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363 Sales Continue to Play Important Role in Corporate Transactions

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The interplay between environmental law and bankruptcy is complex. The laws have different purposes. The bankruptcy code is designed to give companies a "fresh start" while environmental laws often look backwards under their "polluter must pay" approach. Thus, if environmental issues are not adequately addressed in bankruptcy so that environmental claims are not discharged, a purchaser of corporate assets or the new company that has emerged from bankruptcy might be considered a successor to the debtor and find itself saddled with unexpected environmental liabilities.

Traditional Chapter 11 Reorganization Process

In past recessions, companies facing economic difficulties would file for chapter 11 reorganization. In most chapter 11 cases, the debtor's current management usually will continue to operate the business and will have a fiduciary obligation to protect the interests of the creditors. Under this arrangement, the debtor is known as a "Debtor in Possession" (DIP). In some chapter 11 cases, a private trustee will be appointed and wrest control of the business from the debtor's management. Chapter 11 trustees are only appointed in extraordinary circumstances such as fraud, incompetence, gross mismanagement or when it is in the best interests of the creditors and equity holders.

As part of its chapter 11 petition, a debtor must prepare Official Form 7 formally known as the Statement of Financial Affairs. Item 17 of this form called "Environmental Information" requires the debtor to list every site for which it has received a notice of potential liability from the government or notice of violation as well as sites that it owns or possesses that pose a threat of imminent and identifiable harm to public health and safety. The debtor is also required to list every site where it has been notified by the government of a release of hazardous substances. Finally, the debtor must list all judicial and administrative proceedings, including settlements, related to environmental laws in which it is a party.

The bankruptcy court will also set a "bar date" which will be the deadline for creditors to file their proofs of claims." A creditor is required to file a proof of claim only if its claim is not listed on the schedule of liabilities filed by the debtor or if the claim is dispute, unliquidated, or contingent.[1] In the proof of claim, the creditor must indicate the basis of is claims, classify the claims (i.e., secured unsecured priority, or unsecured non-priority), as well as the amount of its claims. If a creditor who is required to file a proof of claim fails to do so by the bar date it will be deemed to have waived its rights and will be precluded from participation in the distribution of the debtor's assets, and its claim will be discharged."[2] Generally, a known creditor (even one holding a disputed, contingent, or unliquidated claim) will not be deemed to have waived its claims if it was not listed as a creditor in the debtor's schedules or did not receive actual notice of the bar date.[3] Contingent or unknown creditors need only receive constructive notice of the bar date, such as notice by publication in newspapers or other appropriate periodicals.[4] EPA will review the disclosure of Environmental Information to determine if it will file a notice of claim. Generally, the bar date for the federal government will be the later of 180 days from the filing of the petition or the bar date.

Upon the issuance of the chapter 11 order of relief, the debtor will have an exclusive right to file a reorganization plan for 120 days. As soon as practicable after the chapter 11 order of relief, the United States trustee will appoint a committee of creditors holding unsecured claims

Before a reorganization plan can be disseminated to the debtor's creditors for a vote, the debtor (or other plan proponent) must file a written disclosure statement in connection with the proposed plan. The disclosure statement is akin to a prospectus and must contain sufficient information to allow a hypothetical investor typical of the class being solicited to make an informed judgment about the plan. The disclosure statement must provide creditors with "adequate information" regarding the debtor's historical, current, and future affairs to enable creditors to make informed decisions regarding the plan.[5]

The discussion of environmental liabilities can be one of the more overlooked topics in the disclosure statement. As a result, environmental lawyers and consultants can play

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[1]. 11 U.S.C. 1111(a).

[2]. 11 U.S.C. 1141(d).

[3]. Sylvester Bros. Dev. Co. v. Burlington R.R., No. 4-88-692 (D. Minn. Nov. 5, 1991); In re Bicoastal Corp., f/k/a/ Singer Co., No. 89-8191-8P1 (M.D. Fla. Feb. 8, 1991, Waterville Indus. v. First Hartford Corp., 124 Bankr. 411 (D. M. 1991); United States v. Union Scrap Iron & Metal, 123 Bankr. 831 (D. Minn. 1990).

[4] *See*, *e.g.*, *Waterville Indus. v. First Hartford Corp.*, 124 B.R. 411, 413 (D. Me. 1991); *cf. PacifiCorp and Van Cott Bagley Cornwall & McCarthy v. W.R. Grace*, 2006 WL 2375371 (D. Del. 16, 2006).

[5] 11 U.S.C. § 1125(a).

an important role in ensuring that the disclosure statement adequately discusses environment issues. It is not unusual for the federal government to object to a disclosure statement if it does not provide adequate information about how the proposed plan will address environmental liabilities.

Following a confirmation hearing, the bankruptcy court will issue an order confirming the plan of reorganization. Entry of the confirming order will discharge all debts that arose prior to the plan in accordance with the terms of the confirmation plan. The confirming order has the effect of a final judgment and will serve as *res judicata.* Creditors will be limited to the rights provided by the plan and will be barred from taking actions to collect debts that are inconsistent with the plan. The order will often contain what is known as a confirmation injunction that will enjoin filing of claims against the reorganized entity for pre-petition and pre-confirmation liabilities released pursuant to the plan. Bankruptcy courts will often retain jurisdiction to hear all matters arising out of or related to the chapter 11 case and the confirmation plan. Once the plan is confirmed the only cause for relief from the stay that may be validly asserted is the debtor's material failure to comply with the plan. One exception is section 1141(d) which provides that a discharge may not apply to a creditor that is not given notice of the case and the creditor's claim is not scheduled or the claim was scheduled as disputed, contingent or unliquidated as to amount if due process dictates that the claim not be discharged. This section has been used on occasion by PRPs seeking to bring contribution or cost recovery actions. Corporate debtors also do not receive a discharge if the plan provides for their liquidation and they do not engage in business after confirmation. [6]

Section 1141 allows property of the debtor’s estate addressed by the plan shall be free and clear of all claims and interests of creditors, equity holders and general partners of the debtor. This provision is more likely to cut off successor liability for pre-confirmation conduct of the debtor. Some courts have argued that state laws imposing successor liability frustrate the purposes of the Bankruptcy Code and therefore are preempted when the underlying liability has been discharged under a plan of reorganization. [7] Parties have argued that if a court is allowed to disregard a condition in a sale agreement, a purchaser would be buying “a pig in a poke” since it would never know when its seller's customers or creditors could come out of the woodwork and bring suit against it under some theory of successor liability. As a result, this could have the effect of depressing the price of the bankrupt's assets to the prejudice of creditors. Others have suggested that while the price of an asset is important, bankruptcy courts do not have blanket power to immunize buyers from all state and federal laws that might reduce the value of assets purchased through bankruptcy or to extinguish the rights of third parties such as future tort claimants without some notice to those claimants or some consideration of their rights.[8]

363(f) Sale Process

[6] See In re Eagle-Picher Industries, Inc, 216 B.R. 611 (S.D. Ohio 1997)

[7] In re White Motor Credit Corp., 75 B.R. 944, 950–51 (Bankr. N.D. Ohio 1987).

[8] Zerand-Bernal Group v. Cox, 23 F.3d 159 (7th Cir. 1994)

However, because of tight credit markets it has been very difficult to obtain DIP financing during this recession. As a result, many debtors are turning to Section 363 sales to raise cash, shed unwanted assets or lines of business, or to reduce debt. At the same time, buyers may be able to acquire assets at an extremely attractive price that would not otherwise be available outside the bankruptcy process. Section 363 sales can provide an attractive opportunity for corporations to acquire assets at a bargain price or to acquire discrete assets of a business or even a competitor without incurring all of the liability associated with that business. Purchasers can acquire the assets as a going-concern which enhances the value of the assets.

Under section 363 of the Bankruptcy Code, a trustee or DIP may sell property of the debtor's estate free and clear of a third-party's interests or liens. In many cases, the buyer may be able to acquire assets without also incurring environmental liabilities associated with those assets. In the past, courts have traditionally authorized expedited sales under section 363 only in extraordinary or exigent circumstances. Usually, courts have required debtors to show that such a sale was needed to preserve rapidly declining asset values and avoid what has been called the "melting ice cube" effect. In some cases, courts might want to see that the sale was a condition of DIP financing agreement.

In the wake of the Great Recession, though, judges have an increasingly willingness to approve 363 sales since the assets can be sold for going-concern value and avoid the asset-destroying process of piecemeal liquidation sales. As illustrated by the recent GM and Chrysler bankruptcy cases, 363 sales can be accomplished on an expedited basis.

To obtain court approval of a 363 sale, the debtor must demonstrate to the court one of the following:

- applicable state law authorizes the sale (i.e. no one objects);
- the debtor's creditors consent to the sale;
- the sale price for the property exceeds the value of all creditor liens attached to such property;
- alleged creditors' interests in the debtor's assets are disputed; or
- the creditors are compelled by court order to accept money from the sale proceeds as satisfaction of their interests in the debtor's assets.

The sales are usually done pursuant to an auction to maximize value. Some purchasers do not wait for assets to be put up for auction but instead try to negotiate a deal upfront in what is known as a stalking horse bidder. The parties will then execute an agreement and the seller will file bankruptcy for the sole purpose of conducting a court-approved 363 sale. In many cases, the auction will be a mere formality.

The stalking horse bidder is does its own due diligence on its own timetable. It then negotiates the terms of the sale including any necessary representations or warranties are contained in the purchase agreement. Any subsequent bidders must accept the terms contained in the initial purchase agreement negotiated between the stalking horse bidder and the DIP. Subsequent bidders frequently rely on the due diligence performed by the stalking horse because of the time constraints associated with the bidding process.

After the stalking horse and the DIP reach an agreement regarding the sale terms and the bidding procedures, the parties will submit the deal to the court for approval. As part of this process, the stalking horse can negotiate provisions that will protect its bid and enhance its chances of being the successful bidder by disqualifying or discouraging other bidders. For example, other bidders may be subject to various prequalification requirements before they can even submit a bid. The stalking horse bidder can often negotiate for a shortened auction notice period, thereby reducing the time other bidders may have to conduct their own due diligence or meet any prequalification requirements.
The stalking horse bidder will submit the initial bid to establish the base price for the assets and facilitate the sale process. The stalking horse will also receive "bid protection" meaning that other potential bidders will have to offer an amount in excess of the stalking horse's bid. The bid protection will vary but usually ranges from 2% to 5% of the stalking horse's purchase price.

The stalking horse bidder will receive a break-up fee if it is outbid. The break-up fee is intended to compensate the stalking horse bidder for the expenses incurred in doing its due diligence. In contrast, other potential bidders will have to pay for their own diligence even if they are not the successful bidder.

Once the court approves, a notice will be sent to all of the debtor's creditors announcing the auction and the auction rules. Often times, no bids are submitted by qualified bidder, in which case an auction is not necessary. If an auction is conducted, the debtor is required to accept the best bid, which is then subject to approval by the bankruptcy court. The winning bid may not be limited to the best price but could be based on contractual terms such as the existence of an environmental indemnity. The bankruptcy court must approve the winning bid. Once the court approves the winning bid, the parties may proceed to the closing. Often, the closing may occur on the same day.

Because the specific conditions of these sales will vary, it is important for environmental consultants who are retained by stalking horses or other bidders to understand the terms of the sales and what liabilities, if any, will be potentially assumed by the prospective client. The consultant will then need to develop diligence that will address these liability concerns as well as the often truncated timing for preparing a bid.

363 Sales and Successor Liability

The ability of a bankruptcy court to approve a sale free and clear is particularly important to a purchaser acquiring an ongoing business from the debtor since the purchaser could face possible liability as a successor corporation.[9] While protection of asset purchasers is not an express goal of the Code, some commentators have argued that insulating asset purchasers from successor liability is an essential part of the Code's framework because it will maximize the value of the debtor's assets, thereby making more resources available for distribution to creditors.[10] Others, though, assert that a bankruptcy court is limited by its power to discharge claims and cannot future claims that do not arise until after the time of the bankruptcy proceeding.

A critical question is what is meant by "interest". Many courts have held that the section 363(f) only provides bankruptcy courts with the power to convey assets free and clear of *in rem* interests or interests that run with the property such as liens and encumbrances.[11] However, other courts have held that section 363(f) applies to pre-conveyance claims that are not property interests but are *in personam* liabilities of the transferor. [12] Other courts have found that the Code does empower bankruptcy courts to approve sales "free and clear" but that the origin of this authority is in a court's equitable power pursuant to section 105.[13]

Not surprisingly, the federal courts are divided on whether a sale of assets free and clear pursuant to section 363(f) can insulate the asset purchaser from environmental liabilities associated with those assets. The easier question involves purchasers of real estate could not assert a third party or innocent purchaser defense.[14] Given this uncertainty, some real estate purchasers have entered into Prospective Purchaser Agreements. Of course, the new bona fide prospective purchaser defense allows purchasers to knowingly acquire contaminated property without incurring CERCLA liability.

Because of this confusion, many purchasers request that 363 orders contain express language cutting off successor liability for pre-petition environmental conditions. 365(f) orders may become a more viable tool in brownfield development. Some developers of brownfield sites believe they can use section 363(f) to avoid liabilities associated with contaminated properties where they might not qualify for an innocent purchaser or prospective purchaser defense and then use the new Bona Fide Prospective Purchaser Defense to eliminate their liability as a current owner of contaminated property.

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9 See §10.03 for a detailed discussion of successor liability

10 Schnapf, CERCLA and the Substantial Continuity Test: A Unifying Proposal for Imposing CERCLA Liability on Asset Purchasers, 4 Environmental Lawyer 435, 493 n.401 (1998).

11 In re Wolverine Radio Corp, 930 F.2d 1132 (6th Cir. 1991);In re Fairchild Aircraft Corp., 184 B.R. 910 (Bkrtcy. W.D. Tex. 1995)

12 Griffin v. Bonapfel, 805 F.2d 1515 (11 Cir. 1986)

13 In re White Motor Corp, 75 B.R. 944 (Bktrcy. N.D.Ohio 1987)

14 Matter of CMC Heartland Partners, 966 F.3d 1143 (7th Cir. 1992); U.S. v. LTv Corp., 944 F.2d 997 (2nd Cir. 1991)

An early example of the use of a section 363 to cutoff environmental liability was In *In re Heldor Industries, Inc.* [15] In this case, the debtor sold substantially all of its assets pursuant to a sale agreement that permitted the debtor to sell "free and clear" and without setting aside proceeds to comply with state environmental cleanup laws.[16] In particular, the sale agreement contained no terms requiring that the debtor comply with the environmental laws and specifically allowed the purchaser to take title to the assets free and clear of any obligations to comply with environmental laws. The NJDEP received notice of the impending sale and had an opportunity to object to the sale, but failed to do so until after the sale order became final. Nevertheless, the NJDEP argued that the sale order could be voided because a debtor *must* comply with environmental cleanup laws. The court disagreed and held that the order became final after the NJDEP failed to object in a timely manner, having received sufficient notice, citing the need for finality of bankruptcy court orders.[17]

A more recent example of the usefulness of 363(f) sales to cut-off successor liability as illustrated in *In re: Cone Mills Corporation.*[18] In this case, Cone Mills had operated a dye and chemical manufacturing facility at a property located in Newark, New Jersey. Cone Mills sold the business line to Ciba Geigy in the 1970s and sold the site in 1980 to Crompton and Knowles, a predecessor of Crompton Colors Corporation and Crompton Colors, Inc (collectively Crompton"). Shortly before ceasing operations at the Newark property, Crompton entered into a voluntary cleanup agreement with the New Jersey Department of Environmental Protection (NJDEP) and estimated the cleanup costs at approximately $6 million.

In 2003, Cone Mills filed a voluntary petition for bankruptcy under chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware. Thereafter, Cone Mills filed a motion for an order under section 363(f) authorizing the sale of substantially all of its assets free and clear of liens, claims, encumbrances, and interests. After a hearing on the proposed sale, the court issued the order authorizing the sale to International Textile Group ("ITG") for approximately $40 million. The order included a provision incorporated a finding of fact that the Buyer would not have agreed to the Asset Purchase Agreement if the sale was not "free and clear of all Interests of any kind or nature whatsoever", or if the buyers "would, or in the future could, be liable for any of the Interests". In addition, the order further provided that those interest-holders who had not objected to the sale were deemed to have consented to the sale, and that the Buyers are not the successor to Cone Mills "by reason of any theory of law

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[15] 131 B.R. 578 (Bankr. D. N.J. 1991).

[16] *Id.* at 580.

[17] *Id.* ("The bankruptcy system would be severely damaged if parties could not rely on the finality of court orders entered after notice and opportunity for hearing. This is particularly true in relation to orders authorizing sale of property of the estate.") (citations omitted). The court also noted that since the sale order had become final, any objections by the DEP were barred by the doctrine of *res judicata*.

[18] 2009 U.S. App. Lexis 4520 (3rd Cir. March 3, 2009)

or equity" and shall not be responsible for any of its liabilities or obligations, including environmental claims.

Approximately six months after the entry of the order approving the sale to ITG, the NJDEP filed a claim for cost recovery action and natural resources damages against Cone Mills, Crompton and ITG. Crompton, in turn, filed a proof of claim of $4.2 million asserting that ITG was liable as a successor to Cone Mills. ITG filed a motion with the Bankruptcy Court to direct the NJDEP and Crompton to comply with the Sale Order, arguing that these successor liability claims violated the terms of that order. Alternatively, ITG asked the court to set aside the sale on grounds that the debtors had not conveyed the assets “free and clear.”

Relying on *In re Savage Industries, Inc.*,[19] Crompton responded that the provisions of the sale order cutting off successor liability of ITG should not be enforced because Cone Mills failed to provide it with notice that it’s environmental/successor liability claims would be eliminated because of the asset sale.[20] . The bankruptcy found that Crompton had been provided sufficient notice. The district court [21]and Court of Appeals for the Third Circuit affirmed, agreeing that that the Bankruptcy Court properly held that Crompton was bound by the Sale Order relieving ITG of any successor liability for claims.[22]

The more difficult question involves CERCLA generator liability associated with the purchased assets. Some federal courts have held that environmental liability does not fall within the meaning of “liens and interests” or that the bankruptcy court does not have the jurisdiction to alter the CERCLA liability scheme or cutoff the rights of parties under federal environmental laws.[23]

For example, in *Ninth Avenue Remedial Group v. Allis-Chalmers Corp.*,[24] the defendant had acquired assets pursuant to 365(f). In addition, the asset purchaser agreement specifically provided that the defendant was not assuming any environmental liabilities and the debtor remained liable except for claims disallowed or discharged by the confirmed plan. Moreover, the bankruptcy court order approving the sale provided that the rights of the creditors and other parties asserting liens or interests against the purchased assets would attach to the sales proceeds. The plaintiffs sought contribution from the defendant as a successor corporation and the defendant filed a summary

[19] 43 F.3d 714 (1st Cir. 1994)

[20] Among the allegations, Crompton alleged that it was not served with the "auction and sale notice," or the many other forms of notice it claimed it should have received, and alleged that it was "left off of all service lists related to the notice of sale, the motion to approve the sale, the proposed order and the Sale Agreement

[21] 2008 U.S. Dist. LEXIS 32021 (D. Del. Jan. 31, 2008)

[22] For an example where a purchaser pursuant to a 363 sale expressly assumed environmental liabilities, see In Re Safety Kleen, 331 B.R. 605 (D.Del. 2005)(court denies motion for sanctions for violating injunction against filing claims against reorganized company).

[23] Ninth Avenue Remedial Group v. Allis-Chalmers Corp., 195 B.R. 716 (N.D.Ind. 1996)

[24] Id.

judgment motion, arguing, inter alia, that the bankruptcy order precluded any successor liability. The federal district court denied the defendant's summary judgment motion because there was a question whether the plaintiffs' claims had been discharged by the bankruptcy proceeding because since it was unclear that the plaintiffs had receive adequate notice of the bankrupt filing. However, other courts, though, have suggested that sales pursuant to section 363(f) can apply to future environmental liability.[25]As a result, purchasers often request the bankruptcy order approving the sale provide the purchaser is a bona fide purchaser under section 363(m) and shall not be deemed to be a successor of the seller under a variety of successor liability theories.

Examples of 363 Sale Orders Providing Protection Against Environmental Liability

The bankruptcy cases of Chrysler and General Motors are examples of the growing trend toward "fast-track restructuring" through the use of section 363 to sell the debtors' assets free and clear of liens, claims and interests, including environmental claims. In the Chrysler case, the bankruptcy court authorized the sale of substantially all of the debtors' operating assets free and clear of all claims and interests not expressly assumed by the purchaser, whether arising before or after the Chapter 11 filing.[26] For purposes of the sale, "*claims and interests"* included, among others, all claims or rights based on successor, environmental and products liability, with all such claims to attach to the proceeds of the sale. The sale order explicitly enjoined third parties from asserting against the purchaser any and all claims and interests related to the sold assets, though it did provide a carve-out for governmental entities seeking to enforce environmental claims to which the purchaser would be subject as the post-closing owner or operator of property. Indeed, the sale order expressly provided that the sale order not be interpreted in any way to deem the purchaser liable under a successor liability theory for violations of environmental laws or liabilities relating to any off-site waste disposal prior to entry of the sale order.

A group of Indiana state pension funds and a coalition of consumer groups, which argued that the Chrysler sale discriminated against secured lenders and abrogated key liabilities, appealed, challenging the sweeping relief contained in the bankruptcy court's sale order. The Second Circuit Court of Appeals upheld the sale order

Perhaps the most important precedent for fast-track section 363 sales was the General Motors' Chapter 11 case which authorized a section 363 sale for substantially all of General Motors' operating assets on substantially similar terms.[27] The federal government may object to proposed sales of substantially all of the assets of a debtor if they do not provide adequate assurances that environmental liabilities will be addressed or if the proposed order purports to cut-off potential successor liability of the purchaser

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[25] In Re Paris Industries, 132 B.R. 504, 510 n.14 (D.Me. 1991)

[26] *In re Chrysler LLC, et al.*, 405 B.R. 84 (Bankr. S.D.N.Y. 2008, Aff'd 2009 U.S. App. LEXIS (2nd Cir. June 5, 2009)

[27] *In re General Motors Corp.*, et al., Case No. 09-50026 (Bankr. S.D.N.Y. July 5, 2009).

for pre-sale penalties, pre-sale response costs or pre-sale off-site disposal by the debtor. An example of language that has been acceptable to the federal government is the following:

"Nothing in this Order or the Asset Purchase Agreement releases or nullifies any liability to a government entity under police and regulatory statutes or regulations that any entity would be subject to as the owner or operator of property after the date of entry of this Order."

Like conventional reorganization plans, disclosure is of paramount importance in a 363 sale as courts need to be shown that the sale is providing fair value and has been done in good faith. Material information needs to be developed and disclosed. Thus, it is important for debtors, purchasers and their counsel to carefully review environmental issues as part of the 363 sale process to avoid unexpected environmental liabilities down the road.

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