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HEADLINES

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Pre-petition Agreements To Modify The Automatic Stay: Are They Enforceable?

In an effort to avoid the expense and delay associated with a motion to modify the automatic stay of section 362(d) of the Bankruptcy Code, many secured creditors will enter into pre-petition agreements with debtors providing for a waiver of the stay in the event of a later bankruptcy filing. Forbearance and workout agreements commonly provide that the debtor agrees to waive the protections of the automatic stay in exchange for the lender's forbearance and other consideration. Courts agree that general restrictions upon a debtor's right to seek bankruptcy relief are unenforceable. However, courts are divided on the more narrow issue of whether pre-petition waivers of the automatic stay should be honored.

Some courts have held that pre-petition waivers of the automatic stay are *per se* unenforceable. Of these courts, some maintain that only the bankruptcy court has the power to grant relief from the automatic stay. Others state that allowing a debtor to waive the benefits of the automatic stay conflicts with the legislative intent, which was to provide the debtor with a "breathing spell" so that it may reorganize or develop a repayment plan without being pressured by creditors. Still others reason that allowing one creditor to benefit from a stay waiver may deplete the bankruptcy estate and unfairly skew the distributions to other creditors. Courts comment that the automatic stay protects not only debtors, but creditors as well.

Despite these arguments, a growing number of courts enforce pre-petition waivers of the automatic stay. These courts distinguish between a pre-petition waiver of the automatic stay and a waiver of the right to file a bankruptcy petition. They reason that a pre-petition waiver of the automatic stay does not implicate the same public policy concerns that prohibit waivers of the more fundamental right to seek bankruptcy relief. Indeed, a pre-petition waiver of the automatic stay involves only a single benefit provided under the Bankruptcy Code and does not affect other protections, such as the right to conduct an orderly liquidation, discharge a debt, assume or reject executory contracts, sell property free and clear of liens, and pursue preferences and fraudulent conveyance claims.

There are also public policy reasons in favor of allowing a debtor to waive the automatic stay. When courts enforce such agreements, they encourage out-of-court restructurings and settlements, which are designed to achieve a quicker and less costly resolution of disputes than litigation or bankruptcy. While the direct costs of a chapter 11 reorganization case, such as attorney's fees for the debtor and an official creditors' committee, can be significant, indirect costs are also a factor. For example, a bankruptcy filing may endanger essential relationships with the debtor's vendors and customers. These costs can hamper the debtor's ability to successfully reorganize. On the other hand, if the debtor and its major creditors are able to reach an out-of-court agreement, the debtor may be able to avoid bankruptcy and minimize restructuring costs. Basic principles of contract law also favor enforcement of pre-petition waivers of the automatic stay. In exchange for its agreement to waive the automatic stay, a debtor receives consideration in the form of debt forgiveness or restructuring, or other modifications to its credit agreements.

Recognizing that there are legitimate arguments both for and against enforcement of pre-

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The Auction Isn't Over Until The Fat Lady Sings - But When Is That?

For a debtor wishing to sell its assets, one option is a sale under section 363 of the Bankruptcy Code. While bankruptcy auctions can reward the debtor's estate, the question of when a debtor may entertain an even higher "post-auction" bid from another bidder is becoming increasingly common.

CORPORATE ASSETS, INC. V. PALOIAN

The Seventh Circuit recently addressed this question in *Corporate Assets, Inc. v. Paloian*, 368 F.3d 761 (7th Cir. 2004). In *Paloian,* the bankruptcy court approved specific bidding procedures for the auction of certain of the debtors' assets. Included in these procedures was a "modification provision" that gave the debtors the authority to reject any bid that was contrary to the best interests of the debtors. The debtors' initial asset purchase agreement contained a provision requiring any successful bidder to remove the purchased assets from the debtors' facility prior to a certain date. Responding to bidders' concerns with this provision, the debtors removed it prior to the auction, which increased the bids substantially. However, not all of the prospective bidders received notice of the change in the asset purchase agreement, including Myron Bolling Auctioneers ("MBA").

At the auction, Corporate Assets Inc. ("CAI") submitted the highest bid of $2.25 million. After the auction, but prior to the bankruptcy court's approval of the CAI bid, MBA learned of the removal of the un-popular provision in the asset purchase agreement, and increased its bid from $2.05 million to $2.45 million. At the debtors' request, the bankruptcy court continued the sale hearing and the debtors conducted a second auction at which CAI made a winning bid of $2.6025 million, approximately $350,000 higher than its initial winning bid. CAI filed an objection at the sale hearing, arguing that it should be allowed to purchase the assets for its initial bid of $2.25 million. The bankruptcy court denied CAI's objection, and the district court affirmed.

The Seventh Circuit likewise affirmed the bankruptcy court's decision and upheld the results of the second auction. In its analysis, the Seventh Circuit identified two competing interests at issue in the case: securing the highest price for the debtors' assets on the one hand, and the finality and integrity of the sale process on the other. In deciding to uphold the result of the second auction, the Seventh Circuit focused on three factors.

First, because the sale procedures order allowed the debtors to reject bids that were not in the best interest of the estate, the bidders had no absolute expectation of finality prior to the sale hearing. Although the bidding procedures only made allowance for a single auction, MBA's higher bid represented a significant benefit to the bankruptcy estate. Second, the subsequent auction leveled the uneven playing field that resulted when certain bidders were not informed of the revisions to the asset purchase agreement. Finally, the winning bid from the second auction was significantly higher than that from the first auction.

The Seventh Circuit's analysis in *Paloian* is consistent with other courts' approaches to the question of finality in bankruptcy sales. Other courts have employed a sliding scale in allowing post-auction bids, with the courts' discretion decreasing as the expectations of the winning bidder solidifies. At one extreme are cases where the bankruptcy court has already entered an order approving a sale. In such cases, the results of the initial auction have been upheld because the bidders had a substantial expectation of finality and only the existence of a grossly inadequate sales price or mistake or fraud in the bidding process would justify setting the results of the initial auc-

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petition waivers of the automatic stay, some courts have enforced them only in limited circumstances. These courts hold that such waivers are not self-executing, and will scrutinize whether or not the waiver is fair, freely entered into, and supported by consideration. Additionally, some courts have held that pre-petition waivers of the automatic stay are binding only if the rights of other creditors are not affected. Along the same lines, some courts have held that a waiver of the automatic stay does not prevent third parties from contesting a lender's motion for relief from automatic stay. Still other courts have held that a pre-petition agreement in and of itself is not enough to lift the automatic stay; a creditor must also show that the debtor filed bankruptcy in bad faith.

Despite these limitations, waivers of the automatic stay are prevalent in pre-petition workout agreements, and such agreements are enforced in many jurisdictions. Creditors should become aware of the trends in the jurisdictions where their debtors do business in order to take steps to increase the likelihood that such agreements will be enforceable in the event of a later bankruptcy filing.

Susan B. Gloss | *312.443.0260* | *sgloss@lordbissell.com*

Maximizing Asset Values And Reducing Transactional Costs Through Federal Receiverships

Federal bankruptcy court is becoming increasingly less effective as a means of maximizing asset values. This is especially true with respect to small- to medium-sized borrowers whose assets may not justify the significant administrative costs (*i.e.*, professional fees) inherent in a chapter 11 liquidation. Under certain circumstances, a federal receivership may provide a way to maximize the value of a borrower's assets at a minimum, and predictable, cost.

GETTING STARTED

A federal receivership is an insolvency proceeding driven by the lender's interests. Unlike a trustee or debtor-in-possession in bankruptcy, the receiver owes its fiduciary duty to the lender, not the insolvent company or its unsecured creditors and equity holders. A federal receivership is typically initiated by a lender filing a complaint against the borrower in federal court based on the borrower's breach of its loan agreement. The lender may request the appointment of a receiver as ancillary relief on the same day. In most instances, the receiver is chosen by the lender and, barring any conflicts of interest, approved by the court as a matter of course.

Although federal courts describe the appointment of a receiver as a "drastic remedy" similar to injunctive relief, the appointment is rarely refused where the lender demonstrates that a receiver is necessary to preserve the *status quo* or prevent further dissipation of the borrower's assets. Once the receiver has been appointed, his or her authority is subject only to the court's broad equitable powers and the requirements of due process.

The major limitation of a federal receivership is that diversity jurisdiction must be established because the action, while filed in federal court, is based on a state law claim (*i.e.*, breach of contract). Diversity jurisdiction requires that the amount in controversy exceed $75,000 and that the parties be citizens of different states. For purposes of diversity jurisdiction, a party is a citizen of the state in which it is incorporated and where it has its principal place of business. Although there is some disagreement among the courts as to the citizenship of national banks, the trend is to treat national banks as citizens of both the state in which they maintained their principal place of business, and the state listed in their most recent articles of association.

> "...an experienced receiver can obtain many of the benefits of a chapter 11 liquidation while avoiding many of its burdens.

One of the major benefits of a federal receivership is that it is filed in federal court, which gives the receiver nationwide jurisdiction over the borrower's assets and avoids potential inconsistencies of state law. The most powerful feature of a federal receivership, however, is that an experienced receiver can obtain many of the benefits of a chapter 11 liquidation while avoiding many of its burdens. Federal district courts routinely grant receivers quasi-bankruptcy relief, including imposing an "automatic stay," which prevents any party from disposing of the borrower's assets, authorizing debtor-in-possession financing in the form of "borrower certificates" entitled to super-priority status, authorizing the receiver to continue operating the borrower's business as a going concern, and issuing injunctions permitting the sale of the borrower's assets "free and clear" of other potential claims and liabilities.

CONTROLLING COSTS

Federal receiverships can be more cost-effective than a chapter 11 liquidation primarily because there are fewer "mouths to feed" and there is less likelihood of organized opposition to the process. Every bankruptcy filing is monitored by an attorney from the Office of the United States Trustee (the "US Trustee"). Although the US Trustee is neutral, he often acts as a *de facto* representative of the debtor's unsecured creditors until an official committee can be appointed. In cases of any significant size, the US Trustee will appoint at least one official committee of unsecured creditors. Where the value of the debtor's assets is less than the amount owed to the lender, the bankruptcy court may require the lender to fund the committee in exchange for the privilege of liquidating its collateral in the bankruptcy court. Depending on the experience and temperament of the committee and its counsel, this can significantly increase the transactional cost associated with a chapter 11 liquidation.

The US Trustee does not monitor federal receiverships and there are no provisions for the appointment of official creditors' committees. The burden is on the creditors to organize opposition to any relief sought by the receiver. Bankruptcy courts are split as to whether creditors can convert an on-going receivership to an involuntary bankruptcy filing. Those courts that recognize such authority are reluctant to grant the creditors' request where the receiver has made significant progress toward the sale of the borrower's assets.

Federal courts often create "creeping receiverships" by incrementally expanding the receiver's authority to dispose of the borrower's assets. Creeping receiverships can be avoided by declaring the receiver's intent to liquidate the borrower's assets, with the borrower's consent, on the first day of the case. In cases where the borrower's assets are being sold as a going-concern, the consent of key creditor constituencies (*e.g.*, utilities, landlords and parties to executory contracts) will ensure that the transaction proceeds efficiently.

The procedural mechanics of a federal receivership are similar to the operation of a chapter 11 case. The receiver's professionals are required to seek approval of their fees, which are subject to review by the court and challenge by other creditors.

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Editors

Timothy W. Brink
tbrink@lordbissell.com
312.443.1832

Thomas J. Cunningham
tcunningham@lordbissell.com
312.443.1731

Anne R. Garr
agarr@lordbissell.com
312.443.1844

Patrick M. Jones
pjones@lordbissell.com
312.443.1868

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Receivers may be required to file periodic operating reports disclosing the income and expenses of the borrower's operations. Although creditors may subpoena information from the borrower, the disclosure requirements and overall transparency of a federal receivership is far more limited than in a chapter 11 proceeding.

WINDING UP

Upon completion of the liquidation process, the receiver typically will be required to file an accounting with the court to obtain authority to distribute the net proceeds of the sale, to the extent that any exist after satisfaction of the claims of the lender, the receiver and his professionals. Once the report is filed, the case is typically dismissed. There is no conversion to chapter 7 or the associated appointment of a chapter 7 trustee, which in bankruptcy has the potential to drag the lender and other creditors into protracted litigation. The receiver maintains control over any causes of action that the borrower possesses following liquidation, including fraudulent transfer claims under state law and breach of fiduciary duty claims against the borrower's former officers and directors. Other creditors may petition the court for standing to prosecute these actions if the receiver refuses. In practice, however, the creditors may not be sufficiently organized or have adequate information or funds to pursue such claims. With careful planning and a little "public relations," the lender may emerge from a federal receivership a hero to the borrower's trade vendors and suppliers (who may be current or prospective customers) for avoiding the time, response and potential for litigation inherent in a typical chapter 11 liquidation.

Patrick M. Jones | 312.443.1868 | pjones@lordbissell.com

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tion aside. For example, in *In re Chung King, Inc.*, 753 F.2d 547 (7th Cir. 1984), the Seventh Circuit allowed an initial winning bid of $120,000 to stand, despite another bidder's subsequent $135,000 bid, because the bankruptcy court had approved the sale and the original price was not grossly inadequate.

At the other end of the spectrum are cases in which the bankruptcy court has not entered an order approving the sale. In such cases, courts are given more discretion to entertain a higher bid. For example, in *In re Food Barn Stores, Inc.*, 107 F.3d 558 (8th Cir. 1997), the Eighth Circuit held that the bankruptcy court properly exercised its discretion in allowing a subsequent bid because the initial bid had not yet been approved by the court, the procedures governing the initial auction were informal and flexible, and the subsequent bid of $2.1 million was significantly higher than the original $1.5 million winning bid. *See also In re Financial News Network Inc.*, 980 F.2d 165 (2d Cir. 1992).

TIPS FOR BIDDERS

Bidders for assets at bankruptcy auctions should beware that there is no guarantee that the highest bid at an auction will be the final winning bid. In addition, bidders should tread lightly when the order governing auction procedures is unclear or gives the debtor flexibility to address unanticipated events at or subsequent to the auction.

Still, there is no reason for bidders to sit on the sidelines and let the debtor exclusively control the auction when they can influence the process to their advantage. Indeed, bidders can take certain steps in order to decrease the likelihood that late bids will be considered. For example:

- Bidders should insist that the debtor include provisions in the bid procedures stating: i) that there will only be one auction; ii) that the debtor is required to accept the highest bid at the auction; and iii) that the debtor will refuse to accept any bids after the auction.
- Bidders should confirm that all potential bidders are aware of any last-minute changes to the form of asset purchase agreement or the bid procedures themselves.
- Bidders should urge the debtor to schedule the sale approval hearing as soon after the auction as possible in order to reduce the opportunity for another bidder to make a higher offer.

Although none of these steps will guarantee that the first auction will be the last, they will improve the winning bidder's chances of success if the debtor or another bidder seeks to re-open bidding.

Timothy S. McFadden | 312.443.0370 | tmcfadden@lordbissell.com

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