

## Chapter 16

# CESSATION AND SALE OF A BUSINESS IN A CASE UNDER THE U.S. BANKRUPTCY CODE

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### § 16.1 • INTRODUCTION

A business entity can use Title 11 of the United States Code (herein, Bankruptcy Code) as a means to cease operating and dispose of its assets in an orderly manner. The commencement of a case under the Bankruptcy Code can also enable a business entity to terminate its operations and sell its assets, either piecemeal or as a going concern, without exposing the acquiring entity to successor liability. This Chapter discusses the process by which a business entity can cease operations and dispose of its assets in the context of a case under either Chapter 7 or Chapter 11 the Bankruptcy Code.

### § 16.2 • CESSATION AND SALE OF A BUSINESS IN A CHAPTER 7 CASE

When a business ceases operations, one means of achieving finality is to file a petition for relief under Chapter 7 of the Bankruptcy Code. In a typical Chapter 7 case involving a business entity, the assets, if any exist, are liquidated by a trustee.<sup>1</sup> The duties of a trustee in a Chapter 7 case involve the collection, liquidation, and distribution of the assets of the debtor. The debtor can choose to commence a Chapter 7 liquidation case by voluntarily filing a petition.<sup>2</sup>

Alternatively, creditors seeking to terminate operations or liquidate the assets of a business entity may also commence an involuntary Chapter 7 case against the entity as long as the petitioning creditors meet certain threshold requirements.<sup>3</sup> The filing of a petition under the Bankruptcy Code — be it in a Chapter 7 or Chapter 11 case — results in the creation of an “estate,” which is defined in § 541 of the Bankruptcy Code and its case law progeny. The filing of a bankruptcy petition also results in the immediate imposition of an automatic stay, which, by operation of law, shields the debtor and its estate from creditor actions.<sup>4</sup>

Usually when a Chapter 7 case is commenced by a business entity, the entity immediately ceases doing business and the trustee takes possession of all assets to which the entity has title. The trustee then determines whether the assets are secured by liens and/or other encumbrances, or whether the debtor has equity in its assets that might result in cash to distribute to creditors. In certain situations, the bankruptcy court may authorize the trustee to operate the debtor’s business for a limited time period if it is in the best interests of the debtor’s estate and is consistent with the orderly liquidation of the estate.<sup>5</sup> The Bankruptcy Code contemplates such authorization in those rare situations where it appears that a business could be sold for a greater price as a going concern than rather in an ordinary liquidation.<sup>6</sup> Moreover, in certain situations, the public interest may require that a debtor’s business, such as a hospital or nursing home, continue to operate in Chapter 7, pending a sale.<sup>7</sup> If the trustee continues to operate a business, he or she needs to become familiar with the debtor’s industry or seek assistance in effectively operating the business. This often requires the trustee to retain key employees or principals of the debtor during this “winding down” period. While operating the debtor’s business, the trustee is granted certain rights and powers that, presumably, enable him or her to meet the goal of maximizing the realized liquidation values and effect the liquidation as quickly as possible.<sup>8</sup> For example, the trustee is authorized to incur unsecured debt and obtain unsecured credit in the ordinary course of business, or secured debt with priority over administrative expenses.<sup>9</sup>

A trustee operating a debtor’s business in a Chapter 7 case also has certain duties and obligations, such as compliance with record keeping and reporting requirements.<sup>10</sup>

Another obligation of a trustee operating a debtor’s business is to comply with applicable state law.<sup>11</sup> For example, a trustee operating a business holding environmentally contaminated property should also consider the implications of any relevant state law.<sup>12</sup>

The final step in a Chapter 7 case is the trustee’s disposition of property of the debtor’s estate. If the property is of value and there is equity in the assets, the trustee will attempt to sell such property in either a public auction or in a private sale.<sup>13</sup> If the property is burdensome to the estate or is of inconsequential value and benefit to the estate, the trustee may abandon such property back to debtor, after notice and a hearing.<sup>14</sup> Finally, once the estate property has been sold and reduced to cash, the trustee then, after notice and a hearing, distributes the proceeds in accordance with the priority scheme set forth in § 507(a) of the Bankruptcy Code.<sup>15</sup>

## **§ 16.3 • SALE OF SUBSTANTIALLY ALL OF THE DEBTOR'S ASSETS IN A CHAPTER 11 CASE**

To cease its operation and sell assets in an orderly manner and for going concern value without having to surrender control to a trustee, a business entity can file a petition for a relief under Chapter 11 of the Bankruptcy Code, then seek bankruptcy approval of the sale of substantially all of its assets. In the course of the Chapter 11 case, the debtor can sell substantially all of its assets, either in the context of a liquidating plan of reorganization or outside of a plan reorganization. Due to the complexity of a discussion of Chapter 11 liquidating plans of reorganization, the scope of the balance of this Chapter will be limited to sales outside of a plan of reorganization.

### **§ 16.3.1—Sales Of Substantially All Of The Assets Of A Debtor Outside Of A Plan Of Reorganization**

In the situation where there is the need to accomplish a sale of the assets of a debtor within a short period of time, the debtor likely will opt to sell substantially all of its assets outside of a plan of reorganization, as the process of confirming a plan of reorganization in a Chapter 11 case is generally time-consuming. Additionally, the debtor may prefer to consummate a sale of substantially all of its assets shortly after commencing Chapter 11 to avoid the risk that its assets will deteriorate in value or that its financial posture will continue to deteriorate, thus causing a decline in the potential going concern value of its assets. This may certainly be the case where a debtor has identified a purchaser and the purchaser wants to close the sale before the viability of the debtor's business declines to the point of diminishing returns.

Faced with this scenario, a debtor should seek to sell its assets outside of plan of reorganization pursuant to § 363 of the Bankruptcy Code. This process is faster than a sale in a plan since "the purchaser can focus on deleting the assets it wishes to purchase and the liabilities it is willing to assume without having to negotiate how the proceeds of the sale will be distributed among creditors, the disposition of the remaining assets, or the other considerations attendant to the plan process."<sup>16</sup> To approve a sale of substantially all of the debtor's assets, the debtor must demonstrate to the bankruptcy court that (1) sound business reasons exist for the sale; (2) there has been adequate and reasonable notice to interested parties, including full disclosure of the sale terms and the debtor's relationship with the buyer; (3) the sale price is fair and reasonable; and (4) the proposed buyer is proceeding in good faith.<sup>17</sup>

When the sale is conducted outside the context of a plan of reorganization, it may be challenged by certain creditors as being a "sub rosa" plan, *i.e.*, "an attempt to evade the creditor protections built into the plan process."<sup>18</sup> Although § 363(b) of the Bankruptcy Code provides that "the trustee, after notice and hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate,"<sup>19</sup> the majority of U.S. bankruptcy courts require that in a sale of substantially all of the assets of a debtor outside of a plan of reorganization, the movant show a "good business reason" to justify the sale.<sup>20</sup> In ascertaining whether good business reasons exist to approve the sale, a bankruptcy court considers (1) the proportionate value of the asset to the estate as a whole; (2) the amount of elapsed time since the commencement of the case; (3) the

likelihood that a plan of reorganization will be proposed and confirmed in the near future; (4) the effect of the proposed disposition on the future plans of reorganization; (5) the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property; (6) which of the alternatives of use, sale, or lease the proposal envisions; and (7) whether the asset is increasing or decreasing in value.<sup>21</sup> These seven factors are known as the *Lionel* factors,<sup>22</sup> which are followed by the courts in this circuit.

One of the greatest benefits of acquiring property in a bankruptcy case is the purchaser's ability to acquire assets free and clear of all liens and encumbrances.<sup>23</sup> Thus, a sale of assets in a bankruptcy case to either a truly independent third party or to a group of which former equity owners of the debtor are affiliated is an effective means to terminate a business and start up a similar business while retaining continuity, since the purchaser can acquire the assets without the liabilities. However, the buyer must be cautioned that there is still a risk of successor liability associated with such a purchase. Even if a bankruptcy court enters an order approving a sale free and clear of all liens, interests, and encumbrances pursuant to § 363(f) of the Bankruptcy Code, either in the context of a plan of reorganization or outside of a plan, the purchaser may take the assets subject to product liability claims under the doctrine of successor liability.<sup>24</sup> Where the product liability claim arises prior to the sale and the claimant has notice of the pendency of the bankruptcy case, there should be no successor liability.<sup>25</sup> However, the purchaser may find itself subject to successor liability based upon future claims that arise out of debtor/seller's pre-petition conduct.<sup>26</sup> Although the definition of a "claim" that should be discharged in a bankruptcy case is very broad,<sup>27</sup> if concepts of fundamental fairness in the bankruptcy process mitigate against discharge of a claim, then a purchaser in a bankruptcy sale may remain liable on account of that claim.<sup>28</sup> If a creditor has claims that arise out of the pre-petition conduct of the debtors, the debtor has enough information to know and reasonably anticipate that these types of claims could arise in the future. Therefore, if there is no provisions or mechanisms for the representation and/or treatment of these future claimants' interest during the bankruptcy case, these future claims may not be extinguished in a § 363 sale or discharged in a Chapter 11 plan.<sup>29</sup>

While the prospect of potential successor liability may "chill" the sale of assets in a bankruptcy case, courts may not consider that problem in imposing successor liability on the purchaser of assets in a bankruptcy sale.<sup>30</sup> However, what courts may object to is a "second opportunity for a creditor to recover on liabilities after coming away from the bankruptcy proceeding empty-handed."<sup>31</sup> Thus, a creditor's opportunity to satisfy its claim in the bankruptcy case of the debtor-seller is a significant factor that will determine the purchaser's successor liability.<sup>32</sup>

In addition to problems associated with future claims, there are several other exceptions to the general rule that a purchaser in a bankruptcy sale does not risk the imposition of successor liability. The first such exception is where the asset-purchase agreement, either expressly or implicitly, provides that the purchaser will assume certain liabilities of the debtor-seller.<sup>33</sup> A second exception is where there is merger or "de facto" merger of the seller and buyer.<sup>34</sup> A third exception is the "mere contribution exception," where the purchaser is nothing more than a reconfigured form of the seller.<sup>35</sup> In this scenario, there is "a common identity of directions, stockholders and the existence of only one corporation at the completion of the transfer."<sup>36</sup>

To reduce the risk of successor liability, a purchaser can take certain preventive measures. First, any order issued by the bankruptcy court should contain very broad release language limiting the purchaser's exposure with respect to successor liability.<sup>37</sup> Second, as discussed earlier, the more notice provided giving creditors an opportunity to object to the sale, provides the purchaser with greater protection from successor liability.<sup>38</sup> Therefore, it may be a sound investment for the purchaser to fund a legal advertisement giving the "world" constructive notice of a sale and an opportunity to object.

There are other steps a purchaser can take at the time of the sale to further mitigate against successor liability. These steps include, but are not limited to:

- 1) Ceasing the debtor's operations for at least one day;
- 2) Firing and hiring new employees under new contracts in accordance with a provision in the asset purchase agreement stating that the purchaser is under no obligation to existing employees;
- 3) Not honoring outstanding purchase orders or accepting returns;
- 4) Making sure that the asset purchase agreement clearly (a) identifies those liabilities, being assumed (b) provides that the purchaser will not be assuming any of the debtor's remaining liabilities and (c) disclosures any express or implied agreement by a purchaser to assume the remaining liabilities; and
- 5) Making sure that the asset purchase agreement specifies both the assets being purchased and those not being purchased.<sup>39</sup>

## NOTES

1. 11 U.S.C. § 701.
2. 11 U.S.C. §§ 301 and 302.
3. 11 U.S.C. § 303. In an involuntary case, the court enters an "order for relief" if the involuntary petition is not controverted by or if court determines that the debtor has met the factors for involuntary relief. 11 U.S.C. § 303(h).
4. 11 U.S.C. § 362(a).
5. 11 U.S.C. § 721.
6. *See In re A & T Trailer Park, Inc.*, 53 B.R. 144, 147 (Bankr. D. Wyo. 1985).
7. *Norton Bankruptcy Law and Practice 2d*, § 68:1 (Clark Boardman Callaghan 2003)
8. *Id* at § 68:2.
9. 11 U.S.C. §§ 364(a) and (c).
10. 11 U.S.C. §§ 704(8) and (9). *See also* Rule 2015 of the Federal Rules of Bankruptcy Procedure.
11. 28 U.S.C. § 959(6).
12. *In re A&T Trailer Park Inc.*, 53 B.R. at 148.
13. 11 U.S.C. § 704(1).
14. 11 U.S.C. § 554.
15. 11 U.S.C. § 726.
16. "Sales Under 363 (Successor Liability; Finality; Sub Rosa Plans; What Does "Free and Clear" Really Mean?)," ABI-CLE 75 (Sept. 20, 2002).
17. *In re Medical Software Solutions*, 286 B.R. 431 (Bankr. D. Utah 2002).

18. "Sales Under 363," *supra* n. 16 at 2.
19. 11 U.S.C. § 363(b).
20. *In re Medical Software Solutions*, 286 B.R. at 439 (citing *Licensing by Paolo, Inc. v. Sinatra (In re Gucci*, 126 F.3d 380, 387 (2d Cir. 1997); *In Re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983)).
21. *In re Medical Solutions*, 286 B.R. at 440-41 (citing *In re Lionel Corp.*, 722 F.2d at 1071).
22. *In re Lionel Corp.*, *supra* n. 20.
23. 11 U.S.C. § 363(f) provides that "The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if — (1) applicable non-bankruptcy 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 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."
24. *Norton Bankruptcy Law and Practice 2d*, § 37:22n (Sept. 2003).
25. *Id.*
26. *Fairchild Aircraft Corp. v. Campbell (In re Fairchild Aircraft Corp.)*, 184 B.R. 910 (Bankr. W.D. Tex. 1995), *vacated* 220 B.R. 909 (Bankr. W.D. Tex., 1998). Although the order was subsequently vacated as part of the settlement of the matter, the court's reasoning has been relied upon by other courts and commentators.
27. *Id.* at 925. "The definition of claim implies the inclusion of every type of liability which could be traced to pre-petition conduct. The definition includes "all legal obligations no matter how remote or contingent." *Id.*
28. *Id.* "Notions of fundamental fairness will not normally tolerate a potential claimant's rights being affected without its having had any way of participating in or being involved in the bankruptcy process." *Id.* at 928.
29. *Id.* at 922-923.
30. *Chicago Truck Drivers Pension Fund et al. v. Tasemkin*, 59 F.3d 48, 50 (7th Cir. 1995).
31. *Id.*
32. *Id.*
33. Brighton, "How Free is Free and Clear? A Practical Guide to Protection Against Successor Liability When Purchasing Assets Out of A Bankruptcy Estate," 2002 *ABI Journal*, 12 (Sept. 2002).
34. Brighton, *supra* n. 33 at 12. "To find that a de facto merger has occurred there must be a continuity of the selling corporation, evidenced by the same management, personnel, assets and physical location; a continuity of stockholders accomplished by paying for the acquired corporation with shares of stock; a dissolution of the selling corporation, and the assumption of liabilities by the Purchaser." *Shamis v. Ambassador Factors Corporation*, 34 F. Supp.2d 879, 897 (S.D. N.Y. 1999) (quoting *Arnold Graphics Indus. Inc. v. Independent Agent Center Inc.*, 775 F.2d 38, 42 (2d Cir.1985)). Additionally, in applying this exception, courts consider whether shareholders of the seller become shareholders of the purchaser subsequent to the consummation of the transaction. *Id.*
35. Brighton, *supra* n. 33 at 13.
36. *Shamis v. Ambassador Factors Corp.*, 34 F. Supp.2d. at 897 (citations omitted).
37. Brighton, *supra* n. 33 at 16.
38. *Id.*
39. *Id.* at 18.