior creditors by producing low value, I confront two issues in this article. First, I address the depth and breadth of the low value phenomenon for junior creditors, concluding that(a) although sales appear to cut deeply into creditor recoveries, causation has yet to be shown; and (b) sales have not, contrary to the predictions of some scholars, overtaken reorganization. Second, using qualitative and quantitative analysis, I challenge four explanations of the low value phenomenon: weak capital markets, secured creditor control, manager and financial advisor conflicts of interest, and judicial corruption and forum shopping. I conclude that none of these explanations is satisfactory in light of junior creditor powers and the protective procedures that have evolved under § 363. This conclusion stands even in Delaware, which employs the business justification standard and is the forum of choice for most large § 363 cases.*

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## INTRODUCTION

Aside from disputes over Bankruptcy Code integrity<sup>1</sup> and absolute priority,<sup>2</sup> the only objection to modern comprehensive<sup>3</sup> § 363 sales, which are

<sup>1</sup>See, e.g., *In re Gulf Coast Oil*, 404 B.R. 407, 415 (Bankr. S.D. Tex. 2009) (citing *Pension Benefit Guar. Corp. v. Braniff Airways, Inc.* (*In re Braniff Airways, Inc.*), 700 F.2d 935, 940 (5th Cir. 1983)) (stating that judges should protect the “carefully crafted scheme” of Chapter 11).

<sup>2</sup>In 2009 and 2010, frantic commentators predicted that the § 363 asset sale in the Chrysler bankruptcy, *In re Chrysler LLC*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009), *aff'd*, 576 F.3d 108 (2d Cir. 2009), *cert. dismissed sub nom.*, *Loritz v. Chrysler LLC*, 557 U.S. 961, 130 S. Ct. 41, 174 L. Ed. 2d 626 (2009), *cert. granted, judgment vacated sub nom.*, *Ind. State Police Pension Trust v. Chrysler LLC* (*In re Chrysler LLC*), 130 S. Ct. 1015, 175 L. Ed. 2d 614 (2009) and *judgment vacated*, 592 F.3d 370 (2d Cir. 2010)—and in the General Motors case, *In re Gen. Motors Corp.*, 407 B.R. 463 (Bankr. S.D.N.Y. 2009), *certification denied*, 409 B.R. 24 (Bankr. S.D.N.Y. 2009) and *aff'd sub nom. In re Motors Liquidation Co.*, 428 B.R. 43 (S.D.N.Y. 2010)—would lead to a replacement of Chapter 11 by priority-evading *sub rosa* reorganizations. See, e.g., Barry E. Adler, *A Reassessment of Bankruptcy Reorganization after Chrysler and General Motors*, 18 AM. BANKR. INST. L. REV. 305 (2010); Ralph Brubaker & Charles Jordan Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of Chrysler and GM*, 2010 U. ILL. L. REV. 1375 (2010); Fred N. David, *Interpreting the Supreme Court's Treatment of the Chrysler Bankruptcy and Its Impact on Future Business Reorganizations*, 27 EMORY BANKR. DEV. J. 25 (2010); Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727 (2010) (arguing that *Chrysler* inserted so much uncertainty into financial markets—particularly regarding the absolute priority rule—that the cost of credit would increase for distressed firms).

Later commentators correctly argued that *Chrysler* and *General Motors* were aberrations: reorganization and absolute priority violations came to those cases by blending a recession, TARP funds, and government strong-arming support for public policy. See Stephanie Ben-Ishai & Stephen J. Lubben, *A Comparative Study of Bankruptcy as Bailout*, 6 BROOK. J. CORP. FIN. & COM. L. 79 (2011); Robert M. Fishman & Gordon E. Gouveia, *What's Driving Section 363 Sales after Chrysler and General Motors?*, 19 J. BANKR. L. & PRAC. 4 (2010); Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*,

sales of a Chapter 11 debtor's assets outside the normal course of business, is low value.<sup>4</sup> Other objections, including the oft-repeated complaint that creditors lack protection, are actually value-based because if creditors need protection, it is against low recovery. Thus, the pervasive objection to § 363 sales is that too many debtors, or, more likely, powerful secured creditors like debtor-in-possession ("DIP") lenders escape through a side door while freezing weak creditors out of going-concern value.<sup>5</sup>

The current condition of value in comprehensive § 363 sales is not as frightening for junior creditors as some claim. In fact, junior creditors appear to protect themselves in sales. Part I introduces the general features of § 363 sales, which are governed by sparse and flexible statutory authority. Against this bare statutory canvas, bankruptcy courts have adopted standards, which are analyzed in Part II(B)(4), to evaluate debtors' proposed sales and sale procedures in light of objections raised by creditors, U.S. Trustees, and po-

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83 AM. BANKR. L.J. 531 (2009). To calm critics further, the Supreme Court vacated the Second Circuit's decision in *Chrysler* to preclude its precedential effect. See George W. Kuney, *Vacating Chrysler* (Univ. of Tenn. Legal Studies Paper Series, Research Paper No. 116, 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1564299](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1564299) (last visited Nov. 11, 2012).

<sup>3</sup>I define comprehensive § 363 sales as those that dispose of at least half of the debtor's assets. By definition, then, comprehensive sales often include the "crown jewel" of the corporation.

<sup>4</sup>Generally I adhere to Thomas Jackson's definition of the purposes of Chapter 11 and, by extension, § 363 sales: "[c]hapter 11's . . . provisions should be tested against the standard of whether they facilitate achieving the asset deployment of greatest benefit to the claimants as a group." THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 210 (1986). Thus, I define value as creditor-centric and bounded by two questions. First, will the sale generate more money for creditors than reorganization or piecemeal liquidation? Second, assuming sale is the right choice, does the price reflect reasonable valuation of the assets? Almost all discussion of equity holders will be omitted, as the central § 363 controversy focuses on the unsecured creditor rung above equity holders.

<sup>5</sup>A freeze-out prevents junior creditors from exercising their call option in the firm's residual value, which is often most easily done in reorganization. Their call option is essentially a bet that the firm will be worth more in the future—an option hardly exercised in asset sales, which collapse the option to present value, arguably destroying the potential upside while not preventing much downside risk. See Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 760–61, 785 (2011). As explained by Professor Jackson, creditors can participate in going-concern value through claim conversion, or turning a claim into stock in the reorganized company. JACKSON, *supra* note 4, at 211–12. See also Kimon Korres, *Bankrupting Bankruptcy: Circumventing Chapter 11 Protections through Manipulation of the Business Justification Standard in § 363 Asset Sales, and A Refined Standard to Safeguard against Abuse*, 63 FLA. L. REV. 959 (2011); Todd L. Friedman, *The Unjustified Business Justification Rule: A Reexamination of the Lionel Canon in Light of the Bankruptcies of Lehman, Chrysler, and General Motors*, 11 U.C. DAVIS BUS. L.J. 181 (2010); Gennady Zilberman, *Bankruptcy Section 363(b) Sales: Market Test Procedures and Heightened Scrutiny of Expedited Sales May Prevent Abuses and Safeguard Creditors without Limiting the Power of the Courts*, 5 BROOK. J. CORP. FIN. & COM. L. 241 (2010); Benjamin A. Berringer, *"It's All Just A Little Bit of History Repeating": An Examination of the Chrysler and GM Bankruptcies and Their Implications for Future Chapter 11 Reorganizations*, 7 N.Y.U. J.L. & BUS. 361, 387–88 (2010); Elizabeth B. Rose, *Chocolate, Flowers, and § 363(b): The Opportunity for Sweetheart Deals without Chapter 11 Protections*, 23 EMORY BANKR. DEV. J. 249 (2006); Craig A. Sloane, *The Sub Rosa Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 EMORY BANKR. DEV. J. 37, 45 (1999).

tential bidders. Particularly, I introduce the influential business justification (also known as “sound business purpose” or “business judgment”) standard<sup>6</sup> and the emergent *Gulf Coast Oil* standard,<sup>7</sup> which has been called the “sound business purpose test with bite.”<sup>8</sup> The different standards are based on fundamentally different views of asset sales, with the former built on the assumption that DIPs fulfill their fiduciary duties to creditors and the latter based on the notion that DIPs are unwilling or incapable of seeking high value in bankruptcy.<sup>9</sup> The lack of junior creditor objections in business justification cases,<sup>10</sup> coupled with the documented strength of junior creditors’ committees,<sup>11</sup> however, suggests that little reform is needed in the business justification standard.

Nonetheless, § 363 sales are allegedly “fraught with potential for abuse,”<sup>12</sup> particularly in Delaware. Studies led by Lynn LoPucki show that § 363 sales produce low value compared to reorganizations.<sup>13</sup> Consequently, reorganization-defending commentators use systemic corruption as an explanation for this low value phenomenon. Junior creditors, according to these commentators, are frozen out of going-concern value because asset sales do not provide the protections of reorganization or because credit markets are incapable of producing sale prices high enough to capture going-concern value. In fact, capital markets might be so weak that going-concern value can never be captured by sale.<sup>14</sup> Furthermore, these commentators claim that § 363 sales are sweetheart deals for senior creditors, conflicted management,

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<sup>6</sup>See, e.g., *In re Dura Auto. Sys.*, No. 06-11202, 2007 Bankr. LEXIS 2764, at \*258 (Bankr. D. Del. Aug. 15, 2007).

<sup>7</sup>*In re Gulf Coast Oil*, 404 B.R. 407, 422 (Bankr. S.D. Tex. 2009). This standard has been used in or has influenced the following Chapter 11 cases: *In re Cloverleaf Enters., Inc.*, No. 09-20056, 2009 Bankr. LEXIS 3019 (Bankr. D. Md. Apr. 2, 2010) (using portions of the standard to deny insufficiently marketed sale); *In re On-Site Sourcing, Inc.*, 412 B.R. 817 (Bankr. E.D. Va. 2009) (discussing the standard at length and using it to evaluate a sale); *In re Tidal Const. Co., Inc.*, 446 B.R. 620, 623 (Bankr. S.D. Ga. 2009) (noting *Gulf Coast Oil*’s insistence on reorganization-like procedures in asset sales).

<sup>8</sup>Jessica Uziel, *Section 363(b) Restructuring Meets the Sound Business Purpose Test with Bite: An Opportunity to Rebalance the Competing Interests of Bankruptcy Law*, 159 U. PA. L. REV. 1189 (2011).

<sup>9</sup>This difference in interpreting the relationship between § 363 and Chapter 11 is due to lack of clarity in the Bankruptcy Code regarding the relationship. See A. Joseph Warburton, *Understanding the Bankruptcies of Chrysler and General Motors: A Primer*, 60 SYRACUSE L. REV. 531, 547-81 (2010).

<sup>10</sup>See Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 37-38 (2007).

<sup>11</sup>Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors’ Committees in Business Reorganizations*, 64 VAND. L. REV. 749, 756 (2011) (noting that, though imperfect, “committees are fulfilling at least part of their oversight responsibilities with some zeal”).

<sup>12</sup>*Admin. of Large Bus. Bankr. Reorganizations: Has Competition for Big Cases Corrupted The Bankruptcy System?: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary*, 108th Cong. 15 (2004) (statement of Lynn LoPucki).

<sup>13</sup>LoPucki & Doherty, *supra* note 10, at 24-25.

<sup>14</sup>*Id.* at 28-34.

and stalking horses.<sup>15</sup> Relatedly, some have argued that Delaware and, to a lesser extent, the Southern District of New York (“SDNY”), are selected as Chapter 11 forums so frequently because judges in these jurisdictions attract self-serving senior creditors and managers and give them the quick and low-value § 363 sales they desire.<sup>16</sup>

I question these assertions in Part II, showing that in most instances the dominant concerns with § 363 sales either don’t exist or are unsubstantiated, even in Delaware. I conclude that currently, relevant stakeholders are able to protect themselves. However, there are areas of potential concern upon which further research will shed more light, the most important being that too many potential buyers drop out before bidding. Nonetheless, based on available data, the current state of § 363 sales should be defended.

## I. THE BASICS OF § 363 SALES

The goal of comprehensive § 363 sales, like reorganization plans, is to achieve the greatest value for a company’s creditors and shareholders while preserving going-concern value.<sup>17</sup> Section 363(b), which allow sale of a debtor’s assets outside the normal course of business<sup>18</sup> after notice and a hearing, has been used since the Bankruptcy Code was passed in 1978. The obvious advantage of these sales is the ability to quickly sell a debtor’s assets, free from liabilities.<sup>19</sup> The assets, as in Chapter 7, can be sold as a going concern or liquidated piecemeal.<sup>20</sup> Potential buyers include creditors, new entities created for the purpose of continuing the debtor’s business absent its liabilities, and especially bidders in the same industry. By one estimate, approximately two-thirds of comprehensive corporate asset sales are made to an industry competitor who already knows how to put the assets to work.<sup>21</sup>

Likewise, secured creditors are important factors in asset sales. In addi-

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<sup>15</sup>See *supra* note 5.

<sup>16</sup>LoPucki & Doherty, *supra* note 10, at 39–41.

<sup>17</sup>H.R. REP. NO. 95-595, at 220 (1977) (“The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business’s financings so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders.”).

<sup>18</sup>There are no clear rules dictating whether a particular sale is in the ordinary course of business. COMMERCIAL BANKRUPTCY LITIGATION § 7:2 (2012). For present purposes, I focus on comprehensive sales, which are clearly outside the ordinary course.

<sup>19</sup>This ability can certainly be controversial. For example, when Chrysler was sold to Fiat-led New Chrysler, future punitive damages liability was not part of the deal, meaning that harmed consumers could not seek these damages if they were injured by a dangerous car made before 2009. See Mike Spector, *Chrysler Got Legal Shield in Chapter 11*, WALL ST. J., April 4, 2012, available at <http://online.wsj.com/article/SB10001424052702304450004577277802983129074.html>.

<sup>20</sup>See 11 U.S.C. § 721 (2006) (permitting trustee to operate the business to preserve going-concern value).

<sup>21</sup>LoPucki & Doherty, *supra* note 10, at 29.

tion to their influence over distressed debtors,<sup>22</sup> § 363(k) permits secured creditors to “credit bid” for assets using their allowed secured claims instead of cash to bid on the estate’s assets. The Supreme Court recently reaffirmed this practice.<sup>23</sup> Their ability to credit bid, coupled with their intimate knowledge of the debtor’s business, can grant secured creditors a leg up on the bidding competition.<sup>24</sup>

Furthermore, a sale—irrespective of the buyer—can be made free and clear of claims and interests as long as one of five conditions under § 363(f)<sup>25</sup> is met as to each claim or interest. Finally, under § 363(m), the buyer, if acting in good faith, can take the assets with knowledge that the sale cannot be reversed on appeal. This provision gives certainty to the buyer but disallows review of sales that, in hindsight, do not maximize the estate’s value.

When a debtor seeks a comprehensive § 363 sale—often after failing to meet contingencies set by contract with a DIP financier who likely has a super-priority secured claim on all of the debtor’s assets and who wants to be repaid quickly when reorganization becomes unlikely—it uses an investment bank to market its assets to various potential bidders.<sup>26</sup> Many of these potential bidders sign confidentiality agreements to gain access to the firm’s financial data.<sup>27</sup> The debtor then proposes bidding and sale procedures meant

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<sup>22</sup>See *infra* Part II(B)(2).

<sup>23</sup>RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 132 S. Ct. 2065, 182 L. Ed. 2d 967 (2012) (upholding right of secured lender to credit bid even when asset is sold as part of reorganization plan in which debtor seeks, under § 1129(b)(2)(A)(iii), to auction the asset without credit bidding and give secured lender proceeds of sale). For a thorough discussion of credit bidding and its role in § 363 sales, see Vincent S. J. Buccola & Ashley C. Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 GEO. MASON L. REV. 99 (2010).

<sup>24</sup>Credit bidding is generally permitted unless inside information is used to the detriment of the estate. See Radnor Holdings Corp. v. Tennenbaum Capital Ptnrs., LLC, (*In re* Radnor Holdings Corp.), 353 B.R. 820, 845 (Bankr. D. Del. 2006). . . The practice, however, is not without its critics. See Jacob A. Kling, *Rethinking 363 Sales*, 17 STAN. J.L. BUS. & FIN. 258, 275-94 (2012).

<sup>25</sup>Pursuant to 11 U.S.C. § 363(f) (2006),

The trustee may sell property . . . 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.

<sup>26</sup>See Casey, *supra* note 5 (arguing that junior creditors can be frozen out of going-concern value if oversecured creditors seek and obtain a quick, low-value sale); Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. L. ANAL. 511 (2009) (showing, based on their sample, that Chapter 11 cases are significantly more likely to result in sale if DIP lenders are oversecured).

<sup>27</sup>See, e.g., Motion of Debtor and Debtor in Possession for the Entry of Orders (I) Approving Sale Procedures with Respect to the Sale of Substantially All of the Debtor’s Assets as a Going Concern, etc.,

to select a stalking horse, take objections and hold a hearing on the procedures, fix deadlines for the submission of qualified bids and objections to the sale motion, conduct a sale auction, approve the prevailing bid at a hearing, and close the sale—all within a few months.<sup>28</sup>

Individual creditors, creditor committees, United States Trustees, examiners, and potential buyers can object to proposed sales and bidding procedures under Rule 6004(b) of the Federal Rules of Bankruptcy Procedure, converting sales into contested matters governed by Rule 9014. Rule 9014, in turn, allows for motions and hearings—with depositions and testimony of interested parties' competing investment bankers. After a comprehensive § 363 sale is consummated, the proceeds are divided among creditors according to the absolute priority rule, possibly in conjunction with a liquidation of any remaining assets or a reorganization of what is left of the firm.<sup>29</sup>

Beyond the Federal Rules, court-specific procedural rules governing proposed § 363 sales, like precedent-based standards judges use to approve or deny sales on their merits,<sup>30</sup> are not uniform across jurisdictions, but they are all designed to protect creditors by allowing them to review and object to proposed sales. These local rules often govern who must receive notice; how long before a hearing notice must be given; how objections can be made; how public versus private sales will be conducted; and which connections, relationships, and compensation must be disclosed.<sup>31</sup> Courts created these rules to fill gaps in the Bankruptcy Code and to help streamline procedures to allow interested parties to forecast, plan, and participate in the proposed sale.

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at ¶ 15, *In re Gottschalks, Inc.*, No. 09-BK-10157, 2009 Bankr. LEXIS 4874 (Bankr. D. Del. Feb. 13, 2009) (noting that twenty-four potential buyers signed confidentiality agreements and were given detailed information about Gottschalks, including access to an “electronic data room” created to give potential buyers full access to the firm’s finances); LoPucki & Doherty, *supra* note 10, at 34–35.

<sup>28</sup>See, e.g., *id.* Of the cases cataloged in the LoPucki-UCLA Bankruptcy Research Database from 1982–2011, 30 of 127 comprehensive asset sales were approved within two months of filing Chapter 11.

<sup>29</sup>Theoretically, the absolute priority rule is more effective in asset sales than in reorganization. Negotiations when passing a plan of reorganization might anticipate a higher judicial valuation than actually occurs after the plan is fixed, leading to promises of payment to junior creditors or equity holders who would otherwise deserve nothing. Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 *YALE L.J.* 1930, 1943 (2006). This problem should not be present in asset sales, given that “[a] market transaction [sale] resolves valuation uncertainty by rewarding the highest bidder with ownership of the asset. . . . When the business is sold in its entirety to a third party, outcomes are, to a large extent, consistent with absolute priority . . .” *Id.* There is normally no plan or its equivalent to fix rights against expected, rather than actual, valuation. Cf. *In re Gulf Coast Oil*, 404 B.R. 407, 422 (Bankr. S.D. Tex. 2009) (requiring that, whenever possible, creditors in § 363 sales be given procedures as if they were following Chapter 11 rules; in this situation, where the creditors must vote on the plan, the Chapter 11-based problem pointed to by Baird and Bernstein could exist). This potential side effect of the *Gulf Coast Oil* standard has yet to receive attention in the literature.

<sup>30</sup>These standards are discussed *infra* Part II(B)(4).

<sup>31</sup>For a dated but informative survey of the court rules that go beyond the Federal Rules of Bankruptcy Procedure, see George W. Kunej, *Let’s Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy*, 40 *HOUS. L. REV.* 1265, 1305–22 (2004).

They do little, however, to address the central controversy of § 363 sales: value.

## II. TAMING THE VALUE-CENTERED CONTROVERSY OF § 363

Most § 363-related commentary, including that of jurists,<sup>32</sup> relates to value. A notable exception came after the Chrysler and General Motors bankruptcies, when commentators focused on creditor protection, particularly the absolute priority rule, which was arguably violated in both cases.<sup>33</sup> In this Part, I examine four salient value-centered controversies under current debate, preceded by a two-part introduction to the depth and breadth of the low value phenomenon.

### A. DEPTH AND BREADTH OF THE LOW VALUE PHENOMENON

#### 1. *Depth: How Large Is the Difference between Sale and Reorganization?*

Section 363 sales generally bring lower value than reorganizations.<sup>34</sup> LoPucki and Doherty found that, when controlling for various factors,<sup>35</sup> comprehensive sales achieved an average of only 35% of book value whereas reorganizations achieved 80%, based on pre-bankruptcy book value and post-reorganization market capitalization.<sup>36</sup> This disparity is not without controversy,<sup>37</sup> and § 363 sales do not account for the entire difference,<sup>38</sup> but a difference remains. Employing a broader and less controlled approach, Harner and Marincic found that unsecured creditors received more than 50% of their claims in 57% of reorganizations, but received more than 50% of their claims in only 28% of asset sales or liquidations.<sup>39</sup> Lumping liquidations with asset sales surely affected their results, but the finding is nevertheless concerning.

These studies fail to answer the most important value-related question: in a particular asset sale, would reorganization have brought more value? Even

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<sup>32</sup>See, e.g., *In re Humboldt Creamery, LLC*, No. 09-11078, 2009 Bankr. LEXIS 2470, at \*1-4 (Bankr. N.D. Cal. Aug. 14, 2009) (arguing that the “melting ice cube” theory popularized in *Chrysler* was problematic because “it is easy enough for the debtor to unplug the freezer prior to bankruptcy.”).

<sup>33</sup>See Brubaker & Tabb, *supra* note 2 (arguing that the absolute priority rule was violated in GM but was not, strictly speaking, violated in *Chrysler*).

<sup>34</sup>Harner & Marincic, *supra* note 11, at 796 n.206; LoPucki & Doherty, *supra* note 10, at 24.

<sup>35</sup>Most importantly, they controlled for prepetition earnings and industry health, which, as they explain, are two of the fallback justifications for asset sales.

<sup>36</sup>LoPucki & Doherty, *supra* note 10, at 44.

<sup>37</sup>James J. White, *Bankruptcy Noir*, 106 MICH. L. REV. 691 (2008) (arguing that LoPucki & Doherty (1) overstate creditor recoveries in reorganization; (2) select cases favorable to their agenda; and (3) inflate the difference between reorganization and sale that is attributable to the sale decision rather than to earning potential).

<sup>38</sup>LoPucki & Doherty, *supra* note 10, at 23-24 (stating that sale accounts for only 29% of the variance observed between the two groups).

<sup>39</sup>Harner & Marincic, *supra* note 34.



without that answer, however, the difference in average recovery between asset sales and reorganization demands explanation. The simplest answer is that asset sales and reorganizations reflect different populations: one whose value is maximized by sale and another whose value is maximized by reorganization.<sup>40</sup> Merely because sales generally bring lower value compared to reorganizations doesn't mean that sales don't maximize the value of any particular estate in light of earning potential. Had the sales been reorganizations, they might have returned even less value than they achieved as sales. In other words, managers, valuers, creditors, and courts *might* be getting it right. Given the duties of managers, valuers, and courts—and the power of junior creditors who often stand to recover nothing if they do not demand value<sup>41</sup>—this is a reasonable starting point.

As shown below,<sup>42</sup> LoPucki and Doherty avoid this reasonable interpretation of the data and contend that sales are driven by failed capital markets, strong secured creditors, self-serving managers and financial advisors, and even courts. These unsatisfying accounts do not reflect the simpler explanations for the value disparity between sales and reorganizations. Before addressing those arguments, however, I demonstrate that § 363 sales have not overrun reorganization.

## 2. *Breadth: Is Reorganization Dead?*

Low value, real or alleged, might not be very alarming if sales are infrequent. They're not infrequent, but neither are they as frequent as Professors Baird and Rasmussen predicted in 2002.<sup>43</sup> Further, the proportion of comprehensive sales to all large corporate Chapter 11 cases has not significantly increased over the last decade ( $p = .81$ ). Thus, although § 363 sales are undoubtedly here to stay, they have not overrun reorganization.

I analyzed Chapter 11 cases ( $N = 853$ ) emerging from bankruptcy between 1982 and 2011 using data (as of February 24, 2012) from the UCLA-LoPucki Bankruptcy Research Database, which tracks bankruptcies of public corporations with assets of \$100 million or more in 1980 dollars (about \$273 million in 2011 dollars).<sup>44</sup> Although a few sales did occur shortly after passage of the Bankruptcy Code, their use has grown over time and seems to have reached a point of normalcy—not stasis, however, as the sales appear to

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<sup>40</sup>White, *supra* note 37, at 702 (suggesting that LoPucki and Doherty's study is plagued by selection bias).

<sup>41</sup>See Harner & Marincic, *supra* note 11, at 764–65.

<sup>42</sup>*Infra* Part II(B).

<sup>43</sup>Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 751–52 (2002).

<sup>44</sup>The Bankruptcy Research Database is available for academic research at <http://lopucki.law.ucla.edu/>. This database is also used for the data analysis in Part II(B)(4).

ebb and flow with economic cycles.<sup>45</sup>

Until *In re Lionel Corp.*,<sup>46</sup> which introduced the business justification standard and expressly approved of easier access to asset sales as a matter of congressional intent and bankruptcy policy,<sup>47</sup> courts rarely allowed comprehensive § 363 sales outside of “emergency” situations in which an asset was wasting away and losing value.<sup>48</sup> After *Lionel*, as shown by Table 1 and Chart 1, comprehensive § 363 sales took some time to become popular in large corporate bankruptcies. Since 1996, however, these large asset sales have occurred multiple times each year, with high-water marks reached during the Great Recession. The largest annual proportion of § 363 sales to all Chapter 11 cases (41%) came in 2008, while the largest raw number of sales (24) was seen in 2009. The past two years have returned the proportion of § 363 sales to normalcy, as 2010 and 2011 are closer to the sixteen-year weighted average of 21%. Only time will tell if there is a long-term trend of

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<sup>45</sup>The reason for this ebb and flow is unclear. LoPucki and Doherty argue that when an industry encounters distress, other players in the industry are *more* likely to acquire the assets of floundering industry competitors. *Supra* note 10, at 29. I don’t dispute this argument, as it is apparent that industry players buy up other industry players. I would venture to guess that when firms in a distressed industry have less access to capital—whether due to a 2008-style downturn or otherwise—those that are not insolvent will seek to acquire as many of the industry’s assets as possible to increase their relative market share and strength. See Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343 (1992) (saying that *fewer* acquisitions would take place during times of industry distress). This is often a difficult task. See Baird & Bernstein, *supra* note 29, at 1948 (arguing that it is challenging for “strategic buyers,” with their own debt and liquidity problems, to obtain financing to purchase the assets of another industry player).

Buyers have little to lose. If the entire industry is going downhill, they might go bankrupt regardless of an acquisition; however, if the industry will emerge at some point, then buyers will be stronger for having purchased their competitor’s assets. Of course, for those industries that will struggle on rather than emerge from troubles or die out altogether, the acquisition of assets, likely through debt financing, might make the buyer insolvent. But the buyer likely has little incentive to invest in itself if it thinks struggling is its long-term fate. More importantly, the sale price for the assets, like the probability of successful reorganization, is probably low during these times, as there are few industry players strong enough to take them on and there are even fewer investor coalitions willing to make a bet. As for secured creditors themselves, who due to their closeness with management have even more information than other bidders, they will most likely join with a strategic buyer or will bid up the price themselves. See *id.* at 1949. The downside potential is higher for bidders who are not strategic buyers, as these parties might not be part of a distressed industry that could be heading for general failure or major reform anyway.

Why are there not more reorganizations during periods of industry distress? Because, I would argue, creditors are unwilling to wait and see if reorganization is a better option. If convinced that the industry is heading in the wrong direction, creditors want a quick exit. Consequently, very few creditors object to sales. See LoPucki & Doherty, *supra* note 10, at 37–39. As the economy stabilizes, the firms that haven’t sold appear less likely to sell—as we can infer from the lower proportion of asset sales during the recovery or stabilization periods of the mid-2000s and 2010–2011. At this point, the firms can better predict whether they will survive reorganization and compete in their respective industries.

<sup>46</sup>Comm. of Equity Sec. Holders v. *Lionel Corp.* (In re *Lionel Corp.*) 722 F.2d 1063 (2d Cir. 1983).

<sup>47</sup>*Id.* at 1069–72.

<sup>48</sup>See Berringer, *supra* note 5, at 389.

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increasing § 363 sales, but that doesn't seem to be the case given that sales decreased as the recession abated in 2010 and 2011.

TABLE 1: LARGE CORPORATE CHAPTER 11 CASES BY COMPREHENSIVE § 363 SALE, 1982–2011

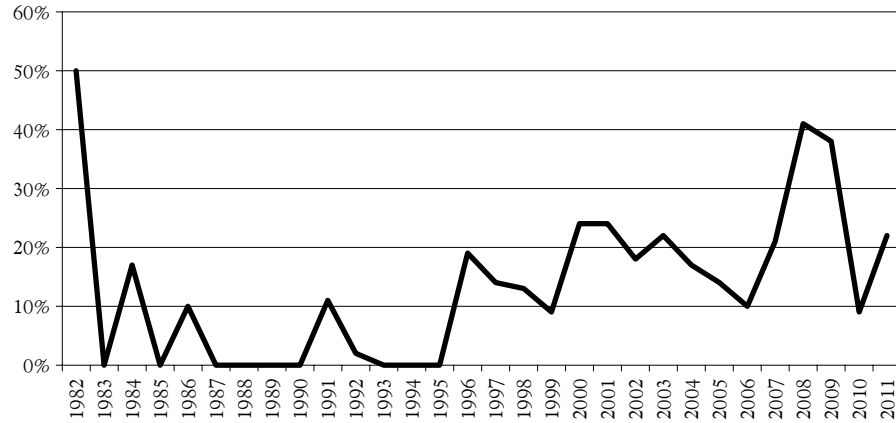
Year emerging	# of § 363 Sale Cases	# of non-§ 363 Ch. 11 cases	All emerging Ch. 11 cases	Proportion of § 363 cases to all Ch. 11 cases*
1982	1	1	2	.5
1983		4	4	0
1984	1	5	6	.17
1985		10	10	0
1986	1	9	10	.1
1987		7	7	0
1988		8	8	0
1989		10	10	0
1990		16	16	0
1991	2	16	18	.11
1992	1	40	41	.02
1993		34	34	0
1994		28	28	0
1995		15	15	0
1996	3	13	16	.19
1997	3	18	21	.14
1998	2	14	16	.13
1999	4	31	35	.09
2000	11	32	43	.24
2001	15	42	57	.24
2002	18	74	92	.18
2003	18	64	82	.22
2004	9	43	52	.17
2005	4	25	29	.14
2006	2	19	21	.1
2007	5	19	24	.21
2008	9	13	22	.41
2009	24	40	64	.38
2010	4	43	47	.09
2011	5	17	23	.22
Weighted Average, 1996–2011				.21

\*See Chart 1.

Thus, Baird and Rasmussen's prediction (and others' fear)<sup>49</sup> that asset sales would overrun reorganization never has been true—at least not for large corporate cases. Indeed, never have asset sales reached half of Chapter 11 cases. The scope of the alleged low value phenomenon, while certainly not trivial, is no broader now than the last decade's average. With this un-

<sup>49</sup>See Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird & Rasmussen's The End of Bankruptcy*, 56 STAN. L. REV. 645 (2003) ("[B]ankruptcy reorganization would remain necessary even if firms could be sold for their full going-concern value."); Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 129–30 (2005).

CHART 1: PROPORTION OF § 363 CASES TO ALL LARGE CH. 11 CASES



derstanding of the depth and breadth of the phenomenon, I turn to popular explanations for it.

## B. WHY LOW VALUE? RESPONSES TO FOUR UNSATISFYING ANSWERS

### 1. *Weak Capital Markets*

Baird and Rasmussen claim that capital markets are sufficiently liquid to handle even the largest asset sales.<sup>50</sup> Indeed, some of the large cases show that billions of dollars can be gathered and change hands quite seamlessly.<sup>51</sup> Even in the early 2000s, firms' assets were being sold for huge sums.<sup>52</sup> But other commentators dispute that credit markets can regularly support high value.<sup>53</sup> I argue that if the bidding process leads to low value, this result is

<sup>50</sup>Baird & Rasmussen, *supra* note 43, at 786 ("The market for selling firms as going concerns is well-developed. In such a world, a straightforward path exists for keeping the assets of the firm together and reestablishing coherent control rights.")

<sup>51</sup>*See, e.g., In re Adelpia Commc'n Corp.*, 352 B.R. 578, 587 (Bankr. S.D.N.Y. 2006) (noting approval of \$17.6 billion asset sale to Time Warner and Comcast).

<sup>52</sup>*See, e.g., In re Allegiance Telecomm'n, Inc.*, 356 B.R. 93, 96 (Bankr. S.D.N.Y. 2006) ("XO offered the highest price, a combination of approximately \$311.2 million in cash and 45,380,000 shares of XO common stock"); *In re Burlington Indus., Inc.*, No. 01-11282 (Bankr. D. Del. Aug. 1, 2003) (approving sale of \$614 million); Gus G. Sentementes, *Court OKs Bethlehem's Sale to ISG*, BALT. SUN, Apr. 23, 2003, at 1D (\$1.5 billion sale); Margot Habiby, *Enron CEO Says Debt, Other Claims May Total \$100 Bln*, BLOOMBERG NEWS, Apr. 12, 2002 (noting that Enron had agreed to sell water utility to YTL Corp. for \$1.77 billion in cash and assumed debt).

<sup>53</sup>*See, e.g., LoPucki & Doherty, supra* note 10, at 34-35; LoPucki, *supra* note 49, at 666-69 (noting that, notwithstanding the possibility that capital markets have improved, many reorganizations still exist, so prices must not be high enough to force them into sale).

not due to bidders' inability to raise capital but to bidders' rational action in light of available information.

Where investors and lenders are convinced of a return that is better than alternatives, they will provide the capital or credit necessary to make a purchase.<sup>54</sup> Indeed, even distressed industries generate "developed, but not perfect, market[s]" for asset sales.<sup>55</sup> Yet LoPucki and Doherty decry the fact that there are few firms that actually bid and that buyers generally come from the same industry as the debtor, suggesting that credit markets are unable to handle more competition. Secured creditors attempting to gain control of the company through credit bidding can also raise concerns, but these concerns have been adequately explained.<sup>56</sup> I argue that venture capitalists and acquisitions lenders seek a high rate of return, and they are often most likely to get that return from someone in the industry who can exploit economies of scale, vertical integration, and so forth.<sup>57</sup>

Determining which few industry players are able to most profitably incorporate the debtor's assets is not likely a complicated task for potential bidders. In Baird and Bernstein's words, "It is the highest bidder's perspective that counts,"<sup>58</sup> and potential buyers are not unaware of who the highest bidder is likely to be. In the run up to an asset sale, the firm is shopped, even by LoPucki and Doherty's estimate, to 80 potential bidders,<sup>59</sup> 30 of whom gain access to the company's intimate financial data and conduct preliminary valuations<sup>60</sup> while simultaneously determining their own best use of the assets and comparing their projected profitability to that of other potential bidders. This leads to most potential bidders voluntarily dropping out, leaving just a few (1.6, on average—the stalking horse and perhaps one or two others)<sup>61</sup> who can expect an acceptable capitalization rate in light of opportunity cost. With so many dropping out before bidding, the bulk of the sale's surplus might go to buyers,<sup>62</sup> but lack of liquid capital markets is not the

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<sup>54</sup>See Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 182–83 (2004).

<sup>55</sup>Baird & Rasmussen, *supra* note 43, at 1950. Cf. Buccola & Keller, *supra* note 23, at 124 ("[T]here are periods where capital is scarce even to the most credit-worthy borrowers.").

<sup>56</sup>For a thorough discussion, see Buccola & Keller, *supra* note 23. Cf. Kling, *supra* note 24.

<sup>57</sup>See, e.g., *Allegiance Telecomm'n*, 356 B.R. at 97 (noting "XO's [(the buyer's)] strong desire to integrate its business with Allegiance's as soon as possible to obtain what XO believed to be \$100 million to \$200 million of synergies").

<sup>58</sup>*Supra* note 29, at 1943.

<sup>59</sup>LoPucki & Doherty, *supra* note 10, at 34–35.

<sup>60</sup>*Id.*

<sup>61</sup>*Id.*

<sup>62</sup>Surplus going to the buyer is surplus not going to creditors, but this distribution does not mean that the sale should not occur. The sale is allocatively efficient if the buyer's willingness to pay is higher than the seller's (representing creditors) marginal cost, measured by the opportunity cost of allocating the assets in some other way. Sale should not occur only if the price falls below the present estimated value of

problem, as money is available if desired returns are possible.<sup>63</sup> The problem is the inability to give potential investors the return they seek when they are forced to bid against industry powerhouses who can best exploit the assets.<sup>64</sup>

Further incentivizing dropout, going-concern value for firms is found largely in relationships, which cost time and money to recreate after asset sales.<sup>65</sup> A buyer who does not already have relevant relationships in place or who cannot reform them easily (as strategic buyers within the industry can) will have to bid at a lower price to recoup the planned cost of relationship building that will arise while reconstructing the going concern.<sup>66</sup>

Regardless of the dropouts, money is available if the return is right. Potential financiers of buyouts can hardly be faulted for taking their bidding money elsewhere if (1) their return will be higher elsewhere or (2) they know that the comparatively higher return of a competing potential buyer will incentivize the latter to pay more to reach that return. If investors have hitched their wagon to one bidder who will make a predictably lower return on the assets than another, they will promptly unhitch and leave the sunk costs of valuation and pre-bidding research behind. This is why so many potential bidders with the ability to fund the purchase are contacted but so few go beyond the valuation stage.

Thus, LoPucki and Doherty are not incorrect when they state that “[b]ankruptcy reorganization provides a remedy for capital market inade-

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reorganization or, much less likely, liquidation, which are measures of opportunity cost for creditors under the absolute priority rule. However, as I show below, creditors have options to obtain value regardless of sale price, so their opportunity cost in asset sales is complex. For an illustration of what sellers should do when sale price falls below estimated reorganization value, see the Orleans Homebuilders example, *infra* notes 105-106 and surrounding text.

<sup>63</sup>For example, it is estimated that hedge funds and private equity firms alone, which are extremely active in the § 363 sale market, controlled more than \$2 trillion in assets as of 2007. Harvey R. Miller, *Chapter 11 in Transition—From Boom to Bust and into the Future*, 81 AM. BANKR. L.J. 375 (2007). Indeed, there is reportedly “relentless competition for deals . . . . When the competition grows intense, companies are sold at the high end of their valuations.” *Hedge Fund Drive to Succeed Fuels Turnaround Industry*, HEDGE FUND DAILY, May 8, 2007 [hereinafter *Hedge Fund Drive*], available at <http://www.institutionalinvestor.com/article.aspx?articleID=1341144>.

<sup>64</sup>Of course, investor coalitions not linked to an industry powerhouse do purchase the debtor’s assets on occasion (about one-third of the time, according to LoPucki and Doherty). LoPucki & Doherty, *supra* note 10, at 29. Much depends on the industry and whether economies of scope or scale are readily available. In the telecommunications industry, for example, where fiber optic switches are owned by debtors that do not exploit their capacity, and where adjoining networks can be linked, economies of scale are often easily obtained. Allegiance Telecom and Adelpia Communications are great examples here. See *supra* notes 51-52, 57 and accompanying text. Other industries might be very different. To emphasize the frequency with which industry players are the winning bidders, see George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 AM. BANKR. L.J. 235 (2002) (arguing that § 363(f) makes bankruptcy court the forum of choice for mergers and acquisitions).

<sup>65</sup>LoPucki, *supra* note 49, at 652. LoPucki was responding here to the contention, advanced by Baird and Rasmussen, that assets have little going-concern value and can be unplugged from one firm and into another when efficiency calls for the move. See Baird & Rasmussen, *supra* note 43, at 786.

<sup>66</sup>LoPucki, *supra* note 65.

quacy,”<sup>67</sup> but they miss the point: even where capital markets are adequate and many parties could fund a bid, there will not necessarily be many bidders. The runners know who else is in the race, and there’s no medal for second place. Consequently, it can simultaneously be true that debtors are getting the highest price available *and* the winning bidder is getting a great deal on the assets—all without alleging that secured creditors force bad sales, managers are conflicted, advisors are lazy, and judges are corrupt—because competitors drop out well before they expend resources on a bidding war they are confident of losing. This does not mean, however, that the highest price available is as high as it would have been if the potential buyers did not know who else was running.

Indeed, *more* information, especially information about other potential buyers, can lead to prices below where they would be with less information. That is, if the bidders did not know who else was in the race, they would bid up to their opportunity cost rather than dropping out before bidding gets started. Preventing potential bidders from discovering who else might bid would be almost impossible. Nonetheless, some sales see many bidders. As long as there are multiple bidders with similar opportunity costs and similar ability to exploit the assets, less sale surplus will go to the buyer and more will go to the estate, as bidding will be more competitive. Additionally, as long as creditors use their powers, which I discuss in more detail in the next section, they should be able to protect themselves from single-bidder sales that do not produce fair value. In fact, even if a sale is not made at what junior creditors would consider a fair price and reorganization cannot be forced, these creditors can extract payments as if the price were higher. Thus, even if there is a bidder dropout problem, the parties who need protection appear to be protected.

## 2. Creditor Control

Creditors, and particularly secured creditors, exercise contractual control over debtors-in-possession. Many suspect that this control is dangerous given that oversecured<sup>68</sup> lenders can force asset sales in an attempt to cash out quickly, leaving no or low recovery for junior creditors and limiting the DIP’s fiduciary responsibility to *all* creditors.<sup>69</sup> In addition to contractual

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<sup>67</sup>LoPucki & Doherty, *supra* note 10, at 3.

<sup>68</sup>DIP financiers generally acquire an all-assets lien. See Casey, *supra* note 5, at 774.

<sup>69</sup>See generally Harner & Marincic, *supra* note 11, at 760–62 (noting, however, the protections of the bankruptcy court and U.S. Trustee against DIP lender control); Michelle M. Harner & Jamie Marincic, *Behind Closed Doors: The Influence of Creditors in Business Reorganizations*, 34 SEATTLE U. L. REV. 1155 (2011); Andrew A. Wood, *The Decline of Unsecured Creditor and Shareholder Recoveries in Large Public Company Bankruptcies*, 85 AM. BANKR. L.J. 429 (2011) (noting that secured credit makes up more of debtors’ financial structures now, naturally leaving junior creditors with lower recoveries); Casey, *supra* note 5, at 760–62; Miller, *supra* note 63, at 390 (“By controlling terms of the DIP agreement, creditors

power, when a secured creditor is in danger of inadequate protection,<sup>70</sup> that creditor has a great deal of leverage to force a sale.<sup>71</sup> Finally, secured creditors in times of distress are often hedge funds rather than traditional banks, and they demand high returns and have little patience for poor performance.<sup>72</sup>

I present four responses to this explanation of the low value phenomenon.

a. Strength of Creditors' Committees

First, unsecured creditors' committees are strong, a fact not lost on them. "Emboldened by . . . their relative lack of power compared to the all-mighty DIP lenders and even second lien lenders, creditors' committees in many cases have begun to view themselves as the directors of the process. They consider themselves to be the owners of the debtors, a super board-of-directors of sorts. . . ."<sup>73</sup> Junior creditors, as noted by various scholars,<sup>74</sup> have little to lose by holding up a sale because they bear, in many cases, almost none of the

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substitute the judgment and decision-making of the debtor-in-possession, who is supposed to serve as an independent fiduciary, with that of a self-interested creditor who uses the process to protect its interests. Effectively, the debtor-in-possession is neutered."); Baird & Bernstein, *supra* note 29; Ayotte & Morrison, *supra* note 26, at 514, 525 (discussing covenants imposing line-item budgets, profitability targets, and deadlines for submitting reorganization plans); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006) (discussing extensive covenants including replacement of managers, restricted access to further credit, etc. exercised by creditors during trouble and bankruptcy); LoPucki & Doherty, *supra* note 10, at 37. *Cf.* LoPucki, *supra* note 49, at 666 ("[C]reditors force few bankruptcy liquidations. Firms liquidate in bankruptcy only after their boards conclude that the firms could not survive even if bankruptcy relieved them of all their unsecured debt. So long as distressed firms can survive on their own, they exhibit an overwhelming preference for reorganization over liquidation.").

<sup>70</sup>11 U.S.C. §§ 361, 363(c), (e) (2006).

<sup>71</sup>According to Baird and Bernstein:

If the debt-free enterprise value of the debtor substantially exceeds the amount of secured claims, the debtor has free cash flow to pay administrative expenses, and the business is not declining in value after paying such expenses, the debtor may well be able to demonstrate that secured creditors are adequately protected. In such circumstances, it will be difficult for the secured creditors—at least in the early stages of the case—to insist upon a sale if the debtor opposes one, and an adequate protection package typically is negotiated permitting the debtor to use the secured creditors' collateral, including cash collateral.

*Supra* note 29, at 1970 n.37. If senior creditors are undersecured, they can push for reorganization and "[t]hey are often willing to forego a market sale in order to recapitalize the debtor through a stand-alone reorganization." *Id.* at 1950. Creditors can make the best choice between "selling the business to other investors in a developed [(even where the industry is depressed)], but not perfect, market or acquiring it themselves . . ." *Id.*

<sup>72</sup>See Miller, *supra* note 63, at 393–94.

<sup>73</sup>*Id.* Note that, in many large cases, there are multiple creditors' committees, as there are different levels of creditors with different interests. See, e.g., Harner & Marincic, *supra* note 11; Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 136–40 (1990).

<sup>74</sup>See, e.g., Casey, *supra* note 5, at 785 n.107 (citing sources).



downside risk of extended time or reorganization. “When the senior debt is \$100, the junior creditor prefers reorganization with a 50 percent chance of \$110 or \$0 to a quick sale of \$100. Even though the reorganization has a total expected return of \$55, the junior creditor’s expected return (\$5) is greater than its return from the sale (\$0).”<sup>75</sup> This desire for junior creditors’ call option is coupled with power to extract it.

Committees have power to value the company at the estate’s expense;<sup>76</sup> use their valuation to push for reorganization; seek appointment of an examiner; ensure more oversight, protections, or time before sale by make objections to a proposed sale or procedures;<sup>77</sup> and encourage more bidders, even from among the ranks of junior creditors.<sup>78</sup> Further, there are many examples of junior creditors (and shareholders)<sup>79</sup> defending their rights and even taking value beyond their absolute priority.<sup>80</sup> Relatedly, junior creditors can, and

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<sup>75</sup>*Id.*

<sup>76</sup>LoPucki & Doherty, *supra* note 10, at 38 n.159.

<sup>77</sup>See Casey, *supra* note 5, at 785 (citing sources); LoPucki & Doherty, *supra* note 10, at 38–39 (arguing that objections by creditors’ committees will not lead to higher value but will instead drain the estate and lead to lower recoveries for junior creditors).

As for examiners, of the 142 § 363 cases in the Bankruptcy Research Database, only seven (5%) had an examiner appointed. Fifty-three (7.5%) of 711 non-§ 363 cases employed an examiner. This difference is not statistically significant ( $p = 0.23$ ), and the fact that creditors in § 363 cases do not obtain the appointment of examiners in more § 363 cases, as they have a right to seek under 11 U.S.C. 1104(c) (2006), is further evidence that they are content with their informal negotiations.

Some courts have given § 1104(c)(2) strict construction, requiring appointment of an examiner in cases with qualifying debt of at least \$5 million. See *Loral Stockholders Protective Comm. v. Loral Space and Commc’ns, Ltd.* (*In re Loral Space & Commc’ns, Ltd.*), 2004 U.S. Dist. LEXIS 25681, at \*7–8 (S.D.N.Y. Dec. 23, 2004); *In re Erickson Ret. Comtys., LLC*, 425 B.R. 309, 310–11 (Bankr. N.D. Tex. 2010). Others disagree. See *U.S. Bank Nat’l Assoc. v. Wilmington Trust Co.* (*In re Spansion, Inc.*), 426 B.R. 114, 126 (Bankr. D. Del. 2010) *appeal dismissed*, *Ad Hoc Comm. of Convertible Noteholders v. Spansion Inc.* (*In re Spansion Inc.*), Civ. No. 10-369, 2011 U.S. Dist. LEXIS 86152 (D. Del. Aug. 4, 2011).

As predicted by its disagreement with the strict statutory construction, the Delaware court approves fewer motions to appoint examiners. I found that 28 (80%) of 35 requests for the appointment of an examiner made in Delaware were denied. By contrast, in SDNY, 13 (54%) of 24 motions were denied. Explanations for this phenomenon are potentially diverse, but I believe, until more data emerges, that the answer lies in different jurisdictions’ interpretations of § 1104(c)(2), into which all of the cases in the Bankruptcy Research Database almost certainly fall. Judges everywhere define and limit examiners’ duties, but courts are required to appoint an examiner if the statutory requirements of § 1104(c)(2) are met, regardless of whether the judge thinks an examiner is necessary and whether the court gives the examiner any responsibility upon appointment. In Delaware, as Judge Carey opined, “I find no sound purpose in appointing an examiner, only to significantly limit the examiner’s role when there exists insufficient basis for an investigation. To appoint an examiner with no meaningful duties strikes me as a wasteful exercise, a result that could not have been intended by Congress.” *Spansion*, 426 B.R. at 127.

<sup>78</sup>See *infra* Part II(B)(2)(c).

<sup>79</sup>See, e.g., *Pension Benefit Guar. Corp. v. Braniff Airways, Inc.* (*In re Braniff Airways, Inc.*), 700 F.2d 935 (5th Cir. 1983) (giving shareholders a return where they deserved none).

<sup>80</sup>See, e.g., Casey, *supra* note 5, at 789; Baird & Bernstein, *supra* note 29, at 1932 (showing that “[j]unior creditors invoke expensive and time-consuming procedures merely to extract a payout exceeding their entitlements.”); Kerry O’Rourke, *Valuation Uncertainty in Chapter 11 Reorganizations*, 2005 COLUM. BUS. L. REV. 403, 433–34 (2005) (referring to *In re Exide* as example of powerful junior creditors

often do, negotiate a carve-out with the secured creditor in return for their support of the sale, thereby securing a guaranteed recovery before the sale occurs.<sup>81</sup> Creation of a carve-out on their own is, in my view, junior creditors' most powerful tool if judges, United States Trustees, examiners, and DIPs fail them.

Many of these tools, or the threat of using them, are employed behind the scenes, so creditors' committees and individual junior creditors rarely object to sales themselves, opting instead to prolong the process and seek more bidders by using procedural objections.<sup>82</sup> Indeed, they often push for cheaper protection packages for stalking horses, more time or fewer restrictions for bidding, etc., but they normally agree that sale is the appropriate response in a given situation.<sup>83</sup> Given that junior creditors face the greatest downside risk when the wrong choice between reorganization and sale is made, and given that they not only have access to the firm's financial data but have the power to value the firm and even bid from among their ranks if they want a different outcome, the lack of objection—and lack of creditor-induced appointment of examiners—is telling.

Cynics, however, point to the few objections as evidence that creditors' committees have been flogged into submission by debtor-favorable (i.e., senior creditor-favorable) judges who will never rule to benefit a committee anyway.<sup>84</sup> This explanation ignores an important point: creditors' committees, charging their expenses to the estate, can make the process expensive and long if they investigate the debtor's operations, demand their own valuation, file objections and extend hearings, seek appointment of examiners and trustees, and even help DIPs respect their fiduciary duty to seek the highest value for creditors.<sup>85</sup> Even if the court does not side with creditors, the procedures ensure that delaying the process and draining estate assets are effective tools for committees that want reorganization, different procedures, or a rearrangement of priority.<sup>86</sup>

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who obtain "cram-up" plan against secured creditors through valuation battle); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 871 (1996) (noting that "certain features of Chapter 11 reorganizations tend either to waste value or to enrich junior claimants at the expense of secured creditors"); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 188 (1989) (discussing tradeoffs inherent in deviations from the creditors' bargain).

<sup>81</sup>See Richard M. Bendix, Jr. & David E. Beker, *Carve-Out Agreements for the Benefit of Unsecured Creditors: Unanswered Questions*, 26 AM. BANKR. INST. J., April 2007, at 24.

<sup>82</sup>White, *supra* note 37, at 707 (using LoPucki and Doherty's data to point out just two cases in which objections were unsuccessful, one case in which they were, and 27 cases without objections).

<sup>83</sup>Harner & Marincic, *supra* note 11, at 784.

<sup>84</sup>LoPucki & Doherty, *supra* note 10, at 39.

<sup>85</sup>See, e.g., Harner & Marincic, *supra* note 11, at 764–65 ("Debtors often use the refrain, 'Management would like to pursue this deal but the creditors' committee will never sign off on it.'").

<sup>86</sup>See, e.g., Casey, *supra* note 5, at 789; Berringer, *supra* note 5, at 387–88.

Even procedures under the business justification standard require notice, allowance for independent valuations, bidding by interested parties, and other protections.<sup>87</sup> These procedures ensure that asset markets are generated even in distressed industries,<sup>88</sup> making the judge's valuation task simpler and surer.<sup>89</sup>

Further, all potential bidders not only have access to the virtual data room but also to firm management and possibly even employees.<sup>90</sup> Creditors and potential bidders can object to a sale or sale procedures and timelines by motion, and at least two hearings will be held: one approving sale procedures and another before approving the sale.<sup>91</sup> Thus, even the least restrictive process seems adequate to seek a fair price for the assets, and although some creditors "go to their fate kicking and screaming,"<sup>92</sup> the very fact that procedures allow them to delay and revalue shows that, at the very least, judges are not ignoring the Bankruptcy Code. Whether they systematically ignore creditors' valid protests is much more difficult to determine as, at best, there are often large and legitimate differences between valuator's appraisals of assets' worth.<sup>93</sup> Even if it were true that judges rarely side with creditors' substantive objections, the procedures give creditors power to extract value through carve-out or other agreement behind the scenes.

#### b. Foreseeability and Protection by Contract

Second, the power balance in the event of trouble is not unfamiliar or unpredictable to junior creditors, who can be expected to protect themselves through their own contracts.<sup>94</sup> Indeed, both before and during distress, senior and junior creditors are not unaware of where they stand in line, what

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<sup>87</sup>See, e.g., Friedman, *supra* note 5, at 191-92; Kuney, *supra* note 31, at 1290. See also *infra* Part II(B)(4).

<sup>88</sup>Baird & Rasmussen, *supra* note 69, at 1950.

<sup>89</sup>JACKSON, *supra* note 4, at 220; Barry E. Adler & Ian Ayres, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 YALE L.J. 83, 90 (2001); Michael C. Jensen, *Corporate Control and the Politics of Finance*, 4 J. APPLIED CORP. FIN. 13, 31 (Summer 1991); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 137 (1986); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 547 (1983). Cf. LoPucki & Doherty *supra* note 10, at 10-11 (arguing that judges in reorganizations do a much better job of valuing companies than some give them credit for).

<sup>90</sup>Baird & Rasmussen, *supra* note 69, at 1949.

<sup>91</sup>11 U.S.C. § 363(b) (2006) (requiring notice and hearing); Kuney, *supra* note 31, at 1290 (noting that, generally, at least two hearings are held—one to approve the stalking horse and establish procedures, and one to approve the sale after bidding).

<sup>92</sup>LoPucki & Doherty, *supra* note 10, at 38 (noting, however, that only *two* of their sampled cases involved objecting creditors who were overruled).

<sup>93</sup>See at Baird & Rasmussen, *supra* note 69, at 1951-52.

<sup>94</sup>Obvious exceptions to this proposition are what Bebchuck and Chang call "involuntary creditors," such as tort victims, who don't have contracts with the debtor at all. Lucian Arye Bebchuck & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization*, 8 J.L. ECON. & ORG. 253, 274 (1992).

they have to do to improve their position in return for another's subordination, and so forth.<sup>95</sup> If a junior creditor wants to avoid the power of secured creditors ruling the roost during distress and bankruptcy, it can seek securitization, a higher interest rate, or some control for itself in the event of things going awry.

### c. Creditor Protection through Creditor Bidding

Third, if junior creditors think they are being frozen out of going-concern value by an inadequate sale price, they can make their own bid for the assets by forming a coalition.<sup>96</sup> A creditor who thinks she's being shortchanged by a proposed sale can try to find a team of investors, other creditors, and/or strategic buyers to get the lost going concern-value for herself. Indeed, creditors' committees, valuing the companies themselves, would not likely hesitate to encourage more bidders from among their own ranks. Charging the cost of valuation to the estate would make the process cheaper for these bidders than for others, but I can find no evidence that junior creditors regularly attempt to protect themselves in this way. It is possible that they, like other potential bidders, are dissuaded by industry players with the capacity to best exploit the assets, but I can also find no evidence that junior creditors attach themselves to these dominant players (assuming the latter needs or would accept help). That junior creditors apparently do not bid or join bidders is evidence that, in their view—and after behind-the-scenes negotiations and carve-outs, where needed—they are not being frozen out of going-concern value.

### d. DIP Financing Does Not Lead to More Asset Sales

Fourth and most importantly, although the proportion of secured debt may be the best predictor of a Delaware Chapter 11 filing—further supporting the notion that secured creditors take a role in forum selection—studies suggest that DIP financing is actually correlated with *higher* rates of reorgani-

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<sup>95</sup>See Baird & Rasmussen, *supra* note 69, at 1951.

<sup>96</sup>This proposition has three potential transaction costs that can dissuade junior creditors from making such a play in the asset sale context: "(1) liquidity constraints, (2) information constraints, (3) lack of coordination among junior creditors . . ." Casey, *supra* note 5, at 786 (noting another cost, that of negotiation with secured creditors, which is not present in asset sales). As long as capital markets are sufficient, the first problem is overcome by creditors seeking outside investment partners or lenders. The second is largely—but not totally, as secured creditors presumably have had more access for a longer time—overcome when creditors' committees are given access to data rooms and management. The third is only a problem if many, most, or all junior creditors are, for some reason, required to participate. It seems more likely that even a small contingent of junior creditors could seek capital and bid on the assets. If some creditors don't want to risk taking back their call option on the going-concern value of the firm, they don't have to; I don't see collective action as a problem. After all, even Casey recognizes that the junior creditors' bargain is in fact a bet. If there are some junior creditors who don't want to risk that bet, they can opt out of the collective and take whatever the sale or reorganization gives them.

zation, not lower.<sup>97</sup> DIP financing improves the outlook of firms in Chapter 11 by providing funding where it might otherwise not exist, leading to greater investor confidence and more successful reorganizations.<sup>98</sup> DIP lenders might have reasons, beyond immediate financial incentives, to seek the highest value for the estate—even by reorganization. These lenders presumably seek to be repeat players in the market for distressed debt, and pushing for a low-value sale might earn them an unfavorable reputation.<sup>99</sup> As long as DIP lenders are adequately protected, their pursuit of highest value potentially maintains a valuable reputation in the market and a long-term relationship with the reorganized firm.

In the end, although the creditor control theory is a plausible problem facing § 363 creditors, there is little evidence that control by DIP financiers actually leads to less value, and no evidence that junior creditors routinely object to sales or seek the appointment of examiners in these situations anyway, suggesting that they are not unhappy enough to protest.

### 3. *Managerial and Financial Advisor Conflicts of Interest*

LoPucki and Doherty claim that managers and financial advisors (i.e., investment banks) encourage asset sales due to conflicts of interest and self-serving laziness.<sup>100</sup> These explanations are deficient.

#### a. Managers

One might think that managers would benefit from a plan of reorganiza-

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<sup>97</sup>See, e.g., Upinder S. Dhillon et al., *Debtor-in-Possession Financing and the Resolution of Uncertainty in Chapter 11 Reorganizations*, 3 J. FIN. STABILITY 238 (2007) (arguing that DIP financing leads to increased probability of reorganization, given that the financing is a positive signal to the market that the firm can be recovered); Sris Chatterjee et al., *Debtor-in-Possession Financing* 28 J. BANKING & FIN. 3097 (2004) (citing evidence that firms receiving DIP financing successfully emerge from bankruptcy significantly more often than firms without financing); Sandeep Dahiya et al., *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. FIN. ECON. 259, 270–76 (2003) (arguing that DIP financing increases likelihood of emergence from Chapter 11); Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 428–89 (1997). Cf. Ayotte & Morrison, *supra* note 26 (arguing that sale is more likely when lenders are oversecured). Although Ayotte & Morrison might have found a distinct subgroup of DIP lender cases, I would argue that the cases in their study are different: they are those in which all-assets liens were permitted by the debtor, and all-asset liens are more likely where reorganization is less likely (there is less need for an all-assets lien when the secured creditor is confident of assets being profitably reorganized by the debtor). That is, all-asset liens are more prevalent when sale is of greater probability anyway, thus leading to bias in their study.

<sup>98</sup>Kenneth M. Ayotte & David A. Skeel, *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425, 462–67 (2006).

<sup>99</sup>Indeed, investment banks serving on the seller's side might be a strong behind-the-scenes force in seeking value. If the bank, which expects to receive a success fee as a proportion of the sale price, fails to ensure a high price, which turns out to be below the DIP lender's secured claim, then they will not receive that fee. See Stuart A. Laven, Jr., *The Perils of Sell-Side 363 Sale Engagements: Protecting Your Success Fee in Underwater Situations*, 8 ABI COMM. NEWS (2011), available at <http://www.abiworld.org/committees/newsletters/financialadvisors/vol8num4/perils.html>. Thus, they have an incentive, at least in situations in which they will not achieve their full fee, to push for more value.

<sup>100</sup>LoPucki & Doherty, *supra* note 10, at 32–37.

tion, where they have a chance—however slim—of riding out the storm and keeping their positions.<sup>101</sup> Yet LoPucki and Doherty argue that, even where a CEO has the chance to stay with a reorganized company, selling might be better because they are hired as managers or consultants by the buying firm<sup>102</sup> or receive side payments and other undisclosed benefits in return for making the sale happen.<sup>103</sup> Eleven of the 30 CEOs in their sample received such benefits.<sup>104</sup>

LoPucki and Doherty fail to show, however, that managers' incentives for sale are actually greater than their incentives to reorganize or that, more importantly, the incentives are enough for them to abandon their duties to creditors. They also fail to show why the 19 CEOs who they could not show receiving benefits from buyers apparently did not seek rents from those buyers by balking, pushing for reorganization, or otherwise making the sale difficult. A simpler explanation is that some buyers, 37% in the sample, want to compensate the CEO for her continued expertise, not to purchase her support for a sale. The other buyers, 63% in the sample, simply didn't need the CEO's services moving forward and therefore didn't pay for them. The sales appear to move forward either way, lending no support to the notion that managers routinely violate their fiduciary duties to creditors.

To illustrate managers' pursuit of value, consider *In re Orleans Homebuilders*. Orleans' managers filed a motion to sell their assets, took bids, found a stalking horse, took more bids, and used the stalking horse's bid of \$170 million as the floor in negotiations with distressed asset investors, who offered more for a stand-alone plan of reorganization.<sup>105</sup> After withdrawing the pending sale motion, Orleans attempted to terminate its agreement with

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<sup>101</sup>Most don't keep their positions. Only four of 30 did in LoPucki and Doherty's study. White, *supra* note 37, at 705. For more information on manager replacement, see Ayotte & Morrison, *supra* note 26, at 538 (noting that 70% of CEOs are replaced in the two years prior to bankruptcy); Baird & Bernstein, *supra* note 29, at 1932–33 (noting that management and directors are normally replaced before or during the course of Chapter 11).

Note that most of the CEOs in LoPucki and Doherty's study, including the four that kept their jobs and the few that received other benefits, were likely CEOs put in place by *DIP lenders* or other secured creditors. Given Ayotte & Morrison's figure of 70% replacement by creditors in the two years before a bankruptcy filing, one might have expected to see many more of these presumably favored CEOs keeping their jobs or getting benefits in the bankruptcy process. That few executives receive such benefits is a strong indication of managers' tendency to respect their fiduciary duties to all creditors.

<sup>102</sup>See, e.g., *Cumberland Farms Dairy, Inc. v. Nat'l Farmers' Org., Inc. (In re Abbotts Dairies of Pa., Inc.)*, 788 F.2d 143, 146–48 (3d Cir. 1986); see also LYNN M. LOPUCKI, *COURTING FAILURE*, 169–74 (2005).

<sup>103</sup>See, e.g., *Mission Iowa Wind Co. v. Enron Corp.*, 291 B.R. 39, 40–41 (Bankr. S.D.N.Y. 2003).

<sup>104</sup>LoPucki & Doherty, *supra* note 10, at 32.

<sup>105</sup>Motion of the Debtors for Orders (A)(I) Approving Sale Procedures and Bidding Protections to Be Employed in Connection with the Proposed Sale of Substantially All of the Debtors' Assets, (II) Scheduling an Auction and Hearing to Consider Approval of the Sale of Substantially All of the Debtors' Assets, *In re Orleans Homebuilders, Inc.*, No. 10-10684-PJW, 2010 WL 1484834 (Bankr. D. Del. Apr. 13, 2010).

the stalking horse<sup>106</sup> and sought to establish the plan instead, all while seeking more than \$170 million in value for creditors. These do not appear to be the actions of conflicted managers.

b. Advisors

The corruption of financial advisors is also a difficult story to sell. These advisors, often investment banks, are professionals hired to determine whether a sale or reorganization is preferable and, if sale is pursued, to solicit bids and find a stalking horse.<sup>107</sup> In addition to their base fees (such as a retainer or progress fees, expense reimbursements, etc.), many banks are paid a percentage fee of the sale.<sup>108</sup> As mentioned, although the advisors solicit an average of 80 buyers, 30 of which sign confidentiality agreements to access the firm's data room and management to conduct due valuation diligence, very few (1.6, on average) formally bid.<sup>109</sup> The low number of bidders, LoPucki and Doherty argue, results from a conflict of interest.

Banks' conflicts supposedly arise because they have little incentive to solicit additional bids, as doing so would be difficult and their contingent fees might not justify the extra effort.<sup>110</sup> "The flat percentage fee creates an incentive to provide the low level of effort necessary to sell at a low price and earn the bulk of the fee, rather than the high level of effort necessary to sell at a high price and earn the maximum fee."<sup>111</sup> This is an argument of insufficient marginal return for the banks,<sup>112</sup> which are willing to lazily prepare information for *only* 80 potential buyers and facilitate the diligence of just 30. LoPucki and Doherty do not support this marginal return argument. Instead, they simply assume that (1) banks are not incentivized to shop the assets beyond minimum effort and (2) 80 potential buyers and 30 with access to the data room are not enough because few bidders actually emerge.

To even be argued, the first point needs data, such as the marginal cost of seeking out more potential bidders versus the expected marginal benefit of seeking them out. It should be noted, at the very least, that by LoPucki and Doherty's own estimates, only one in 50 potential buyers ever bids (1.6 of 80), so banks might expect that they would have to contact at least 50 (and many more if they have already contacted those most likely to bid) additional

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<sup>106</sup>The stalking horse, NVR, sued for breach of contract. Complaint, *In re Orleans Homebuilders, Inc.*, No. 10-10684-PJW, 2010 WL 2262315 (Bankr. D. Del. May 28, 2010).

<sup>107</sup>LoPucki & Doherty, *supra* note 10, at 34-37.

<sup>108</sup>See, e.g., *Dissecting Investment Bank Fees*, MSILIMITED.COM, <http://www.msilimited.com/Downloads/Fees%20and%20Services.pdf> (last visited Apr. 16, 2012).

<sup>109</sup>LoPucki & Doherty do not address whether inter-bidder communication substitutes for formal bidding, and I argue that just such communication leads to few bidders. See *supra* Part II(B)(1).

<sup>110</sup>LoPucki & Doherty, *supra* note 10, at 34-37.

<sup>111</sup>*Id.* at 35.

<sup>112</sup>LoPucki and Doherty, replying to White, state: "[I]nvestment bankers are maximizing their fee to effort ratios . . ." LoPucki & Doherty, *Bankruptcy Verite*, 106 MICH. L. REV. 721, 736 (2008).

parties to get one additional bidder—all while charging their retainer or progress fees and expenses to the estate. Even if another bidder did appear, would all of these fees be worth it to the estate? Without data, this question is impossible to answer, but one wonders why banks would not be incentivized to pursue an efficient number of bidders based on their progress fees alone, assuming there is not an alternative project with a much greater possibility of a high contingent payout to which it could shift resources.

The second point, that 30 potential buyers valuing the firm is not enough, seems odd on its face: to say that 30 potential buyers valuing the firm is not enough—and they have full access to the firm's financial information and at least some access to management—is to question how many *would* be enough. My argument, that most potential buyers drop out before they formally bid (while gathering information about other contenders),<sup>113</sup> is a better explanation for why 80 potential buyers turns to 30 valuers, which in turn becomes 1.6 bidders. Banks cannot force potential buyers to stay in the race and there is no indication that seeking more potential buyers will produce more bidders. Thus, seeking additional bidders might actually be harmful to the estate, as the likelihood that another bidder will arise might be outweighed by the progress fees and expenses paid to the bank.

As a final point, LoPucki and Doherty contend that the advisors' delivering the company at a fire-sale price might engender good feeling and future business from the buyer (the authors do not explain why the buyer would trust such a double-crossing bank with its future business),<sup>114</sup> creating more conflicts of interest and further incentive to reach a low price.<sup>115</sup> They fail to explain why the multitude of potential bidders contacted by the investment bank, many of whom evaluate the company, are incapable of bidding due to the *bank's* laziness. The firms and creditors' committees, charging valuation costs to the estate, have full access to the company and the ability, through their own investment banks, to conduct valuations, seek financing, and bid. After the bank shops the assets out, gets dozens of potential buyers into the data room, facilitates communication between the potential buyers and management, and secures a stalking horse, the matter is largely in potential buyers' hands. Information is in the open by that point, and according to one market expert, there is "relentless competition for deals . . ."<sup>116</sup> This relentless competition suggests that investment banks are doing their job without unnecessarily wasting the estate's assets on soliciting more buyers who won't bid.

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<sup>113</sup>See *supra* Part II(B)(1).

<sup>114</sup>White, *supra* note 37, at 706.

<sup>115</sup>LoPucki & Doherty, *supra* note 10, at 35.

<sup>116</sup>*Hedge Fund Drive*, *supra* note 63 (statement of William Brandt, president and CEO of Development Specialists, a corporate finance and turnaround consultant firm).



Thus, there is little reason to believe that managers or advisors are conflicted or that such a conflict leads to additional and lower-value asset sales.

#### 4. *Judicial Corruption and Forum Shopping*

LoPucki and Doherty argue that judges bend to debtors' and lenders' self-serving desires for a quick, low-value sale while letting investment bankers lazily neglect to bring bidders to the game.<sup>117</sup> Because their sales orders cannot be reversed on appeal, judges can attract a lucrative bankruptcy practice, support local industry and tax revenues through bankruptcy activity and incorporation fees, and garner prestige by using the business justification standard to rubber-stamp quick sales proposed by debtors who, controlled by oversecured creditors, file their bankruptcy petitions in Delaware or SDNY for that very purpose.<sup>118</sup> Professors Ayotte and Skeel,<sup>119</sup> however, contend that while secured creditors (particularly DIP financiers) push debtors to file in Delaware to protect their interests,<sup>120</sup> debtors are also attracted by expert Delaware judges (who issue objectively efficient judgments) and by value-saving speed and no-nonsense standards (which reduce administrative costs and get money to creditors sooner).<sup>121</sup>

There are three court-based arguments at the intersection of LoPucki and Doherty and Ayotte and Skeel: (1) speed (the quicker the sale, the lower the value; alternatively, the quicker the sale, the more value saved for creditors<sup>122</sup>); (2) standards (the business justification rule allows the debtor and DIP lenders to force sales that are never seriously questioned; alternatively, the business justification rule is both procedurally predictable and substantively sound); and (3) judicial role (judges in Delaware and SDNY bend to the

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<sup>117</sup>LoPucki & Doherty, *supra* note 10, at 39-40; LoPucki & Doherty, *supra* note 112, at 736-37.

<sup>118</sup>LoPucki and Doherty point to excessive protections for stalking horses selected by the DIP, which discourage other potential bidders; denial of objections to proposed sales or proposed sale procedures, which discourage junior creditors from objecting in the first place; finding business justification simply because the DIP wants a sale; and finding adequate value where there is little. LoPucki & Doherty, *supra* note 10, at 39-40. See LOPUCKI, *supra* note 102 (arguing that, just as Delaware garners tax revenue by attracting companies with its corporate law, it adds to its attraction by its § 363 business justification rule).

It should be noted that, in *Courting Failure*, LoPucki argues that managers, advisors, and attorneys make the self-serving decision to file in Delaware or, less likely, SDNY when choosing a forum outside their own. *Id.* at 17. Ayotte and Skeel, however, effectively showed that managers are subject to the power of DIP lenders. *Supra* note 98. In LoPucki and Doherty's 2007 article, citing Ayotte, Skeel and others, DIP lenders *were* factored into the forum selection analysis. Thus, it seems that everyone agrees: DIP lenders do indeed affect forum selection decisions.

<sup>119</sup>Skeel writes about this separately as well. DAVID A. SKEEL, *DEBT'S DOMINION* 229-30 (2003).

<sup>120</sup>See *supra* Part II(B)(1).

<sup>121</sup>Ayotte & Skeel, *supra* note 98, at 458-62.

<sup>122</sup>Ayotte & Skeel, *supra* note 98. Although speed does reduce administrative costs and leads to quicker recovery, LoPucki argues that at least in the reorganization context, these cost savings are not worth the higher probability of worse performance and of refiling for bankruptcy protection. LOPUCKI, *supra* note 102, at 98-117.

will of self-serving debtors; alternatively, judges there are more expert, so debtors seek them out).

With these three arguments in mind, I first reaffirm that forum *selection*, as opposed to forum *shopping*, does occur. Whereas “forum shopping” means the selection of a forum to seek a selector-favorable judgment, in this article “forum selection” means choosing a forum other than that of the company’s headquarters for any reason. Thus, shopping is a subset of selection. I then address each argument in turn, showing that (1) although it once was, Delaware is not significantly quicker than other jurisdictions now, and SDNY never has been; (2) there is little to fear in the business justification standard other than, perhaps, a strong presumption in favor of managers’ judgments that could stifle creditor opposition; and (3) the best explanation for forum selection is judicial expertise and predictability.

a. Forum Selection and Forum Shopping

Data on forum selection is readily available,<sup>123</sup> but forum *shopping* is much more difficult to determine. As demonstrated, Delaware does authorize more large corporate § 363 sales than any other jurisdiction,<sup>124</sup> and SDNY is a sizeable second. The proportion of cases involving a § 363 sale to other cases in these jurisdictions is also high, and both are often sought through forum selection. Whether debtors seek out these courts for judges’ expertise or for value-killing favoritism and weak standards is hard to tell from the numbers alone.

I evaluated forum-selected cases ( $n = 522$ ) using the 1982–2011 UCLA-LoPucki data ( $N = 853$ ), the results of which are summarized in Table 2. Forum selection is more prevalent ( $p = .01$ ) among cases involving § 363 sales than among non-prenegotiated, non-prepackaged cases confirmed without a § 363 sale, and Delaware is the forum of choice for these forum-selected sales.<sup>125</sup> In fact, 68% of forum-selected § 363 cases go to the District of Delaware. Proportionally, Delaware is even more the forum of choice for

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<sup>123</sup>Bankruptcy Research Database, *supra* note 44.

<sup>124</sup>The history of Delaware’s dominance is an interesting tale tied to the second Continental Airlines bankruptcy. The first, which was filed in Houston and is referred to below in the *Gulf Coast Oil* discussion, ended in a contentious firestorm for Continental that led to the second. When filing the second in 1990, Continental’s managers chose Delaware, unaware of what to expect but hoping for a more efficient process than that offered in Houston. They received it, and this led to others flocking to what became the predictable expertise of Delaware. See SKEEL, *supra* note 119, at 229–230; LOPUCKI, *supra* note 102.

<sup>125</sup>In my analysis, of 142 cases involving § 363 sales from 1990–2011, 94, or 66%, were forum-selected, 83 of which went to either SDNY (19) or Delaware (64). Only 55% of non-363 cases that were neither renegotiated nor prepackaged were forum-selected. (Also interesting is that 70% of renegotiated plans and 74% of prepackaged plans were forum-selected.) Of all § 363 cases, only 25 were filed in SDNY, so six filed there were not forum-selected, while all 64 cases filed in Delaware were forum-selected. This result is expected, as more companies are actually headquartered in New York, whereas companies are often incorporated but not headquartered in Delaware, which gives them the right, under 28 U.S.C. § 1408 (2006), to file there.

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## SECTION 363 SALES

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§ 363 sales than for other Chapter 11 cases ( $p = .009$ ).<sup>126</sup> Thus, large corporate § 363 cases are forum-selected, especially to Delaware, at a higher rate than other Chapter 11 cases generally.

TABLE 2: CASE FILINGS AND FORUM SELECTION, 1982–2011

	Delaware	SDNY	All Other Jurisdictions Combined
Ch.11 Cases Filed in the Jurisdiction	303	169	381
Proportion of All (N = 853) Ch.11 Cases	36%	20%	45%
Forum-Selected Ch. 11 Cases Filed in the Jurisdiction	300	119	103
Proportion of All (n = 522) Forum-Selected Ch. 11 Cases	57%	23%	20%
Section 363 Cases Filed in the Jurisdiction	64	25	53
Proportion of All (n = 142) § 363 Cases	45%	18%	37%
Forum-Selected § 363 Cases Filed in the Jurisdiction	64	19	11
Proportion of All (n = 94) Forum-Selected § 363 Cases	68%	20%	12%

Of contemporary concern, as illustrated in Table 3, 108 of 141 (77%) of large corporate cases filed from 2008 to 2011 were forum-selected, 67 of which (62%) went to Delaware.<sup>127</sup> Additionally, Delaware had 81% of forum-shopped § 363 cases and 58% of all § 363 cases during this period.<sup>128</sup> Thus, preference for Delaware in terms of forum-selection generally, the share of large cases going there, and § 363 forum shopping all appear to be increasing.<sup>129</sup> Why? Is it due to speed, debtor-favorable standards, or judicial expertise?

b. Speed Does Not Currently Drive the Increase in Delaware's Popularity

Based on their model and sample,<sup>130</sup> Ayotte and Skeel concluded that Delaware was a speedier jurisdiction—by an average of 168 days per Chapter 11 case—leading to the conclusion that “the firms with better post-bankruptcy prospects should rationally choose a longer, and hence more thorough,

<sup>126</sup>I found that 63% of all § 363 cases were filed in New York (18%) or Delaware (45%), whereas only 53% of non-§ 363 cases (n = 711) were filed in New York (19%) or Delaware (34%). The proportion of § 363 cases filed in Delaware (45%) is higher still than those filed in Delaware without prenegotiated or prepackaged plans (139 of 487, or 29%;  $p < .001$ ).

<sup>127</sup>Of the 141 large corporate cases filed from 2008 through 2011, 108 (77%) were forum-selected, with 67 of those going to Delaware and another 27 in SDNY, giving those two districts 67% of all large bankruptcies.

<sup>128</sup>Twenty-eight § 363 cases (of 38 total) were filed in Delaware (22) or SDNY (6) during this time, and 26 of those were forum-selected. Just 27 total § 363 cases were forum-selected during this period, giving Delaware and SDNY 97% of all forum-selected § 363 cases during the last four years.

<sup>129</sup>This conclusion should be tempered by possible recession-related effects that could reverse in coming years.

<sup>130</sup>Their sample included cases from the years 1990–1999 involving at least \$50 million in assets. Ayotte & Skeel, *supra* note 98, at 459.

Table 3: Case Filings and Forum Selection, 2008–2011

	Delaware	SDNY	All Other Jurisdictions Combined
Ch.11 Cases Filed in the Jurisdiction	67	34	40
Proportion of All (N = 141) Ch.11 Cases	48%	24%	28%
Forum-Selected Ch. 11 Cases Filed in the Jurisdiction	67	27	14
Proportion of All (n = 108) Forum-Selected Ch. 11 Cases	62%	25%	13%
Section 363 Cases Filed in the Jurisdiction	22	6	10
Proportion of All (n = 38) § 363 Cases	58%	16%	26%
Forum-Selected § 363 Cases Filed in the Jurisdiction	22	4	1
Proportion of All (n = 27) Forum-Selected § 363 Cases	81%	15%	4%

restructuring. Firms with weaker prospects should rationally choose a faster reorganization, which the Delaware court provided.”<sup>131</sup> In other words, time is money, and Delaware saved both in cases likely to end in asset sale anyway. In § 363 sales, the less searching, more debtor-trusting business justification standard would presumably contribute to this speed.

Ayotte and Skeel’s analysis, however, is dated and hence subject to skepticism. Thus, again using the UCLA-LoPucki Bankruptcy Research Database, I conducted my own analysis of speed in large corporate bankruptcies emerging from 1990 to 2011 and the four-year period from 2008 to 2011. Analyzing 759 cases (those with time from filing to plan confirmation or comprehensive § 363 sale of no more than 1460 days or four years)<sup>132</sup> emerging by plan confirmation or comprehensive § 363 sale,<sup>133</sup> I confirmed that Delaware indeed *was* quicker than other jurisdictions, both in § 363 sales and reorganizations. It appears, however, to have lost that advantage.

From 1990–2011, the mean time spent in Delaware for all emerging cases was 300 days, for SDNY 420 days and for all other cases 410 days. Using multivariate regression analysis,<sup>134</sup> I found that when controlling for preban-

<sup>131</sup>*Id.* at 461–62.

<sup>132</sup>The dropped cases were all outliers in the sense that they were more than 1.5 times the interquartile range above the 75th percentile, but most of them were not outliers according to Grubbs’s test. In this gray area, I elected to cut off the data at four years to keep the cases comparable.

<sup>133</sup>As Lehman Brothers illustrates, there is often much to do after a § 363 sale. There, the sale came just two days after filing for Chapter 11 protection, but Lehman did not leave bankruptcy (becoming a liquidating company for creditors) for another 3.5 years. See Caroline Humer, *Lehman Emerges from 3.5-Year Bankruptcy*, REUTERS.COM, March 6, 2012, <http://www.reuters.com/article/2012/03/06/us-lehman-idUSTRE8250WY20120306>.

<sup>134</sup>To control for the positively skewed time to emergence variable, I took its log, thereby forcing a more normal distribution. Comparing regression results before and after the log, I found differences in the estimates. For example, the non-logged variable predicted a time in bankruptcy of 96 days, not 137 (the result, however, is still highly significant).

krupcty asset and sale size, jurisdiction,<sup>135</sup> and whether a case used a comprehensive § 363 sale,<sup>136</sup> filing in Delaware was associated with a significantly shorter stay in bankruptcy (40%, or about 147 days) ( $p < .0001$ ).<sup>137</sup>

Even in light of these strong Delaware-centric results, whether a § 363 sale occurred was the most significant predictor of time in bankruptcy from 1990–2011. The mean time from filing to confirmed comprehensive § 363 sale was 190 days in Delaware ( $n = 59$ ), 342 days in SDNY ( $n = 23$ ) and 206 days in other jurisdictions ( $n = 49$ ). Although these might look like large differences, the standard error of the estimate is so high for each of them that neither is Delaware significantly faster nor is New York significantly slower than the group of asset sales at large. As an independent variable, however, § 363 sale is very significant. That is, when predicting time to emergence based on whether a case contains a § 363 sale, and controlling for jurisdiction and assets and sales, cases with § 363 sales are predicted to be about 65% faster than other emerging cases.<sup>138</sup>

Indeed, for 1990–2011, § 363 sales generally are quicker than plan confirmation, regardless of the jurisdiction, and Delaware is quicker to reach both plan confirmation (46% faster than other non-363 cases) and § 363 sale.<sup>139</sup> On the other hand, SDNY is not significantly speedy for this time period, even controlling for large-asset bankruptcies that tend to be filed there.

For 2008 to 2011, however, a different story emerges. Here, the statistical significance of quicker emergence after filing in Delaware disappears ( $p = .12$ ), even when controlling for asset sales. Indeed, the coefficient itself drops drastically, to  $-0.27$ , and the standard error is so high that all signifi-

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<sup>135</sup>My jurisdiction dummy variables were (1) Delaware, (2) SDNY, and (3) Delaware and SDNY, with all other jurisdictions being the other half of each binary variable.

<sup>136</sup>Delaware cases tend to be much smaller (on average, \$1.7 billion in prepetition assets, compared to \$6.4 billion in SDNY and \$3.2 billion for all other cases), so I controlled for prepetition sales and prepetition assets and dropped one significant (even by Grubbs's test) outlier: Lehman Brothers, which claimed over \$712 billion in prepetition assets as of 2010. By simple regression for the sample as a whole, asset size is not significantly correlated with time in bankruptcy ( $r = .03$ ;  $p = .4$ ), and controlling for it did little to the results—even though an easy explanation for Delaware's speed is that its cases are smaller and, therefore, simpler.

<sup>137</sup>The  $r$ -squared value of, or amount of variance explained by, the model, however, was quite modest when using the 1990–2011 data ( $r^2 = 0.1$ ). So it comes as no surprise that there is more to explaining variability in Chapter 11 speed than these variables. The model as a whole, however, produced very significant results ( $F = 21.56$ ;  $p < .0001$ ).

<sup>138</sup>It must be remembered that reaching a § 363 sale does not mean that the case is complete. See *supra* note 133. Many comprehensive sales involve just over half of a large company's assets, leaving the rest to be liquidated or reorganized. Further, even if all or almost all of the assets are sold, distribution of the assets must then occur, and arguments over claim values and priority can still abound.

<sup>139</sup>Prepackaged and prenegotiated plans were included in these calculations. Excluding them markedly increases the average time in bankruptcy, but I believe they should be included in the data as they are an ever more common part of reorganization practice. Further, including them in the data makes my conclusions stronger.

cance is gone. In other words, we can't say with any predictive confidence that cases emerging in Delaware during these four years were any quicker than those in other jurisdictions. Some might argue that the recession sprung an unexpected surprise on companies, which quickly filed for Chapter 11 protection in Delaware and then took time after filing to create an insolvency plan rather than doing so before filing, but the mean time from filing to emergence for the 149 cases emerging from 2008–2011 is only 250 days for all jurisdictions—much shorter than the average of 369 days for 1990–2011.

Whatever explains the change, Delaware is no longer the king of speed, but it is still dominant, with 76 (51%; SDNY had 23%) of 149 total cases emerging from 2008–2011, including 22 (58%) of 38 comprehensive asset sales. If speed does not explain Delaware's recently increasing dominance—and assuming filing companies are aware that Delaware is no longer predictably faster—we have to look elsewhere. The best explanation is that debtors file in Delaware because judges are more expert and standards are more predictable there, forcing debtors to contend only with creditors—not creditors *and* unpredictable judge-made requirements.

### c. Attracting Debtors with the Business Justification Standard

Valuation in bankruptcy, particularly when comparing immediate sale value to potential future reorganization value, is “a guess compounded by an estimate.”<sup>140</sup> Courts, then, have to do the best they can with what they have, and giving a great deal of weight to debtors' business judgment seems reasonable where the way forward is unclear. Additionally, some have tied forum selection to *better* outcomes in bankruptcy, given a race to the top and market sanctions curbing opportunism.<sup>141</sup> Yet others argue that, given the capture of debtors by creditors and the influence of money on advisors and debtors, the business judgment rule does not ensure efficiency and value for creditors,<sup>142</sup> procedural fairness,<sup>143</sup> or some optimal combination of the two.<sup>144</sup> I argue that the business justification standard is better than its competitor, the *Gulf Coast Oil* standard, which favors reorganization and distrusts the DIP, because even assuming that creditors cannot effectively object

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<sup>140</sup>H.R. REP. NO. 95-595, at 225 (1977); see *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 526 (1941) (“Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made.”).

<sup>141</sup>See Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357 (2000).

<sup>142</sup>Jason Brege, *An Efficiency Model of Section 363(b) Sales*, 92 VA. L. REV. 1639 (2006).

<sup>143</sup>Rose, *supra* note 5.

<sup>144</sup>Korres, *supra* note 5; Jessica Uziel, *supra* note 8 (advocating the approach in *In re Gulf Coast Oil*, 404 B.R. 407, 422 (Bankr. S.D. Tex. 2009) to more heartily question creditor protections); Casey, *supra* note 5 (proposing an efficiency model meant to respect junior creditors' call option value not currently protected by the absolute priority rule).

under the business justification standard, it allows them to draw out the process and pursue backroom deals.

In Delaware (and the many other jurisdictions that use the business justification standard), “[b]ankruptcy courts routinely authorize the use or sale of a debtor’s assets if such disposition or use is based upon the sound business judgment of the debtor.”<sup>145</sup> Sound business judgment is a malleable standard at best, so the modern and widely-used version of the test generally requires the judge to make four objective findings: (1) whether a sound business reason exists for the proposed transaction; (2) whether fair and reasonable consideration is provided—often determined by shopping the assets to potential bidders; (3) whether the transaction has been proposed and negotiated in good faith;<sup>146</sup> and (4) whether adequate and reasonable notice is provided to all interested parties, including the United States Trustee, the creditors’ committee(s), etc.<sup>147</sup> In other words, the judge ensures procedural protections and gives creditors a chance to protect themselves.

The *Gulf Coast Oil* standard,<sup>148</sup> on the other hand, inserts the judge

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<sup>145</sup>*In re Capmark Fin. Group, Inc.*, 2011 WL 6013718, at ¶ 135 (Bankr. D. Del.), citing *In re Dura Auto. Sys.*, 2007 Bankr. LEXIS 2764, at \*258 (Bankr. D. Del. Aug. 15, 2007); *Ayers v. Martin* (*In re Martin*), 91 F.3d 389, 395 (3rd Cir. 1996); *Comm. of Equity Sec. Holders v. Lionel Corp.* (*In re Lionel Corp.*), 722 F.2d 1063, 1070 (2d Cir. 1983); *Dai-ichi Kangyo Bank, Ltd. v. Montgomery Ward Holding Corp.* (*In re Montgomery Ward Holding Corp.*), 242 B.R. 147, 153 (D. Del. 1999) (“In determining whether to authorize the use, sale or lease of property of the estate under this section, courts require the debtor to show that a sound business purpose justifies such actions.”). See also *In re Delaware Hudson Ry. Co.*, 124 B.R. 169, 179 (Bankr. Del. 1991).

<sup>146</sup>The winning bidder must act in good faith to take the asset free and clear of other interests where one of five requirements is fulfilled (363(f)) and to be protected against the sale being overturned on appeal (363(m)).

<sup>147</sup>See, e.g., *In re Exaeris, Inc.*, 380 B.R. 741, 744 (Bankr. D. Del. 2008) (requiring that a sale of assets outside the ordinary course of business be supported by a sound business purpose, a fair sale price, adequate and reasonable notice and good faith); *Titusville Country Club v. PennBank* (*In re Titusville Country Club*), 128 B.R. 396, 399 (Bankr. W.D. Pa. 1991) (same); *In re Indus. Valley Refrigeration & Air Conditioning Supplies, Inc.*, 77 B.R. 15, 21 (Bankr. E.D. Pa. 1987) (same). See also *Lionel*, 722 F.2d at 1071 (setting forth the “sound business purpose” test); *Cumberland Farms Dairy, Inc. v. Nat’l Farmers’ Org., Inc.* (*In re Abbotts Dairies of Pa., Inc.*), 788 F.2d 143, 145-57 (3d Cir. 1986) (implicitly adopting the business justification standard and adding the “good faith” requirement); *In re Delaware & Hudson Ry. Co.*, 124 B.R. 169, 176 (D. Del. 1991) (adopting, roughly, the four-part test given here, in addition to requiring adequate protection for secured creditors; stating, “Once a court is satisfied that there is a sound business reason or an emergency justifying the pre-confirmation sale the court must also determine that the trustee has provided the interested parties with adequate and reasonable notice, that the sale price is fair and reasonable and that the purchaser is proceeding in good faith.”).

Once the court is convinced that the sale is appropriate, it issues a boilerplate order touching on each of these points. See, e.g., *Order Approving the Sale of Assets Free and Clear of Liens, Claims, and Encumbrances to Naviera Mexicana Neptuno. S.A. De C.V.*, *In re Trico Marine Serv., Inc.*, No. 10-12653, 2010 WL 8033222 (Bankr. D. Del. Aug. 25, 2010); *Order Authorizing Sale of Real Estate Equity Investment Advisory Group Business Assets (Including Assumption and Assignment of Contracts) Free and Clear of All Liens, Claims and Interests*, *In re Capmark Fin. Group Inc.*, No. 09-13684, 2009 WL 8519873 (Bankr. D. Del. Oct. 25, 2009).

<sup>148</sup>This standard, according to the court, grows out of Fifth Circuit case law. See, e.g., *Inst.*

deeply into the decision to sell, and the judge stands firmly on the side of the creditors. Chapter 11 procedures and creditor protections are at the heart of the standard, and Judge Steen, citing LoPucki's "fraught with potential for abuse" language,<sup>149</sup> said that Chapter 11-like protections (including class voting)<sup>150</sup> should be employed in every proposed sale, effectively gutting the efficiency gains that asset sales offer.<sup>151</sup> Additionally, comprehensive sales are to be subject to special scrutiny by the judge, even though creditors already have their rights to objection, voting, valuation, delay, and backroom compromise.<sup>152</sup> Thus, even if the creditors do not oppose the proposed sale or procedures, the judge is required to be the adversary of the DIP. Under this standard, DIPs are required not only to show that they have satisfied their fiduciary obligations to all creditors and presented a business justification for the sale; they must also show a "valid business justification for the process occurring separate from the plan confirmation process . . . ."<sup>153</sup> The standard disrupts the current balance between senior and junior creditors. Consequently, assuming as true that "junior creditors are [already] forcing firms that should be sold to languish in a wasteful reorganization process,"<sup>154</sup> the *Gulf Coast* standard will lead even more firms down this path.

As long as junior creditors can protect their presently-valued call option,<sup>155</sup> which is what the business justification standard allows, there is no

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Creditors of Cont'l Air Lines, Inc. v. Cont'l Air Lines, Inc. (*In re* Cont'l Air Lines, Inc.), 780 F.2d 1223, 1227 (5th Cir. 1986) (reasoning, in rejecting a proposed assignment of leases under § 363(b), that "if a debtor were allowed to reorganize the estate in some fundamental fashion pursuant to § 363(b), creditor's rights . . . might become meaningless."); *see generally* Pension Benefit Guar. Corp. v. Braniff Airways (*In re* Braniff Airways), 700 F.2d 935 (5th Cir. 1983) (stating that "[i]n any future attempts to specify the terms whereby a reorganization plan is to be adopted, the parties and the district court must scale the hurdles erected in Chapter 11."). Both of these cases, however, involved *sub rosa* plans in the truest sense: they were methods not only of selling or assigning some asset but also of simultaneously reorganizing the debtor as a going concern—without the approval of creditors, who objected and won. In Continental's case, the debtor was attempting to convert cash flow into a risky bet, and this business justification was not strong enough in light of objections.

<sup>149</sup>*See supra* note 12.

<sup>150</sup>*In re* Gulf Coast Oil, 404 B.R. 407, 422, 427 (Bankr. S.D. Tex. 2009) (stating that sales cannot evade the "carefully crafted scheme" of the chapter 11 plan confirmation process, such as §§ 1125 (disclosure and solicitation), 1126 (acceptance or rejection of plans), 1129(a)(7) (right of dissenters to receive at least as much as they would receive in Chapter 7), and 1129(b)(2) (absolute priority and adequate assurance) rights. If these rights are violated as they are found in the statute, the standard requires that the judge "fashion[ ] an appropriate protective measure modeled on those which would attend a reorganization plan.").

<sup>151</sup>I must note, however, that the only large § 363 sale in the Southern District of Texas since *Gulf Coast Oil*, *In re Seahawk Drilling*, occurred just 53 days after filing.

<sup>152</sup>*Gulf Coast Oil*, 404 B.R. at 422.

<sup>153</sup>*Id.* at 423.

<sup>154</sup>Casey, *supra* note 4, at 785.

<sup>155</sup>In valuing their call option, they likely weigh and average the probable values of reorganization success and failure in their various iterations and come to a judgment about what the option is worth in the present.



need for the judicial intermeddling imposed by the *Gulf Coast Oil* standard. After all, if junior creditors are convinced that they will get as much or more by sale than they would by reorganization, why should the judge try to convince them otherwise? Even if the business justification standard stifles opposition to a proposed sale, giving so much deference to debtors' business justifications that creditors can never win a motions battle, the standard still allows creditors to valueate, delay, seek more bidders, obtain carve-outs, and so on. More research is needed to determine how effectively creditors protect themselves on and off the record, but available data show that they are not unprotected in Delaware.<sup>156</sup>

Indeed, LoPucki and Doherty's finding that creditors opposed sale in three of 30 cases—and the creditors were successful in one of those cases—suggests that creditors are not altogether afraid of objecting and that, when they do object, they are not altogether ignored.<sup>157</sup> Adding credence to this claim are Harner and Marincic's findings that creditors' committees objected in 27% of the § 363 sales they studied,<sup>158</sup> that noncommittee parties also objected to some sales,<sup>159</sup> that *more* objections were filed in sales cases than in reorganizations,<sup>160</sup> and that a great deal of negotiation between debtors and committees occurs behind the scenes.<sup>161</sup> Pairing these findings with others' extensive work on the strength of creditors' committees to draw out estate value for themselves,<sup>162</sup> I suggest that creditors under the business justification standard are well protected—by themselves, certainly, even if not by the judge.

The *Gulf Coast Oil* standard represents increased procedure and increased uncertainty (and, therefore, increased borrowing costs)<sup>163</sup> without

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<sup>156</sup>See *supra* Parts II(B)(2)(a) and (b).

<sup>157</sup>See White, *supra* note 37, at 706–07; see also *In re G.S. Distrib., Inc.*, 331 B.R. 552, 560 (Bankr. S.D.N.Y. 2005) (“In light of [the largest creditor’s] objection to the private sales program, coupled with the Debtor’s lack of an adequate business plan for such program, the Court finds that Debtor has failed to demonstrate sound business judgment and cannot show that the program is in the best interests of the estate.”).

<sup>158</sup>Harner & Marincic, *supra* note 11, at 784. The disparity between LoPucki and Doherty’s estimate and that by Harner and Marincic lies in the fact that the former counted only objections to *sale*, while Harner and Marincic included other objections in their sample.

<sup>159</sup>*Id.*

<sup>160</sup>*Id.* at 781.

<sup>161</sup>*Id.*

<sup>162</sup>Casey, *supra* note 5 at 785 (note that Professor Casey does not regard the strength of creditors as a good thing—in fact, he sees it as a result of the absolute priority rule’s many distortions); Ayotte & Morrison, *supra* note 26, at 514; Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651, 681 (1974).

<sup>163</sup>Uncertainty is ineluctably linked to interest rates and creditors protections: where uncertainty is higher, creditors demand more. See, e.g., Barry E. Adler, *A Reassessment of Bankruptcy Reorganization after Chrysler and General Motors*, 18 AM. BANKR. INST. L. REV. 305 (2010) (arguing that capital costs were

increased value for creditors.<sup>164</sup> Given Judge Steen's discomfort with § 363 sales,<sup>165</sup> it is understandable that he would take upon himself the role of procedural protector to force reorganization, but he apparently has little faith in creditors. When it comes to value, creditors are the best protectors of creditors. Until evidence emerges that creditors cannot protect themselves, the business justification standard needs no modification.

Finally, from a manager and DIP lender perspective—and therefore a forum selection perspective—the business justification standard is preferable because it is predictable: less judicial intervention, and, as shown in the next subsection, more expertise when intervention occurs,<sup>166</sup> allows the DIP to converse with creditors and reach agreements for sales that can move predictably forward. Managers have little incentive to select a forum where the judge is an unpredictable variable, injecting arguments where the creditors need none and adding time and expensive complexity to the sale procedures.

#### d. Attracting Debtors with Judicial Expertise

In addition to employing simpler and more predictable standards, Delaware bankruptcy judges are seen as more experienced in large cases, and debtors seek them out for this expertise.<sup>167</sup> Ayotte and Skeel show that firms headquartered in states with less experienced judges are more likely to file in Delaware.<sup>168</sup> They also conducted a survey that showed an expertise-seeking sentiment among debtors.<sup>169</sup>

I cannot disagree with Ayotte and Skeel on this point. Delaware receives more Chapter 11 cases generally, and more § 363 cases in particular, than other jurisdictions. With seven bankruptcy judges in Delaware<sup>170</sup> and ten in SDNY,<sup>171</sup> it stands to reason that, given more large public Chapter 11 filings and § 363 motions distributed among fewer judges, each Delaware judge must oversee more of these large cases than do judges in SDNY—and almost certainly more than in other jurisdictions. Thus, Delaware judges do appear to have more experience, which can plausibly lead to more expertise.

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to increase due to the uncertainty inserted into bankruptcy practice and priorities by *Chrysler* and *GM*); Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727 (2010) (similar).

<sup>164</sup>Hopefully enough data will be generated soon so that an empirical analysis of value under the different standards can be made.

<sup>165</sup>*Gulf Coast Oil*, 404 B.R. at 426 (“The accepted wisdom is that § 363(b) sales are quicker and less expensive than plan confirmation, but the accepted wisdom is not necessarily correct.”).

<sup>166</sup>SKEEL, *supra* note 119, at 230.

<sup>167</sup>Ayotte & Skeel, *supra* note 98, at 458–62.

<sup>168</sup>*Id.* at 461.

<sup>169</sup>*Id.* at 459–60.

<sup>170</sup>See United States Bankruptcy Court for the District of Delaware, <http://www.deb.uscourts.gov/> (last visited Apr. 9, 2012).

<sup>171</sup>See United States Bankruptcy Court for the Southern District of New York, <http://www.nysb.uscourts.gov/> (last visited Apr. 9, 2012).

Further, as Skeel has argued, Delaware's judges do not likely cater to managers, given social pressure in that state to produce objectively stellar judgments. Reputational concerns, based on sophistication and responsiveness, lead to the conclusion that "Delaware decides cases quickly, and its judges are viewed as having a realistic perspective on what must be done to get a firm in and out of bankruptcy. . . . When a firm files in Delaware, it can be confident that Delaware's judges will not provide unexpected surprises."<sup>172</sup>

A combination of experience, expertise, and predictable and cost-saving standards is the best explanation for Delaware's dominance. Speed is not, based on the last four years, a significant factor. Additionally, judicial corruption and weak standards do not withstand reason, particularly given the lack of creditor objection and the strength of creditors' committees.

### CONCLUSION

In closing, I have six conclusions, which correspond to each of the questions addressed in this article. First, there might indeed be a value difference between reorganizations and comprehensive § 363 sales of similar size, but the disparity could be because debtors seeking asset sales are different—more distressed and less likely to succeed in reorganization—than debtors seeking reorganization. Second, § 363 sales have not overtaken reorganization. Third, although there is little reason to think that capital markets cannot supply prices above debtors' opportunity cost, the asset sale market is not necessarily conducive to competitive bidding, as most potential buyers drop out early. Fourth, although creditors exercise contractual control over debtors, this control does not appear to lead to more § 363 sales or lower value. Fifth, neither managers nor financial advisors are conflicted such that they seek low-value sales. Sixth, Delaware is by far the forum of choice for large corporate reorganizations and asset sales. Indeed, the "current state" of § 363 sales is, essentially, Delaware. Delaware's attractiveness, however, does not lie in value-killing and tax revenue-raising favoritism or in the speed of an alleged rubber stamp. Instead, debtors are attracted by judges' expertise and the forum's simple, predictable, and sufficiently protective business justification standard.

These six findings bolster my ultimate conclusion: the current state of § 363 sales deserves defending. There are just two potential flaws in the current picture. First, too much sale surplus, assuming distribution is important, might go to the buyer because most bidders drop out to cut their losses when they are confident of losing the sale. Information leads to attrition. However, creditors' committees, who value the company at the estate's ex-

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<sup>172</sup>SKEEL, *supra* note 119, at 230, 232.

pense, protect themselves by seeking reorganization when more value is arguably available there, by recruiting potential bidders, and by forcing carve-outs or other backroom deals. More research is needed to uncover the boundaries of this potential problem, but presently it appears that creditors can still protect their call option. Second, although there is considerable evidence that creditors protect themselves under the business justification standard, more research is required to definitively show that they are content with the current scheme.

As long as junior creditors can protect themselves—and it currently appears that they can—the current state of § 363 sales, which protects value and saves time, is precisely what these creditors want.

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