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Fifth Circuit Shows Reorganization Investors How to Get and Keep an Expense Reimbursement Order

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The U.S. Court of Appeals for the Fifth Circuit recently affirmed the lower court's decision authorizing reimbursement of expenses to qualified bidders for a reorganization debtor's assets. The authors of this article explain the case and note that prior court authorization for the expense reimbursement was essential to the result here.

The U.S. Court of Appeals for the Fifth Circuit, on Aug. 16, 2011, affirmed the lower court's decision authorizing reimbursement of expenses to qualified bidders for a reorganization debtor's assets.[1] In the court's view, the debtor provided "a compelling and sound business justification for the reimbursement authority."[2]

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FACTS

The Chapter 11 debtor had invited investors to bid at an auction sale of its most valuable asset. It promptly sought, with advice from its professionals, authorization under Bankruptcy Code ("Code") § 363(b) to reimburse expenses incurred by any selected bidders, explaining "that… it…would [give the bidders] the opportunity to conduct additional due diligence" entailing "highly sophisticated legal analysis" at "substantial" expense."[3] In the debtor's view, it had to "provide bidders with an incentive to undertake this investment."[4]

The bankruptcy court granted the debtor's motion for the so-called expense "reimbursement order" after a hearing. Although the debtor's corporate parent had objected, the bankruptcy court found that the debtor had shown "a compelling and sound business justification" for the relief requested.[5] When the corporate parent appealed, the district court affirmed, but the parent appealed again to the Fifth Circuit.

ARGUMENTS MADE ON APPEAL

The debtor's corporate parent argued that the bankruptcy court had applied the wrong legal standard for authorizing the reimbursement of expenses. In its view, the bankruptcy court should have relied on Code § 503(b), which applies to administrative expenses, a standard that is "more stringent" than the business judgment standard contained in Code § 363(b).[6] Second, according to the parent, even if Code § 363(b) was the correct standard, the bankruptcy erred in finding that the debtor's "motion satisfied the business judgment" test.[7] Finally, although the parent argued that the bankruptcy court abused its discretion in approving the reimbursement procedures "without notice" to it and "without sufficient judicial oversight,"[8] it had not raised this issue in the lower courts, and the Court of Appeals refused to consider the argument, deeming it waived.[9]

LEGAL STANDARD: §§ 363(b) OR 503(b)

Business Judgment — § 363(b)

A Chapter 11 debtor-in-possession may, under Code § 363(b), "after notice and hearing…use, sell, or lease, *other than in the ordinary course of business*, property of the estate" (emphasis added). To satisfy the court in this context, the debtor-in-possession or trustee must articulate a "business justification…." for the use of cash — estate property.[10] According to the Fifth Circuit, the business judgment standard in Section § 363(b) is "flexible and encourages discretion," requiring the bankruptcy judge to "consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike."[11]

Administrative Expense — § 503(b)

Code § 503(b), pertaining to administrative expenses, provides a narrower standard for the use of the estate's cash. It allows a party to recover, as an administrative expense, "the actual, necessary costs and expenses of preserving the estate." As explained by the Fifth Circuit, "[t]he words 'actual' and 'necessary' have been construed narrowly: 'the debt must benefit [the] estate and its creditors.'"[12]

The debtor's parent argued here that "the reimbursement order was in error because the requested reimbursements were not actually necessary to preserve the value of the estate."[13] To support this argument, the parent cited "two Third Circuit Decisions where the lower court applied § 503(b) and not 363(b) to requests for break-up fees."[14]

Resolution

The Fifth Circuit was "not persuaded that *Reliant* and *O'Brien*" applied here. First, the debtor only sought "authority to reimburse expense fees for second-round 'qualified' bidders in a multiple stage auction for a very unique and very valuable but possibly worthless asset."[15] Second, "prospective (and qualified) bidders could be reimbursed regardless of whether they were successful."[16] Finally, there was no bid-chilling here because the

debtor "sought to *increase* competition by providing bidders an incentive to undertake the costly but necessary due diligence."[17] In the court's view, § 363(b) applied to the debtor's advance request to use its funds "*before* any potential qualified bidders…had incurred due diligence and work fees."[18] In contrast, the "unsuccessful bidders in *O'Brien* and *Reliant Energy* sought payment for expenses incurred without the court's pre-approval," making § 503(b) "the proper channel for requesting payment."[19]

The Court of Appeals also deferred to the bankruptcy court's findings in *Asarco* that the "proposed reimbursement…was designed to maximize the value" of the debtor's estate; "was fair, reasonable, and appropriate;" and was "in the best interests" of the debtor, "its estate, creditors, interest holders, stakeholders, and all other parties in interest."[20] Moreover, there was "no evidence…of self-dealing or manipulation among the parties who negotiated the reimbursement procedures; the Reimbursement Order facilitated, not hindered, the auction process; and the approved maximum available size of the reimbursement fee was reasonable."[21]

COMMENTS

The requested fees here were based on actual "due diligence" expenses. They were not merely the typical "break-up fee…paid by a seller to a prospective purchaser in the event that a contemplated transaction is not consummated."[22]

Prior court authorization for the expense reimbursement was essential to the result here. With the proper showing — reasonableness, arm's length negotiations and tangible benefit to the estate — a court is more likely to pre-approve expense reimbursement if it learns of the fees at the earliest stage of the process. For the prospective acquiror, early court review also provides the certainty of reimbursement before incurring substantial expenses.

NOTES

[1] *In re Asarco, LLC*, 2011 BL 213002 (5th Cir. Aug. 16, 2011).
[2] *Id.* at *12.

[3] *Id.* at *3-4.
[4] *Id*.
[5] *Id*.
[6] *Id*. at *7-8.
[7] *Id*. at *8.
[8] *Id*. at *8.
[9] *Id*.
[10] *Id*. at *9.
[11] *Id*. (quoting *In re Cont'l Airlines*, 780 F.2d 1223, 1226 (5th Cir. 1986) and *In re Lionel Corp*., 722 F.2d 1063, 1071 (2d Cir. 1983)).
[12] *Id*. at *10 (quoting *In re Trans American Natural Gas Corp.*, 978 F.2d 1409, 1416 (5th Cir. 1992)).
[13] *Id*.
[14] *In re O'Brien Envt'l Energy, Inc.*, 181 F.3d 527, 529 (3d Cir. 1999) (*held*, no break-up fee to unsuccessful stalking horse bidder; § 503(b) governs unsuccessful bidder's request for break-up fee; applying administrative expense standard, unsuccessful bidder failed to make requisite showing that awarding its fee was actually necessary to preserve value of estate; fee to be paid if prospective bidder unsuccessful; court concerned that fee would "chill…the competitive bidding process."); *In re Reliant Energy Channelview LP*, 594 F.3d 200, 204 (3d Cir. 2010) (same).
[15] 2011 BL 213002 at *11.
[16] *Id*.
[17] *Id*.
[18] *Id*. at *12.
[19] *Id*.
[20] *Id*.
[21] *Id*. at *12-13.
[22] *Id*. (quoting *O'Brien*, 181 F.3d at 528).