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Building Blocks

By Nathaniel R. Hull and Timothy E. Steigelman

Trying the Upset-Bid Case

Nathaniel R. Hull
Verrill Dana LLP
Portland, Maine

Timothy E. Steigelman
Kelly, Remmel & Zimmerman
Portland, Maine

Nate Hull is an attorney with Verrill Dana LLP in Portland, Maine, and serves as a coordinating editor for the ABI Journal. *Tim Steigelman is an attorney with Kelly, Remmel & Zimmerman in Portland, Maine.*

Without the overlay of the Bankruptcy Code,[1] auctions generally progress by virtue of competitive, incrementally higher bids made to an auctioneer until a sole bidder remains. This final bid is then accepted as the highest offer and declared the winning bid, and the sale is promptly consummated. When the auction is conducted pursuant to the Code, however, the goal of maximizing asset values for the benefit of the debtor's estate can lead to flexible understandings of the true "finality" of those "final" bids. This article explores some of the considerations to be weighed when trying a case involving an attempt to reopen bidding and focuses on the importance of the numbers, comparability of bids, local custom, and whether it matters if unsecured creditors will see any benefit from the increased bid.

Section 363(b) of the Bankruptcy Code provides that "[t]he trustee, after notice and hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate."[2] Section 363(f), in turn, provides that "[t]he trustee may sell property under subsection (b) ... free and clear of any interest in such property of an entity other than the estate," provided that certain conditions are met.[3] Sales that are "free and clear" means that the assets "are typically burnished (or 'cleansed') because (with certain limited exceptions) they are sold free and clear of liens, claims and liabilities" and a "§ 363 sale can often yield the highest price for the assets because the buyer can select the liabilities [that] it will assume and purchase a business with cash flow (or the near prospect of it)."[4]

Because "a major objective of the bankruptcy process is to maximize the value of assets,"[5] a bankruptcy court may — under certain circumstances — utilize its broad discretion to revisit the "final" bid from a closed auction to consider an untimely "upset bid." The courts considering such requests nearly universally note the tension in these matters between the estate's interest in obtaining the highest price and the court's need to preserve the integrity of the auction process in order to maximize value efficiently in the future.[6]

Understand the Court's Role

Generally, a court will have no involvement in the actual auction.[7] As the Seventh Circuit Court of Appeals stated, "Under § 363, the trustee or debtor in possession is the seller and the bankruptcy court gets involved only through the requirement of notice and a hearing. The statute fails to clearly define the court's role, but the practice is that the bankruptcy judge, following the hearing, issues an order authorizing the sale (if he or she decides that the property should indeed be sold) and after the sale is made, the judge issues a second order confirming the sale."[8] As such, the judge will often have only have passing familiarity with your auction's particular bid procedures. Intentional drafting in the procedures and notices to alert bidders to the potential for untimely upset bids — or the lack of any such notice — should be highlighted for the court.

Procedural Posture

A challenge to the highest accepted bid at auction is usually made when the matter is brought before the court to confirm the sale free and clear to the winning auction bidder.[9] At this point, the upset bidder objects to the sale, indicates its desire to pay more for the assets and seeks to either reopen the bidding or schedule a second auction.[10] Under

1 11 U.S.C. § 101, *et seq.*
2 11 U.S.C. § 363(b).
3 11 U.S.C. § 363(f).
4 *In re Chrysler LLC*, 576 F.3d 108, 115-16 (2d Cir. 2009), *cert. granted, judgment vacated sub nom., Indiana State Police Pension Trust v. Chrysler LLC*, 558 U.S. 1087, 130 S. Ct. 1015, 175 L.Ed.2d 614 (2009), and *vacated sub nom., In re Chrysler LLC*, 592 F.3d 370 (2d Cir. 2010).
5 *In re Bigler LP*, 443 B.R. 101, 116 (Bankr. S.D. Tex. 2010) (citing *In re T-H New Orleans Ltd. P'ship*, 188 B.R. at 807 (E.D. La. 1995), *aff'd*, 116 F.3d 790 (5th Cir. 1997)).
6 *Id.* at 115; *see also* cases cited *infra.*
7 *But see In re Bigler LP*, 443 B.R. 101, 116 (Bankr. S.D. Tex. 2010).
8 *In re Met-L-Wood Corp.*, 861 F.2d 1012, 1016 (7th Cir. 1988).
9 *See, e.g., In re Bigler LP*, 443 B.R. 101, 116 (Bankr. S.D. Tex. 2010).
10 *Id.*

these circumstances, the party moving for confirmation of the § 363 sale bears the burden of proof by preponderance of the evidence on most issues but the objecting party must bring forward some evidence to support the objection.[11]

The Case Law

In one frequently cited case, the Third Circuit reviewed the integrity of the auction process, whether the bidder won the auction in good faith, and whether the winning bid provided adequate value for the asset.[12] Most circuits have similarly addressed upset-bid cases, and case law across the circuits consists largely of variations on those same themes.[13] This article offers suggestions for litigating a § 363 late-bid contest; however, it is not an exhaustive list of all relevant holdings in this area. Caution should be taken to tailor your presentation to the contours of your circuit. That being said, below are some considerations in preparing your upset-bid case.

Value of the Bid

In a dispute, nearly all courts consider whether the winning bid at auction was "grossly inadequate" compared to the actual value of the asset being sold.[14] In planning your approach to an auction bid dispute, start with the numbers. What is the amount of the winning bid? What is the true "value" of the asset? Most importantly, how should that "value" be determined and presented — by reference to the price paid at an auction? By appraisal? By reference to public record? It should be simple arithmetic to divide the winning bid by the "value" of the asset and see whether the percentage is "so grossly inadequate as to shock the conscience of the court."[15] But it is not.

To begin with, the bankruptcy court necessarily hears this issue only after a completed auction. In other words, a willing buyer and willing seller have come together, albeit with the gentle encouragement of a court-approved liquidation, and found a mutually agreeable price. Following the logic that a properly conducted auction is a market that establishes a fair and proper price, case law suggests that absent collusion,[16] a completed public auction is *itself* adequate evidence of the value of the asset[17] and, therefore, the price paid at the conclusion of an unquestionably fair auction should never be grossly inadequate.

Other case law, however, compares the *appraised* value of the asset to the auction price. When the appraised value of an asset was 180 times the amount of the winning bid, one court had little trouble finding gross inadequacy.[18] On the other hand, a meager 2.4 percent increase in the late bid was not enough additional value to justify reopening the bidding.[19] Most cases fall somewhere in between, and winning bids as close as 75 percent of appraised value have been considered "grossly inadequate."[20] In addition, some courts suggest a sliding-scale approach where bids can be reopened for much smaller increases in value before the sale is confirmed, but require a greater increase after confirmation.[21]

> **The courts are conflicted about § 363 contests, and some lean toward maximizing value to the estate while others prize predictable auctions.**

In a hearing challenging a § 363 auction, the winning bid is easily established. Determining the actual "value" of the property sold, however, is subject to proof and provides a chance for useful advocacy. The potential upset bidder will value the assets as high as possible to increase the percentage discount represented by the winning bid. Conversely, the winning bidder will prefer the lowest value of the assets possible to minimize that percentage. A good appraisal and expert testimony should be carefully considered.

A final thought on the numbers: It seems to be an open question of whether a fair market value appraisal is the proper yardstick in this context. One can argue that because a bankruptcy auction is akin to a liquidation sale, liquidation value is a more appropriate benchmark.[22] As the U.S. Supreme Court held in a different context, "market value, as it is commonly understood, has no applicability in the forced-sale context; indeed, it is the very *antithesis* of forced-sale value."[23] The proper appraisal method could be very powerful in a close case.

Comparability of Bids

In the simplest case, competing bids are in different amounts of U.S. dollars. A court could then readily compare one bid against another, and determine at a glance whether the late bid represents more value to the estate. Not all bids, however, are for a single dollar amount, so apples-to-apples comparisons might be difficult.[24] For example, in a complex bidding scenario with an inconclusive auction where the creditors could not agree which bid represented the best value, the Second Circuit upheld the bankruptcy court's reopening of bidding.[25] Similarly, if a late bidder cannot fully quantify its new bid, it might be in peril because it cannot carry its burden to make that side-by-side comparison.[26] To avoid this predicament, a § 363 contestant should offer

11 *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983) ("While a debtor applying under § 363(b) carries the burden of demonstrating that a use, sale or lease out of the ordinary course of business, ... an objectant ... is required to produce some evidence respecting its objections.").

12 *In re Abbotts Dairies of Penn. Inc.*, 788 F.2d 143 (3d Cir. 1986).

13 *See, e.g., In re Gil-Bern Indus. Inc.*, 526 F.2d 627 (1st Cir. 1975); *In re Financial News Network Inc.*, 980 F.2d 165 (2d Cir. 1992); *In re Abbotts Dairies of Penn. Inc.*, 788 F.2d 143 (3d Cir. 1986); *First Nat'l Bank v. M/V Lightning Power*, 776 F.2d 1258, 1259 (5th Cir. 1985) (vessel auction in admiralty; *see In re Bigler*, 443 B.R. 101, 108-09 (Bankr. S.D. Tex. 2010) (without guiding circuit precedent, applying principles of *First National* to § 363 auction)); *Corporate Assets Inc. v. Paloian*, 368 F.3d 761 (7th Cir. 2004); *Four B. Corp. v. Food Barn Stores Inc. (In re Food Barn Stores Inc.)*, 107 F.3d 558 (8th Cir. 1997); *Onouli-Kona Land Co. v. Estate of Richards (In re Onouli-Kona Land Co.)*, 846 F.2d 1170 (9th Cir. 1988); *J.J. Sugarman Co. v. Davis*, 203 F.2d 931 (10th Cir. 1953).

14 *See, e.g., In re Chung King Inc.*, 753 F. 2d 547, 550-51 (7th Cir. 1985).

15 *Id.* at 550.

16 For a case about allegedly collusive bidding at a bankruptcy auction, *see Boyer v. Gildea*, 475 B.R. 647 (N.D. Ind. 2012).

17 *In re Pacific Cargo Servs. LLC*, No. 13-30439-tmb7, *11, 2013 WL 5299545 (Bankr. D. Ore. Sept. 18, 2013) (citing *In re Onouli-Kona Land Co.*, 846 F.2d 1170, 1174 and n.1 (9th Cir.1988)); *see also BFP v. Resolution Trust Corp.*, 511 U.S. 531, 545 (1994) (fraudulent transfer).

18 *First Nat'l Bank v. M/V Lightning Power*, 776 F.2d 1258, 1259 (5th Cir. 1985); *see also In re Bigler*, 443 B.R. at 108-09 (applying *First National* from admiralty context to § 363 auction in bankruptcy).

19 *In re Bigler*, 443 B.R. at 109-10.

20 *See In re Pacific Cargo Servs.*, 2013 WL 5299545 at *10 (suggesting 75 percent benchmark); *see also Hayes v. Sullivan*, Civ.A.No. 92-12020-K, 1992 WL 486914, *11 (D. Mass. Dec. 3, 1992) (bids between 68.8 and 73.3 percent of appraised value may be considered "grossly inadequate" within bankruptcy court's discretion).

21 *See, e.g., Paloian*, 368 F.3d at 771-72 (8-9 percent increase is insufficient to reopen after confirmation, but sufficient before sale is confirmed).

22 A good appraiser might be able to testify to liquidation value using a recent fair market value appraisal as a starting point.

23 *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 537-38 (1994) (emphasis in original).

24 *In re Financial News Network Inc.*, 980 F.2d at 169-70.

25 *Id.*

26 *See, e.g., In re Ferraiolo Const.*, 13-10164 (Bankr. D. Me. July 22, 2013) (Docket #187, audio of ruling from bench at 1:10-1:27).

evidence that compares the competing bids, or translates the late bid into substantially similar terms as the winning bid. That type of evidence would allow the court to make a straight comparison.

Local Custom

The bidders' expectations at auction and the customs of the local court are also important considerations. While some case law suggests that bidder expectations should not matter,[27] many courts address bidders' reasonable expectations of, and reliance on, finality. For example, if a bankruptcy court regularly receives additional offers at a hearing to confirm a sale to the high bidder at an auction, then a high bidder should reasonably expect that it may have to fight off a later bid challenge after the close of the auction.[28]

Evidence of local custom in a bankruptcy court may be difficult to present in the first instance, as a litigant may offer a different take on local custom than the judicial notice that a presiding judge might assume from his or her own courtroom. While that narrow problem might get easier on an appeal, a litigant cannot skip that step in the initial hearing because as not raised in the initial hearing will be barred in the appeal. Prior decisions from that same court would certainly show the judge what the local custom really is, arming the court with precedent to either permit or exclude the late bid. For substantive evidence of custom, one possible witness could be another bankruptcy lawyer, something akin to an expert witness. It may be uncomfortable, however, for a lawyer to lecture a bankruptcy judge about how he or she really runs a courtroom.

More helpful evidence of custom could come from a fact witness, perhaps a frequent bankruptcy auction bidder, who could testify from experience to their own expectations walking in the door at an auction. That testimony could be very credible when coming from a disinterested witness with no stake in the outcome of that particular § 363 dispute.

Benefit to the Unsecured Creditors

The price received at a bankruptcy auction will often be sufficient only to make a partial payment to the debtor's prepetition secured creditor, leaving no cash remaining from the sale to flow down to the benefit of the debtor's general unsecured creditors. Broadly speaking, unless the late bid in question is for an amount that exceeds the secured creditor's claim, the only parties benefiting from the allowance of a higher, post-auction bid would be the secured lender and any parties that guaranteed the underlying obligation.[29] The Bankruptcy Code, however, already provides both of these parties protection for their risks.[30] Under these circumstances, is the additional benefit to the estate really worth the ripple effects of disturbing finality? Those seeking to maximize the likelihood that a late bid will be permitted under these circumstances are advised to consider whether some of the additional funds generated by the higher sale price can be made available for the benefit of the debtor's general unsecured creditors.[31] If so, quantifying the benefit of that agreement for the court could be a powerful tool. For instance, a court recently permitted an upset bid, in part because it was crafted with a "carve-out" from sale additional sale proceeds that would be available to distribute to unsecured creditors who otherwise would have received no dividend in the case.[32]

Final Thoughts

The courts are conflicted about § 363 contests, and some lean toward maximizing value to the estate while others prize predictable auctions. While there is no substitute for fidelity to the standards articulated in each circuit permitting auctions to be reopened, effective presentation of the considerations raised in this article could help the court decide whether to exercise its considerable discretion in this area. abi

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27 *In re Bigler*, 443 B.R. at 110-11.

28 *See In re Gil-Bern Indus. Inc.*, 526 F.2d at 629 (remanded to look into that question); *see also In re Wintex*, 158 B.R. 540, 545 (D. Mass. 1992) (stating that on remand, in *Gil-Bern*, the district court found that there was such practice and so affirmed bankruptcy court's acceptance of late bid).

29 Presumably, there would be a commensurate reduction in the secured lender's deficiency claim resulting from a higher bid being allowed by the court. Of course, any reduction in the size of the secured lender's deficiency claim by virtue of a higher, late offer being accepted has no tangible value to the balance of the general unsecured (*e.g.*, trade) creditors in a no-dividend case.

30 The secured lender may credit-bid to protect against an auction sale price under § 363(k); the guarantors may file their own petitions.

31 *See, e.g., In re W. Biomass Energy LLC*, 12-21085, 2013 WL 4017147 (Bankr. D. Wyo. Aug. 6, 2013).

32 *Id.* (in additional to grossly inadequate sales price, finding "the possibility of successfully obtaining a 'carve-out' from sale proceeds for distributions to unsecured creditors," a circumstance supporting denial of confirmation of § 363 sale).