NOTE

AN EFFICIENCY MODEL OF SECTION 363(b) SALES

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INTRODUCTION

CORPORATIONS that have entered a Chapter 11 bankruptcy proceeding have chosen to develop a plan to reorganize their capital structure rather than pursue the less time-consuming liquidation option available under Chapter 7. For a large corporation, a reorganization plan under Chapter 11 may be hashed out over several years as all of the interested parties—secured creditors, unsecured creditors, stockholders, and managers—work through the mechanisms that will either satisfy or discharge their various rights and claims. Chapter 11 reorganization is unique among bankruptcy options in that it involves voting rules and other sophisticated mechanisms for assembling a satisfactory plan of reorganization that seeks to preserve the operation of the corporation to some extent,[1] while satisfying specific classes of claims and discharging others. In the interest of preserving corporate operations, the Bankruptcy Code[2] allows certain types of sales to be conducted in the

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[1] Bankruptcy scholars disagree as to the extent to which the Bankruptcy Code should offer to rehabilitate financially distressed businesses. Traditionalists may see the maintenance of operations and continuance of business as the primary goal, while proceduralists may see it differently because the value of assets is not often firm-specific. For a description of these two groups, see Douglas G. Baird, Bankruptcy's Uncontested Axioms, 108 Yale L.J. 573, 576–80 (1998).

[2] Hereinafter, all references to the "Code" refer to the Bankruptcy Act of 1978, codified at 11 U.S.C. §§ 101–1330 (2000). All references to "Rules" refer to the Federal Rules of Bankruptcy Procedure.

ordinary course of business according to Section 363(c).[3] These sales preserve business operations and involve transactions such as the sale of inventory by a retail corporation in order to stay in business during the bankruptcy period. Section 363(b), however, provides a mechanism by which corporations may sell assets outside the ordinary course of business,[4] such as an airline selling off a number of its planes, without first going through the rigors of developing a reorganization plan disposing of that asset.

At first blush, the mere existence of this section appears to be a puzzling contradiction to the purposes of Chapter 11. If Chapter 11 is designed to reorganize failing businesses through an explicit reorganization plan, why should the Code also allow the debtor-in-possession—typically the corporation's management during the bankruptcy process—to sell assets outside the ordinary course of business without regard to that plan? While courts have differed on the extent to which assets can be sold, ranging from partial asset sales to full liquidations, Section 363(b) appears to offer a side door to escape the rigors of the typical bankruptcy plan confirmation.

The prevalence of asset sales under Section 363(b) has shifted some of the focus in corporate bankruptcy away from reorganization toward these quicker methods of sale; some commentators even fear that this side door will replace the main route of Chapter 11 reorganization plans.[5] In creating Chapter 11, the drafters may have had in mind the prototypical large corporate bankruptcy of

[3] 11 U.S.C. § 363(c) (2000). Section 363(c)(1) states: "[i]f the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing."

[4] 11 U.S.C. § 363(b) (2000) (amended 2005). Section 363(b)(1) states in part: "[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . . ."

[5] See Harvey R. Miller & Shai Y. Waisman, Is Chapter 11 Bankrupt?, 47 B.C. L. Rev. 129, 156–57 (2005) (listing some of the factors contributing to the prevalence of asset sales and citing numerous recent court cases); James H.M. Sprayregen et al., Chapter 11: Not Perfect, but Better than the Alternative, Am. Bankr. Inst. J., Oct. 2005, at 1, 60 (describing those who "decr[y] the increasing frequency and rise in importance of §363 sales"); Robert E. Steinberg, The Seven Deadly Sins in §363 Sales, Am. Bankr. Inst. J., June 2005, at 22, 22 (stating that Section 363(b) sales "have become the preferred method of monetizing the assets of a debtor company").

the last century, the railroad, which had a capital structure not duplicated by many modern corporations.[6] While it is doubtful that the drafters anticipated the use of Section 363(b) sales as an alternative method of selling off large portions of businesses,[7] in recent years this method of partial liquidation has swelled to the point that:

> Corporate reorganizations have all but disappeared. Giant corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use Chapter 11 merely to sell their assets and divide up the proceeds. TWA filed only to consummate the sale of its planes and landing gates to American Airlines. Enron's principal assets, including its trading operation and its most valuable pipelines, were sold within a few months of its bankruptcy petition. Within weeks of filing for Chapter 11, Budget sold most of its assets to the parent company of Avis. Similarly, Polaroid entered Chapter 11 and sold most of its assets to the private equity group at BankOne. Even when a large firm uses Chapter 11 as something other than a convenient auction block, its principal lenders are usually already in control and Chapter 11 merely puts in place a preexisting deal. Rarely is Chapter 11 a forum where the various stakeholders in a publicly held firm negotiate among each other over the firm's destiny.[8]

While some bankruptcy scholars argue that this claim is exaggerated,[9] Professors Douglas Baird and Robert Rasmussen make a valid point regarding the prevalence of Section 363(b) sales in the twenty-first century. An increasingly large number of articles praises the benefits and popularity of these sales, with law firms and financial groups urging clients to pursue them whenever possible.[10] The examples of successful sales have become too numerous

[6] See James J. White, Death and Resurrection of Secured Credit, 12 Am. Bankr. Inst. L. Rev. 139, 161 (2004). But see Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 Stan. L. Rev. 751, 759–60 (2002).

[7] See White, supra note 6, at 161.

[8] Baird & Rasmussen, supra note 6, at 751–52 (internal citations omitted).

[9] See White, supra note 6, at 163.

[10] See, e.g., Daniel M. Glosband, Pathology of Section 363 Sales: Not as Simple as They Look, J. Private Equity, Fall 2004, at 60, 60; Jack L. Smith & Erin L. Connor, Selling 'Free and Clear': Will It Continue?, Bankr. Strategist, Jan. 2004, at 1, 1.

to detail, and it appears that these sales will continue to grow in popularity as an alternative to selling assets under a Chapter 11 reorganization.

Although numerous courts have dealt with the issue, the disregard for the effects of Section 363(b) sales on Chapter 11 reorganization is quite striking in academia. For example, in their analysis of Chapter 11's voting rules, Professors Kevin Kordana and Eric Posner developed a detailed model under varying information distributions and participant incentives to break down the complexity of the rules.[11] While thorough in their analysis, Professors Kordana and Posner did not address the fact that Section 363(b) sales offer a method to avoid the voting procedure in its entirety. The existence of this side door potentially undermines the value of their assessment of the efficiency of voting rules as they currently exist, because voting rules are often made irrelevant by the prevalence of Section 363(b) sales. This type of oversight is problematic because Section 363(b) sales, as defined in the Code, appear to have the capability of overriding what Chapter 11 is typically understood to represent. Thus, an analysis of Section 363(b) sales should be central to any assessment of the Chapter 11 reorganization system as a whole—something that much of the bankruptcy scholarship has seemingly failed to recognize.

Scholarly discussions relating to Section 363(b) do exist, but they often focus on the practical texture of the law rather than theory; the precise nature of this section's interaction with the rest of the Code and its purposes has been under-theorized. Many discussions by scholars whose primary work lies elsewhere (proceduralists, in the terminology of Professor Baird[12]) address the overall efficiency of Chapter 11's design without considering the effects of Section 363(b). At most, some of these authors may address the issue in a page or two, citing the seminal cases and making assumptions without digging below the surface. Another group of scholars, such as Professor George Kuney, focus almost exclusively on Section 363(b) sales, calling either for their elimination from the Code[13] or,

[11] Kevin A. Kordana & Eric A. Posner, A Positive Theory of Chapter 11, 74 N.Y.U. L. Rev. 161 (1999).

[12] Baird, supra note 1, at 574–75.

[13] George W. Kuney, Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process, 76 Am. Bankr. L.J. 235, 287 (2002).

alternatively, for an explicit statutory amendment to clarify the operation of a non-plan sale procedure.[14] The work of each of these two groups, however, has gone largely unrecognized by the other, and thus the full theoretical implications of Section 363(b) still require more rigorous exploration.

Two potential stories can be told regarding Section 363(b) sales. The cynical perspective is that this section serves as a loophole to the otherwise tightly arranged and efficient Chapter 11, through which agents of the debtor-in-possession can shirk responsibility and improperly dispose of assets. Rather than proceeding through a reorganization confirmation process designed to ensure a reasonable recovery to all parties involved while respecting pre-bankruptcy entitlements, a Section 363(b) sale offers a quick and easy method for managers to dispose of assets and engage in wasteful control of the company. Although such sales require notice and a hearing before the bankruptcy court, this administrative process does not rise to the same level of detail as a full-blown plan confirmation proceeding, thus potentially leaving the door open for hard-to-detect misbehavior by the debtor-in-possession.[15] Managers and directors shirking their newfound duty of loyalty to creditors can offer to sell assets at below-market values without even requiring confirmation by the creditors. Alternatively, managers may be pressured by creditors into a hurried sale of assets at less than the best price possible, robbing other creditors of the benefit of that best price. Finally, managers may be pressured by other creditors to freeze out a sale opportunity that would otherwise be beneficial. Collectively, these problematic actions are termed "agency costs," and, regardless of the mechanism, such costs appear to be prevalent in the absence of the voting and confirmation system designed

[14] George W. Kuney, Let's Make it Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy, 40 Hous. L. Rev. 1265, 1267–68 (2004); see also White, supra note 6, at 164.

[15] The bankruptcy court will typically hold a hearing only if a party objects to the sale, hence the burden of producing evidence disfavoring the sale is on the various creditors who have incentives to object. Such a sale normally occurs at an early point in the bankruptcy process, so these parties will often have incomplete information on the debtor-in-possession's reorganization plans. A failure to object or an objection based on incomplete information may not serve to protect the creditors' interests as fully as they would be protected in a plan confirmation proceeding, which occurs well into the bankruptcy process.

to minimize these costs in a Chapter 11 reorganization plan.[16] From this perspective, a Section 363(b) sale appears likely to be highly disruptive to the typical goals of Chapter 11 bankruptcy. Pre-bankruptcy entitlements may not be respected, and minimal court interference, combined with constrained markets for assets, will lead to a depressed price and a lower recovery for creditors than they would otherwise obtain through the normal confirmation process. From the cynical perspective, then, Section 363(b) sales might enable inefficient avoidance of the confirmation process, leading to extreme waste of assets by irresponsible agents.

The less cynical story suggests that a Section 363(b) sale is actually a more efficient manner of extracting value from an asset than the lengthy confirmation process. Under this view, an asset sale approved by the court through Section 363(b) is presumed to be beneficial down the road to those parties that vote on a reorganization plan. Rather than wasting corporate funds on the transaction costs of including such a sale plan in confirmation proceedings, Section 363(b) enables these positive net present value sales to move forward at a much quicker pace without incurring the same costs. This sale does not require the extensive haggling of a reorganization plan, and the corporation is potentially able to take advantage of a temporarily high market value and sell the asset with minimal transaction costs. The higher market value is especially significant in the case of assets that may depreciate in value over time, where retention and sale under plan confirmation would reduce recovery. Under this view, Section 363(b) sales offer an improvement—in certain cases—upon the confirmation process, leading to a more efficient system of corporate reorganization.

Scholars have not engaged in a significant amount of direct analysis to determine which of the above stories is more accurate. As with many features of bankruptcy, the more cynical perspective has significant intuitive appeal.[17] It is much easier to criticize un-

[16] Features of the confirmation process such as cramdown, a statutorily available method of forcing certain classes of creditors to accept the plan distribution as long as it is "fair and equitable," see 11 U.S.C. § 1129(b)(1) (2000), enable the confirmation process to be efficient in distributing assets and satisfying claims.

[17] See, for example, the reaction to articles such as Michael Bradley & Michael Rosenzweig, The Untenable Case for Chapter 11, 101 Yale L.J. 1043 (1992), as discussed in Lynn M. LoPucki, Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig, 91 Mich. L. Rev. 79, 80 n.5 (1992). Professors Bradley

usual characteristics of bankruptcy law than it is to truly understand and justify them. An empirical investigation is beyond the reach of this Note; instead, this Note will develop a framework that gives coherence to both scholarly debate and court decisions relating to Section 363(b) sales, weighing the factors to determine which story is most viable in the bankruptcy arena. This framework attempts to offer a rule-like calculus for use in analyzing potential Section 363(b) sales, in contrast to the business justification standard currently used.

The purpose of this Note is to push for a more rigorous exploration of these sales by modeling and evaluating the efficiency of Section 363(b) sales in light of the residual effect they have upon the rest of the Bankruptcy Code. This will shed light on the ideal operation of Section 363(b) sales as part of the bankruptcy system as a whole.[18] This Note will argue, in part, that the divergence between the two views rests on a razor's edge dependent upon the level and quality of court intervention in both confirmation of reorganization plans and in valuation of Section 363(b) sales. This Note's analysis will identify the characteristics of those Section 363(b) sales that are efficient and the features of those sales that should be barred. If the Section 363(b) sale process consumes significant resources to provide the maximum price possible or involves an overly high level of scrutiny by the bankruptcy court, the process may no longer offer a solution more efficient than a reorganization plan. If, however, the court were to engage in no analysis whatsoever and merely rubber-stamp Section 363(b) sales, the opportunity for agency shirking and undervaluation increases to a point where it might undermine the normative goals of bankruptcy. Neither of these levels of court scrutiny will produce correct re-

and Rosenzweig called for repeal of Chapter 11 based on their empirical research, and their thesis was much publicized in the media. See sources cited in LoPucki, supra, at 80 n.5. In ensuing law review articles, Professors LoPucki and Warren largely discredited the empirical basis for Bradley and Rosenzweig's conclusions. See id. at 81; Elizabeth Warren, The Untenable Case for Repeal of Chapter 11, 102 Yale L.J. 437, 438 (1992).

[18] The danger inherent in this inquiry may be that a narrow examination of the efficiency of Section 363(b) sales soon becomes a discourse on the efficiencies of the entire bankruptcy system. The expansive nature of this topic may offer a partial explanation as to the lack of focused scholarship specifically addressing Section 363(b) sales.

sults. The challenge is to identify the optimal level of judicial oversight[19] so as to encourage efficient Section 363(b) sales while discouraging those that would be wasteful. Such a mixed system allows for the optimal resolution of both Section 363-efficient sales and Section 363-inefficient sales.

The core argument of this Note questions the usefulness of the current level of court intervention embodied by the "business justification" standard as currently practiced in Section 363(b) sale hearings. Given the increase in popularity of Section 363(b) sales in recent years, the frequency of such hearings has increased to the point where a precise rule may provide a more efficient calculus than a vague standard. Where a given issue is considered with high frequency, a precise rule offers the most efficient manner of resolution.[20] A vague standard is only appropriate for low-frequency issues because of the high transaction costs imposed on courts in interpreting and developing the standard.[21] This Note will attempt to produce a rule to be used by each party interested in a sale: the debtor-in-possession proposing a sale, creditors considering an objection to the sale, and the courts in overseeing the sale through the hearing process. Such a rule may reduce costs in promulgating a Section 363(b) sale, which in turn increases the efficiency of such sales.

Part I of this Note will address the function of Section 363(b) sales in the Bankruptcy Code in light of their increased use over the last several decades. This Part will discuss significant court cases and elaborate on the "business justification" test currently used in approving these sales.

Part II will introduce and develop a framework for analyzing the interaction of Section 363(b) sales with the normative goals of Chapter 11. This analysis derives—independent of the traditional business justification test—the relevant factors that should drive a choice by a debtor-in-possession or a court between Section 363(b) and the normal reorganization process. Using an efficiency analysis, I will determine the optimal point at which a debtor should

[19] Or, alternatively, oversight or decisionmaking by another party who may be better suited than the judiciary. See infra Section III.B.

[20] See Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 Duke L.J. 557 (1992).

[21] Id.

abandon the inclusion of a particular asset in a Chapter 11 reorganization plan in order to pursue a sale of that asset under Section 363(b) outside the ordinary course of business. The framework in this Part will illustrate that, although not exclusive, the driving factors underlying that decision are agency costs and anticipated fluctuation in the value of the asset itself: as agency costs go up, Section 363(b) sales become less efficient; on the contrary, if the asset is depreciating in value over time, the efficiency of an early sale increases greatly. Although these factors have previously been recognized by the business justification standard, this framework brings to light other factors that are significant. For example, the higher costs of a Chapter 11 reorganization may make Section 363(b) sales more efficient because they save costs down the road. More importantly, the level and quality of judicial oversight and investigation by the bankruptcy courts emerge as critical elements in determining the efficiency of a Section 363(b) sale. While overly detailed judicial intervention increases the costs of promulgating a sale, thereby reducing its efficiency, overly relaxed judicial intervention reduces those costs, but at the potential expense of increasing agency costs because debtor management may engage in inefficient sales absent quality oversight. This Note will articulate the tension between these factors and seek to provide a calculus for optimal decisionmaking.

Part III will explore the implications of the framework developed in Part II. This Part will test the analytical framework's flexibility in describing and critiquing both court decisions and modern scholarly criticisms of Section 363(b) sales. While the framework describes court decisions with some accuracy, its major contribution is its suggestion that courts have not explicitly recognized the agency cost implications of such sales. These agency costs are likely the very reason that the Code requires judicial oversight in the form of notice and a hearing in the first place, yet the business justification test appears to place an overly high level of trust in the business judgment of the very management that has likely contributed to the corporation's need for reorganization. Finally, this Part will respond to Professor Skeel's normative suggestions for minimizing the agency costs in Section 363(b) sales. The framework developed in Part II will offer a partial confirmation that parties other than the courts may, in some situations, be better suited to determine whether a given Section 363(b) sale is efficient.

I. OVERVIEW OF SECTION 363(b) SALES AND THE RELEVANT STANDARDS FOR COURT APPROVAL

The increasing use of Section 363(b) sales may very well indicate an evolution in bankruptcy practice in which the quickest and easiest method of selling assets has finally moved to the forefront. While this may be an efficient development, the potential for increased agency costs relative to the baseline agency costs of a reorganization plan is a matter of concern. Regardless of whether the drafters of this provision envisioned the present scope of Section 363(b) sales, tracing the development of legal standards regarding these sales will help reveal this progression.

A. Statutory Overview

The dynamic of sales under Section 363(b) as written is largely one of rapidity and minimalism relative to the complexity of the reorganization plan confirmation process. The section applies to Chapters 7, 11, 12, and 13 of the Code,[22] so while its use is not limited to reorganization, those uses in Chapter 11 will form the focus of this analysis.

Section 363(b) authorizes a Chapter 11 debtor-in-possession to use, sell, or lease estate property outside the ordinary course of business, requiring only that the movant provide notice and a hearing.[23] According to Rule 2002, the notice is to be sent to all creditors, or the unsecured creditors' committee, and must contain a description of the terms and conditions of the sale, along with a time specification for filing objections.[24] This minimal requirement reinforces the rapidity with which a sale can be consummated, and provided there are no objections in response to the notice, a hearing or court approval order may not even be required.[25] Such sales

[22] 11 U.S.C. § 103(a) (2000) (amended 2005).

[23] 11 U.S.C. § 363(b)(1) (2000) (amended 2005).

[24] Fed. R. Bankr. P. 2002.

[25] Collier on Bankruptcy ¶ 363.03 (Lawrence P. King ed., Matthew Bender 15th ed. 1996); see also In re Robert L. Hallamore Corp., 40 B.R. 181, 183 (Bankr. D. Mass. 1984) ("In the absence of objections or counter-offers, a sale in accordance with Sec-

are often consummated in a period of two to three months, as opposed to the several years often involved in a plan confirmation process for a large corporation.[26]

Beyond the rapid consummation and minimal process required for approval of a Section 363(b) sale, Section 363(f) offers the buyer the benefit of a title free and clear of claims, subject to some limitations not pertinent to this discussion.[27] This benefit increases the market for asset sales, which in turn makes a sale more attractive to the debtor-in-possession. Liberalization of this benefit has contributed in part to the increasing prevalence of these asset sales.[28] When an asset is sold under Section 363(b) subject to the provisions of Section 363(f), a motion under Rule 9014[29] will be required, and the holder of the interest must be notified.[30] Failure to object in this situation will lead to the interest-holder becoming bound by the terms of the notice and ensuing sale.[31]

While court involvement in the sale process is relatively limited, there are certain situations in which courts conduct a closer examination. Prior to the enactment of the Bankruptcy Reform Act of 1978, the equivalent provision to Section 363—Section 116(3) of the Chandler Act[32]—required a demonstration of cause for pursuing a sale outside of the plan of reorganization.[33] The statutory text of Section 363(b) as it stands now, however, requires no such demonstration of cause. Courts have been forced to develop standards to flesh out the statute's ambivalence because the absence of narrowing requirements for Section 363(b) sales could effectively replace Chapter 11 reorganizations with an out-of-plan sale.

tion 363, Rules [sic] 2002 and Rule 6004 does not require court approval. . . . [I]n the absence of a dispute, there is no judicial involvement in and no court supervision of a sale.").

[26] See Glosband, supra note 10, at 60.

[27] See 11 U.S.C. § 363(f) (2000).

[28] Smith & Connor, supra note 10, at 1–2.

[29] Fed. R. Bankr. P. 9014.

[30] See Collier on Bankruptcy, supra note 25, ¶ 363.06.

[31] See Veltman v. Whetzal, 93 F.3d 517, 521–22 (8th Cir. 1996).

[32] See In re Lionel Corp., 722 F.2d 1063, 1067 (2d Cir. 1983).

[33] See id. at 1072–73 n. 1 (Winter, J., dissenting).

B. The Early Cases and Development of the Business Justification Standard: White Motor*,* Braniff*, and* Lionel

One of the first cases to seriously address the absence of narrowing requirements was *In re White Motor Credit Corp*.[34] Troubled by the textual vacuity of a statute that would lead to unacceptable results, the bankruptcy court investigated Section 363(b)'s legislative history to determine whether the debtor could sell substantially all of its assets to another corporation.[35] The court found that statutory authorization of such a significant sale was not a sensible legislative intent, stating that:

> As a matter of legislative intent, to endow section 363 with the purpose of or a potential for a total reorganization would nullify, at debtor's option, the major protections and standards of chapter 11 of the Code. For example, while section 1129 requires a confirmation hearing as to every liquidating (or other) reorganization plan, section 363 taken together with section 102 requires mere opportunity for hearing. [Therefore, a] transaction could proceed without any hearing or court order whatever. So manifestly unacceptable a possibility renders further investigation of statutory thrust unnecessary.
>
> It is clear . . . that in a chapter 11 reorganization under the Bankruptcy Code, Section 363(b) does not authorize sale of all or substantially all assets of the estate.[36]

These considerations led the court to deny approval of the sale in question, stating that such a sale could only be promulgated if an "emergency" condition existed that was not of the corporation's own making.[37] The understanding of Section 363(b) espoused in *White Motor* focuses on the harm that large-scale Section 363(b) sales could effect on normal Chapter 11 proceedings but ignores some of the possible benefits of such sales.

[34] 14 B.R. 584 (Bankr. N.D. Ohio 1981).
[35] Id. at 588–90.
[36] Id. at 590 (internal citation omitted).
[37] Id. This emergency rule had been the predominant rule in some circuits prior to the 1978 enactment of the Bankruptcy Code. See, e.g., In re Solar Mfg. Corp., 176 F.2d 493, 495 (3d Cir. 1949).

In 1983, the result in *White Motor* was followed, but the "emergency rule" reasoning was rejected by the Fifth and Second Circuits. In *In re Braniff Airways*, the Fifth Circuit refused to allow a sale of substantially all the airline's assets under Section 363(b).[38] The proposed sale might have been approved (in contrast to *White Motor*) but for the fact that the sale did not involve a cash transfer. Instead, the purchaser proposed to exchange Braniff assets, including planes, landing slots, and other items, for "travel scrip, unsecured notes, and a profit participation" in the purchaser's enterprise.[39] The court found that this type of transfer exceeded the clear boundaries set out by Section 363(b) and was in fact more of a reorganization than a sale, thereby significantly restructuring the rights of Braniff's creditors.[40]

Meanwhile, in *In re Lionel Corp.*, the Second Circuit produced the seminal Section 363(b) case by prohibiting the Lionel Corporation's proposed sale of their largest single asset.[41] The asset at issue was an eighty-two percent common stock holding in another company, which itself represented thirty-four percent of Lionel's assets.[42] Lionel initially proposed a sale for $43 million in cash, but upon notice and objection the bankruptcy court held a hearing and approved the sale to a higher bidder for $50 million.[43] The bankruptcy court found it sufficient cause that the creditors' committee insisted upon the sale, failing to give significance to the fact that the asset was not wasting away and likely would have been valued at the same level once confirmation of their plan had been completed.[44]

Following summary approval by the district court, the equity committee representing the shareholders appealed, claiming a deprivation of the Code's "safeguards of disclosure, solicitation and acceptance."[45] The equity committee argued that Section 363(b) could only be used in emergency situations, and the creditors' committee countered, claiming that the "bankruptcy judge should

[38] 700 F.2d 935, 939–40 (5th Cir. 1983)
[39] Id. at 939.
[40] See id.
[41] 722 F.2d 1063, 1063 (1983).
[42] Id. at 1065.
[43] Id.
[44] Id. at 1065–66.
[45] Id. at 1066.

have absolute freedom under § 363(b) to do as he thinks best."[46] In deciding the case, the Second Circuit avoided both of these extremes and instead settled on a middle ground. The standard allowed the bankruptcy judge to exert some discretion, limited by the requirement of a "business justification" for the judge's decision.[47] The court implemented a standard that would enable the judge to tailor his approach to varied circumstances without being "shackled with unnecessarily rigid rules,"[48] recognizing the interplay between Section 363(b) and the Chapter 11 confirmation process.[49]

The Second Circuit's choice to allow the bankruptcy court to exercise discretion according to a standard rather than a rule eliminated the necessity of establishing a rule at either end of the spectrum as advocated by the opposing parties—the creditors' committee and the equity committee. This choice of a standard rather than a rule has serious efficiency ramifications,[50] which will be discussed in Part III after developing a more rule-like approach in Part II. Perhaps the prior infrequency of litigation under Section 363(b) supported the determination that a case-by-case ex post approach using a standard was ideal, but now that Section 363(b) sales have become ubiquitous, it is worth investigating whether this choice remains optimal or whether a rule may be better suited to handle the increase in contested Section 363(b) sales.

The "business justification" standard means that certain reasons for a sale are impermissible, such as appeasement of major creditors and the pure need for an expedited process, and the court will have to consider the ramifications of a number of factors before approving a sale.[51] *Lionel*'s analysis provides seven salient factors to consider, but acknowledges that other factors may be relevant as well:

[46] Id.
[47] Id.
[48] Id. at 1069.
[49] Id. at 1071.
[50] See, e.g., Rachael M. Jackson, Responding to Threats of Bankruptcy Abuse in a Post-Enron World: Trusting the Bankruptcy Judge as the Guardian of Debtor Estates, 2005 Colum. Bus. L. Rev. 451. For the seminal discussion concerning modern economic analysis of the rules/standards debate, see Louis Kaplow, supra note 20.
[51] See *Lionel*, 722 F.2d at 1071.

> the proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-a-vis [sic] any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value.[52]

The driving factor in determining that Lionel's proposed sale was not justified was the fact that the stock would likely retain its value during the interval between the proposed sale and confirmation; hence there was no business justification for the sale.[53]

C. Refinements of the Lionel *Business Justification Standard*

Following the *Lionel* decision, other cases refined and confirmed the business justification standard, including *Stephens Industries v. McClung*,[54] which overruled *White Motor*'s "emergency rule" in the Sixth Circuit and established the *Lionel* standard as the majority approach to Section 363(b) sales.[55] Additional factors in the business justification standard now include the requirements that the sale be adequately and reasonably noticed,[56] that the sale has been proposed in good faith,[57] and that the disposition is "fair and expeditious."[58]

Most forms of business justification involve cost and time analysis. Some courts have critically considered the alternative costs that would result if a Section 363(b) sale were denied and the debtor forced to convert to Chapter 7. Approval of a sale in this context saves administrative expenses down the road.[59] Likewise, numerous

[52] Id.
[53] See id. at 1071–72.
[54] 789 F.2d 386 (6th Cir. 1986).
[55] Id. at 389–90; see Honorable William T. Bodoh et al., The Parameters of the Non-Plan Liquidating Chapter Eleven: Refining the *Lionel* Standard, 9 Bankr. Dev. J. 1, 6–7 (1992).
[56] See In re N. Atl. Millwork Corp., 155 B.R. 272, 275 (Bankr. D. Mass. 1993).
[57] See In re Abbotts Dairies of Pa., Inc., 788 F.2d 143, 149–50 (3d Cir. 1986).
[58] See In re White Motor Credit Corp, 14 B.R. 584 (Bankr. N.D. Ohio 1981).
[59] Bodoh et al., supra note 55, at 8–9.

courts consider time to be a primary factor when assessing the validity of a Section 363(b) sale.[60] Sales of rapidly declining assets are often permitted, especially when a prospective purchaser has already been identified.[61] Preservation of going concern value—the value of a corporation's continuing operations rather than its value when broken up and sold in pieces—can be critically important as well when there are external benefits to maintaining a debtor's business, such as employment.[62] Meanwhile, some debtors have entered bankruptcy for the primary purpose of selling their assets free and clear of interests, and some courts have approved these under the auspices of preserving going concern value.[63] Finally, the necessity of partial liquidation for an effective reorganization has been an important refinement to the business justification standard. In certain situations, partial liquidation removes obstacles to reorganization and should be encouraged.[64] All of these refinements have been added to the business justification standard in a haphazard way, such that it is no longer clear which factors determine whether a sale is permissible, or how all of these factors relate to the actual efficiency of a given sale.

Although the business justification standard was initially derived in a case denying a Section 363(b) sale, the modern use of this standard has led to an increase in the number of Section 363(b) sales approved.[65] Given this increase, this Note revisits the issue to determine whether the business justification test is in fact doing the work it should be doing under the Code. The following analysis does not begin with the business justification test but rather independently derives an approach to a debtor's decision between a sale and a reorganization. Part III will compare the contours of the business justification test with the implications of the framework that follows.

[60] Id. at 9.
[61] Id. at 9–10.
[62] Id. at 10–12.
[63] See id. at 11–12.
[64] Id. at 13–14.
[65] See, e.g., Glosband, supra note 10, at 60.

II. A FRAMEWORK FOR EVALUATING SECTION 363(b) SALES

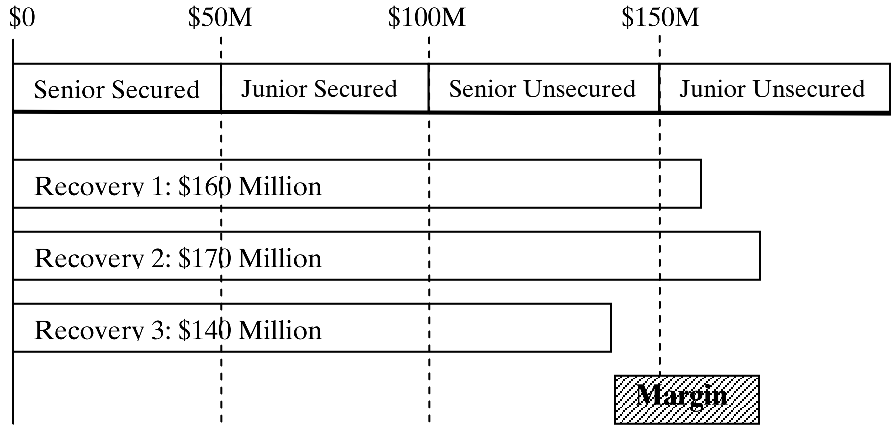
The relationship between Chapter 11 reorganization and Section 363(b) sales may be seen as a choice by the debtor between completing the formal reorganization procedures under Chapter 11 and selling a given asset under Section 363(b). By initially filing for Chapter 11 reorganization, the debtor has engaged in what could be theoretically described as a contract for reorganization. A shift away from that contract—a Section 363(b) sale, for example—adds value when the sale serves to promote higher-valued uses and creates a larger pie for recovery without compromising the size of the piece of pie for any of the individual parties that originally stand to benefit from reorganization.[66]

Absolute priority in the bankruptcy system dictates the order in which creditors will recover.[67] The essence of the absolute priority rule is that entitlements outside of bankruptcy are largely respected: senior creditors will be paid before junior creditors, who in turn are paid before equity holders. In the vast majority of reorganizations, the senior secured creditors will receive significant payment while most junior unsecured creditors will receive only a small return on each dollar they are owed. Finally, equity holders will probably end up with no recovery or ownership stake in the reorganized company.

An increase in the amount of recovery, however, may enable some of the junior creditors to recover a greater return than they would otherwise receive. This group of creditors has the most to gain from a more efficient means of disposing of an asset. Likewise, those creditors who would already recover under reorganization have the most to lose if an asset is sold at a value below the anticipated recovery. A simplified graphical illustration demonstrates this situation:

[66] This concept can be seen as loosely parallel to the idea of an efficient breach in contract theory. See, e.g., Robert E. Scott & Jody S. Kraus, Contract Law and Theory 107 (photo. reprint 2003) (rev. 3d ed. 2002).

[67] 11 U.S.C. § 1129(b)(2) (2000) (amended 2005).



In the illustration, the ordering across the top illustrates a simplified order of priority, with secured creditors ahead of unsecured, each group ordered according to priority outside of bankruptcy, and each having a hypothetical $50 million claim. In Recovery 1, above, the total amount to distribute through a reorganization is $160 million, enough to satisfy the senior secured, junior secured, and senior unsecured creditors in their entirety. As can be seen, however, there is only $10 million in recovery for the junior unsecured category. This $10 million recovery is far short of the $50 million claim held by this category, and thus these unsecured creditors are recovering pro rata a mere 20 cents on the dollar. Recovery 2 illustrates a sale that distributes $170 million, providing the exact same recovery for the three highest priority groups, but giving the junior unsecured creditors $20 million in recovery. Thus, the junior creditors will reap the $10 million benefit of an increase in the overall amount recovered. These creditors can also suffer from a decrease in the overall amount recovered, as illustrated by Recovery 3, where the junior unsecured creditors receive nothing because the total amount recovered, $140 million, is insufficient to satisfy the senior unsecured creditors, who also no longer fully recover.

The group of creditors "on the margin" is demonstrated by the shaded portion of the illustration, which in this case constitutes unsecured creditors of varying priority. These creditors will either gain or lose depending upon how much money is recovered, thus they will care the most about the value recovered. In contrast, the creditors who always recover the full value of their claims—secured creditors in this illustration—do not care about the value recovered, as long as their own claims are still satisfied. The secured creditors would be just as happy with a $100 million recovery as they would with a $200 million recovery. Although stylized and simplified, this illustration demonstrates that senior creditors, who will normally recover fully, have different incentives from creditors on the margin who care about the exact amount recovered. These differing incentives will be detailed below and provide some of the basis for agency costs in Section 363(b) sales.

This Note makes several simplifying assumptions in order to effectively analyze Section 363(b) sales. First, the distribution of proceeds under the Section 363(b) sale process is assumed to occur just as it would under the Chapter 11 reorganization process. By assuming that proceeds of the sale are going into the same pot as proceeds from the reorganization, this Note is able to focus on analyzing how to maximize the value of the pot, rather than addressing distributional concerns. Distributional concerns are beyond the scope of this Note because the rule of absolute priority in bankruptcy is independent of the method of asset sale.[68] The goal of this framework is to maximize the total value gained from any single asset, regardless of whether that is done through reorganization or a Section 363(b) sale. As a value higher or lower than that expected under reorganization is recovered through a sale, marginal creditors will either gain or lose, but the priority in recovery is held constant under either disposition.

The debtor-in-possession—the corporation's management, in essence—is the party who will often propose a Section 363(b) sale. The debtor-in-possession may propose the sale merely because the senior secured creditors want it to do so, as illustrated in *Lionel*. Likewise, the debtor-in-possession may resist a sale proposed by a senior secured creditor because the equity holders do not want such a sale. Once a corporation enters bankruptcy, however, the debtor-in-possession has a duty to all of the stakeholders—all categories of creditors and equity holders—so the risk of any shirking of this universal duty in favor of a particular party can be considered an agency cost.

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[68] Id.

The agency conflicts discussed in this Note, therefore, are not between a party that would improve its distributional priority by pursuing a sale and a party that would improve its distributional priority by reorganization. Instead, they are conflicts regarding the marginal distribution of proceeds where priority is constant and a junior creditor may recover only if the value of the senior creditor's claim is exceeded. For example, if an asset can be sold under Section 363(b) for a value of $100 million, and that is equal to the amount owed to senior secured creditors, the senior secured creditors may seek immediate sale of the asset and attempt to manipulate management into pursuing such a sale. The next creditor in line, however, may prefer plan-based liquidation because the total value at that point may be $110 million, and it will obtain the marginal proceeds of the sale; this creditor will likewise exert an influence on the management. The presence of such marginal creditors—in this case the senior secured creditors and the next creditor in line—and their differing incentives produce agency costs that dramatically affect the decision whether or not to sell an asset under Section 363(b).[69]

This analysis also assumes that distribution under Chapter 11 reorganization and plan confirmation can serve as a distributional baseline—a model of optimal distribution. Plan confirmation is designed to counter creditor incentives and minimize agency costs, so this Note assumes that it perfectly accomplishes those goals and compares the costs of agency under a Section 363(b) sale to that baseline. Thus, this Note merely inquires whether the sale under Section 363(b) improves upon or detracts from that baseline.

The model proceeds as an efficiency analysis, determining both the costs and benefits of using the Chapter 11 reorganization process to dispose of an asset, along with the costs and benefits of an alternative process—the sale of a particular asset under Section 363(b). Modeling the choice between reorganization plans and Section 363(b) sales in this manner does not provide a drastically different calculus than that currently used by the courts under the *Lionel* business justification standard. It does, however, demonstrate how courts may have overlooked or misconstrued some of

[69] Subsection II.D.2 will address these agency costs in greater depth. Part III will discuss a possible method to minimize these agency costs.

the factors involved in this choice and, most importantly, how a rule may offer efficiency gains over the current standard. This model will bring the gains and losses from both plan confirmation and Section 363(b) sales into one coherent framework, which will serve as a baseline for both descriptive and normative analysis. While the framework's utility as a decisionmaking algorithm is limited by the difficulty of reducing many of its factors to numerical solutions, the framework provides an organized exposition of the direction in which each of its factors may tip the scales in favor of either a reorganization plan or a Section 363(b) sale. Furthermore, the framework helps to identify the specific costs whose reduction would improve the efficiency of a proposed Section 363(b) sale.

A. The Efficient Sale Framework

In order to be efficient, a Section 363(b) sale must maximize the value obtained for any specific asset. The sale should only occur when the total value of the sale is greater than the value that would have been recovered through reorganization plus the transaction cost waste incurred in promulgating the sale. Thus, a sale is efficient when:

$$(1)\quad V_{Sale} > E_{Reorganization} + W_{Sale.}$$

V_{Sale} is the present value received for the sold asset; $E_{Reorganization}$ is the expected present value of the asset under a reorganization pathway; and W_{Sale} is the transaction cost waste involved in the propagation of the asset sale under Section 363(b).

The following sections will derive the components of each of these variables. Some of the gains resulting from a potential sale will be the result of a difference between the costs that are included in W_{Sale} and those that are embedded within the calculation of the $E_{Reorganization}$. The most significant single cost lowering the value of a Section 363(b) sale is the agency cost, while higher costs of reorganization or liquidation drive up the value of a Section 363(b) sale. Most of the gains from a sale result from the improvement in the present value of the Section 363(b) sale price over the present value of its sale price under reorganization. If the asset is depreciating in value, for example, a Section 363(b) sale is a cost-effective way to quickly dispose of an inefficient asset.

B. Present Value Received From the Asset Sale

The first factor in this analysis, V_{Sale}, is quite simple to derive in most situations. In order to assist the development of the framework, this Note will illustrate the operation of each of these factors with a hypothetical company, Acme Corporation, which has just entered bankruptcy. The corporation, with a total present firm value of $200 million, holds $50 million in stock of another corporation and wishes to determine whether it should hold onto this asset for eventual disposal under reorganization or if the corporation (through the debtor-in-possession) should sell the asset under Section 363(b). At this stage, it is clear that the present value of the asset, if sold now, is $50 million. If, however, the transaction were structured like the one in *Braniff Airways*,[70] the present value calculation would become more complex. In *Braniff Airways*, the transaction was proposed as an exchange for "travel scrip, unsecured notes, and a profit participation" rather than cash,[71] so the present value of the proposal would have been the sum of the present value of these components. Although the court rejected the sale because the exchange for notes and a profit participation would have had too great an effect on the reorganization rights and recoveries, it is conceivable that the basis for rejecting a sale may be the risk imposed by uncertainty, as such risk would likewise reduce the present value of the asset. In general, however, the variable V_{Sale} serves as a simple proxy for one value, the sale price, which will be the only variable and therefore easy to derive.

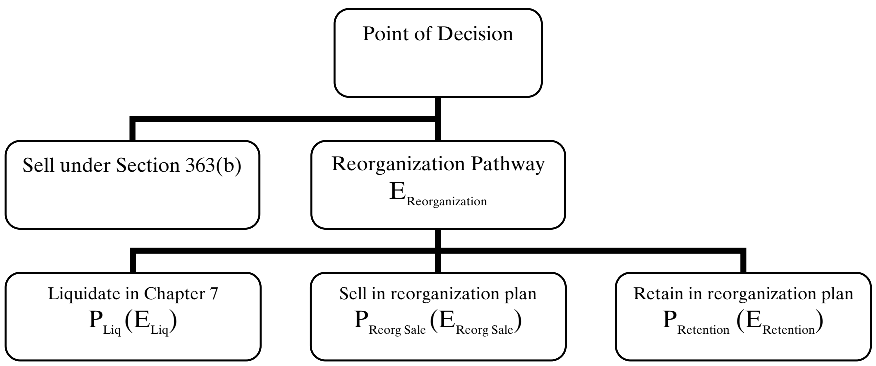
C. Expected Value of the Asset Under the Reorganization Pathway

If the corporation chooses to continue with a reorganization plan that includes the specific asset, it chooses what will hereafter be referred to as the "reorganization pathway." The value of the asset under the reorganization pathway, $E_{Reorganization}$, is influenced by a number of factors, including the presence of voting mechanisms and various time considerations. Three different future scenarios exist for an asset that is not sold under Section 363(b): it may be liquidated under Chapter 7, it may be sold under a successfully

[70] In re Braniff Airways, 700 F.2d 935 (5th Cir. 1983).
[71] Id. at 939.

confirmed Chapter 11 reorganization plan, or it may be retained under a Chapter 11 reorganization plan.

At the point of decision between a sale under Section 363(b) and the reorganization pathway, each of these sub-paths has a finite probability summing to 1.[72] Thus, Acme Corporation knows that if it retains this asset for the present, it will have some likelihood of liquidating it in Chapter 7, selling it under reorganization, or ultimately retaining it in its confirmed plan. This decision tree is charted below:

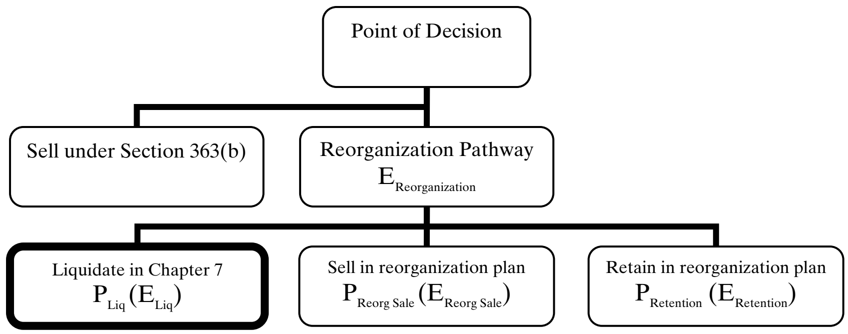


Under each of these sub-paths there will be some expected recovery value, E. Each sub-path is weighted by its relative probability, and the sum of these weighted values yields the total expected value under the reorganization branch:

$$(2)\quad P_{Liq}(E_{Liq}) + P_{Reorg\ Sale}(E_{Reorg\ Sale}) + P_{Retention}(E_{Retention}) = E_{Reorganization}$$

[72] See discussion infra in Subsection II.C.4 for the rationale behind preserving the probability function.

1. Expected Value of the Asset Under Chapter 7 Liquidation

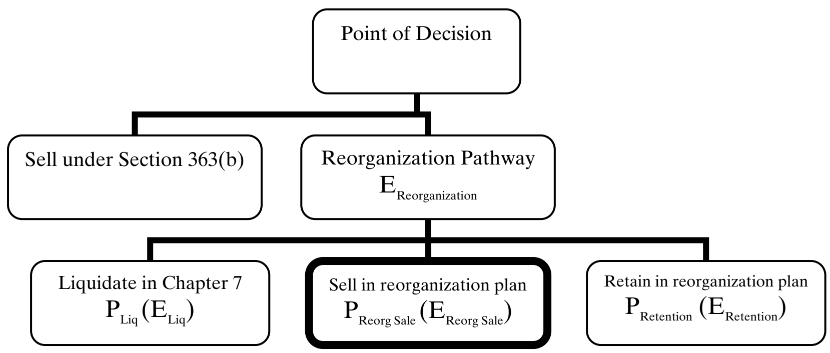


The expected value under the liquidation sub-path is the value of the asset at the liquidation date, discounted to present value given the time needed to complete the conversion to Chapter 7, less the incremental costs of promulgating the liquidation of that specific asset. Each of these costs is weighted according to the specific asset's value relative to the firm's total assets. The costs could be weighted in any other manner without affecting the overall calculation, but for simplicity's sake, proportional allocation will be assumed.

The Chapter 7 liquidation process may take some time, so the present value of that liquidation sale may be discounted, say, to $40 million. The total firm value at present is $200 million, so allocating the appropriate percentage of the liquidation costs to this asset means that twenty percent of the total liquidation cost should be allocated toward liquidation of the stock. This framework assumes that the ratio between the value of an asset and the total firm value is the same as the ratio between the cost of liquidating that asset and the cost of liquidating the total firm. If the total cost of liquidation has a present value of $10 million, then the marginal cost for selling the stock is $2 million. Therefore, the expected value of the asset, if liquidated, is $40 million less the sales cost of $2 million, yielding an expected value of $38 million.

The components of the costs arising from the conversion to Chapter 7 include attorneys' fees, costs of appointing a new trustee, and the court costs incurred in administering the Chapter 7 liquidation. An increase in any of these costs will serve to lower the total return on the liquidation of any given asset. For example, if Acme Corporation's attorneys' fees add an additional $10 million in cost to the process of liquidating the entire firm, the expected value of that specific asset is reduced from $38 million to $36 million, because a portion of those additional attorneys' fees must be allocated to the cost of liquidating the asset. Thus, the present value of the asset under liquidation in this framework is driven by three primary factors: the present value of the asset if sold under liquidation, the costs of selling all assets in the firm, and the percentage of total firm value held in the specific asset.

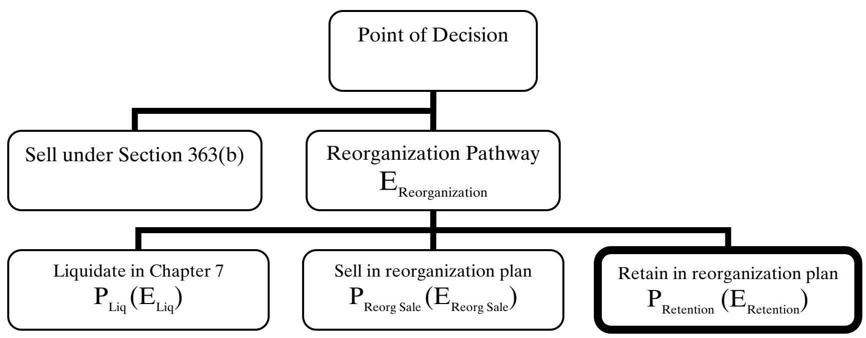
2. Expected Value of the Asset Under a Reorganization Sale



In order to calculate the expected value of the asset under the reorganization sale sub-path, the analysis proceeds in the same manner as the previous discussion. The future value of the asset in the reorganization sale is discounted by the time required for reorganization. The costs are now the costs of promulgating a reorganization plan, and these costs are again allocated according to the asset's percentage of the total firm value. The expected value of the asset, then, is this future value less the marginal costs.

The components of reorganization costs are varied, and some significant additional factors enter the equation. First, reorganization has high costs because of the notification and voting requirements for Chapter 11 plan confirmation. Second, the existence of these formal requirements leads to the potential for confirmation hold-up costs. Third, there are extensive attorneys' fees. Finally, approving and overseeing the reorganization proceeding involve significant court costs. Once again, the higher these costs are, the lower the expected value of the asset becomes. The reorganization plan confirmation process may take a significant amount of time for a large corporation, reducing the present value of the sales price of the stock to something like $35 million. Reorganization plans and proceedings are likewise costly, and the cost for the whole firm may be $20 million. With the total assets of the firm worth $200 million, the specific sales cost for the stock is $3.5 million if we assume proportional allocation of the costs to sell the particular asset. Thus, the expected value of the asset when sold as part of a reorganization plan is $31.5 million, and another $10 million increase in fees would lower Acme's expected recovery to $29.75 million.[73]

3. Expected Retained Value of the Asset Under Reorganization



The final sub-path involves a reorganization plan similar to that immediately above, but instead of selling, the debtor-in-possession retains the asset. The value of the asset when retained as part of the reorganized company may be different from the reorganization sale value. Also, there is no additional factor for the costs of the asset sale when the asset is retained. Reorganization costs and total

[73] Taking a total cost of reorganization of $30 million divided by the total firm value of $200 million means that the costs are 15% of the firm value; hence 15% of the $35 million asset gives costs for that particular asset of $5.25 million, and $35 million minus $5.25 million yields a final expected recovery of $29.75 million.

firm value are all the same, as in the reorganization sale sub-path. The expected value of the asset under reorganization retention is the value of the asset less the costs of reorganization.

The present value of the asset when retained may be something like $40 million, potentially a higher value than would be obtained in a sale of the asset because there may be some firm-specific investment advantages to retaining the asset.[74] The total cost for promulgating the reorganization plan is the same $20 million. Taking the retention value as a total percentage of firm value (still $200 million) and allocating the reorganization costs appropriately yields a specific cost of $4 million to retain the asset, making its expected value under retention $36 million.

4. Expected Value Under All Reorganization Sub-paths

Each of the expected values under each sub-path must be weighted according to its relative probability. For Acme Corporation, suppose there is a 25% chance of liquidation at an expected value of $38 million, a 50% chance of reorganization sale at an expected value of $31.5 million, and a 25% chance of reorganization retention at an expected value of $36 million. Thus, if the decision is made to pursue one of the three options of reorganization rather than selling in a Section 363(b) sale, the expected value of the stock is $34.25 million.

The most significant feature of this result is that higher costs of any of the reorganization options—in liquidation under Chapter 7 or in reorganization plan proceedings—push toward making Section 363(b) sales the more efficient option. The costs are all subtracted from the value recovered at the end of the sub-path, which in turn causes the expected value of the asset to go down. Recalling

[74] A particular asset may be more valuable when retained as part of a given firm than when sold to another party because externalities affecting its value may be specific to that firm. For example, Acme's possession of the stock holding may be worth more to it than the strict monetary value of the stock: Acme may have a controlling stake of a key supplier by owning that stock, thus giving it both the benefit of the income stream represented by the stock value and the benefit of a secure stream of raw materials that benefits Acme Corporation's own profit-seeking activity. If the stock were held by a mere institutional investor, however, the institutional investor's valuation is simply the income stream represented by the stock price, and such an investor gains no value from the supply stream since he is not in the business of using such raw materials.

equation 1, to choose a Section 363(b) sale over the reorganization pathway, the value of the sale must exceed the expected value of the reorganization pathway plus the waste incurred in switching to conducting a Section 363(b) sale. Thus, a lower expected value of reorganization produces a lower threshold for the sale to be efficient.

This result may help explain the rising prevalence of Section 363(b) sales. As costs of reorganization go up in the larger bankruptcy proceedings, so does the appeal of selling assets early under Section 363(b). Further, the probability weighting of each pathway is significant as well. It may be that a reorganization pathway yields a low expected value because of high costs, but that pathway itself may occur only at a low probability. In considering the costs and benefits of pursuing a Section 363(b) sale, the court should not be swayed by the slim possibility of a costly reorganization when conversion to Chapter 7 liquidation is much more probable. In this situation, it may not be worthwhile to sell the asset under Section 363(b) because the most efficient option may end up being Chapter 7 liquidation. The framework takes this into account by weighting the expected value of each scenario with its relative probability.

At this point, it is important to clarify a potential misunderstanding in the calculation of the probabilities of each reorganization sub-path. The total probability sums to 1 because the sub-path decision is being made prior to the time when full information regarding all of the factors that affect the valuation has been gathered. Once a valuation is calculated for each of the sub-paths, however, it initially appears that the probability collapses, and the debtor will automatically choose the option with the highest expected value. This is not correct, however, because the externalities associated with other assets will affect which reorganization sub-path is chosen. A debtor-in-possession cannot choose a Chapter 7 liquidation option for just the particular asset in consideration, nor can it choose to pursue a reorganization plan that only affects this single asset. As a result, the probability reflects the fact that this choice will not be determined only by the expected value of the particular asset in question. Thus, a firm may be driven into a pathway that is suboptimal for the particular asset in question but optimal for the collection of firm assets as a whole. Therefore, this Note assumes complete information for the specific asset at the decision point, but a probabilistic information distribution relating to the eventual disposition once an initial decision not to sell has been made.

As a numerical example illustrating the necessity of the probability distribution, assume that Acme encounters the following situation. Acme's stock asset is valued at $50 million if sold now, and each of the three sub-paths has its expected value, which includes costs. The value would be $38 million if sold under a Chapter 7 liquidation, $31.5 million if sold under a Chapter 11 reorganization plan, and $36 million if retained in a Chapter 11 reorganization plan. Assuming, only for the sake of present analysis, that there are no costs associated with promulgating the Section 363(b) sale,[75] the obvious choice is to sell the asset under Section 363(b). If instead of the assumed $50 million, the present Section 363(b) sale value of the stock is $34 million, it clearly should not be sold, because the expected value of the reorganization pathway as a whole is higher: $34.25 million, as noted above. One might readily argue that because we have determined the value of the specific asset in each of the three sub-paths, there is no reason to consider the low-value sub-paths as an option once we have decided not to engage in the 363(b) sale; the obvious next choice in the decision tree would be to sell the stock through a Chapter 7 liquidation for $38 million rather than $36 million or $31.5 million under the other sub-paths. If there were no outside influences at this point, that would indeed be the case, but the company has value in other assets as well, and disposition of these has some influence. In the Acme example, the stock asset only represents 25% of the total, and there are other assets worth $150 million at the time the debtor makes a decision on the stock sale. Once the stock-specific decision has been made at the initial decision point, the firm must choose a sub-path to pursue for *all* assets of the firm at the second stage—reorganization or conversion to Chapter 7. This cannot be engaged in piecewise, so while it may be optimal to choose Chapter 7 for the stock asset, the remaining assets may have valuations distributed differently than the stock. As an example, it is possible that the remaining assets may be expected to return $130 million in Chapter 7 but $140 million in a reorganization sale after costs have been taken into account, yielding a total of $168 million in Chapter

[75] Section II.D details the costs of carrying out a Section 363(b) sale.

7 and \$171.5 million in a reorganization sale.[76] The correct choice is no longer a sale under Chapter 7, because reorganization yields the highest overall payoff. Thus, this second-stage decision may be constrained by the value of other assets, and full knowledge of the valuation of the asset in question may not dictate the most efficient sub-path for the firm as a whole. The probability distribution at the point of decision on the Section 363(b) sale thus takes into account the probability—based partially on uncertainty about the future—that certain sub-paths will be chosen down the road based on gain to the firm as a whole.

D. Transaction Cost Waste in Section 363(b) Sales

In a world where Section 363(b) sales are costless, the inquiry would have been completed above, and there would be very few situations in which a debtor would choose not to sell. Instead, Section 363(b) sales involve a number of costs similar to those associated with the reorganization pathway, such as court costs, costs of counsel, and sales costs, but these relate to the 363(b) sale process of notice and a hearing rather than the full-blown Chapter 7 liquidation or Chapter 11 reorganization plan. These sales also involve some additional costs that are more difficult to quantify, resulting from the possibility of agency shirking and mismanagement by the debtor-in-possession. These wasted transaction costs simply sum together and are all incorporated into $W_{Sale.}$

1. Costs Related to Promulgating Section 363(b) Sales

The first cost entailed in a Section 363(b) sale includes the expense of the required notice, along with any advertising expenses and bidding incentives that are designed to initiate the auction. When there has been an objection to the sale and a judicial hearing is required, court costs and cost of counsel are necessary expenditures to obtain judicial approval.

[76] This numerical example also serves to demonstrate the benefit of the Section 363(b) sale proposed. If the sale is valued at \$50 million and sold, followed by a Chapter 7 liquidation sale of the remaining assets, the total recovery is \$180 million. Furthermore, if the remaining assets are sold in reorganization, the total recovery is \$190 million. Thus, if the sale is efficient for a particular asset, it will help yield the highest value possible for the firm as a whole.

2. Agency Costs in the Decision to Engage in Section 363(b) Sales

The major component of transaction cost waste in a Section 363(b) sale is the potential that agency costs may be greater in such a sale than they would be in the full Chapter 11 reorganization process. In the reorganization process, voting rules and other protections exist to ensure that the confirmed plan has approval of every classification of interested parties. Because a Section 363(b) sale involves only notice and a hearing, the protection for all classes of creditors may not be as strong as under a full-scale reorganization plan, leading to increased opportunities for the debtor-in-possession to misbehave or take advantage of certain classes of creditors.[77] This analysis still assumes, as earlier, that the Chapter 11 reorganization process produces perfect agency response and obtains the optimal result for all interested parties.[78] A Section 363(b) sale will then be compared to this ideal, and increased agency costs will decrease the value obtained from a sale.

Three distinct agency problems present themselves in determining whether or not to sell an asset under Section 363(b). First, and most obviously, the debtor-in-possession management could sell an asset and, rather than pooling the funds for distribution according to bankruptcy priority entitlements, it could waste those assets through consumption of perquisites—funding management trips to Vegas on the corporate jet, for example—or use the funds to run the company in ways that do not create value for the interested creditors. The second agency problem presents itself when senior creditors have captured the debtor-in-possession and choose to push the firm toward selling an asset at a sub-optimal price that will cover their claims completely but leave other creditors underwater, receiving little to no recovery. The final agency problem arises when junior creditors capture the debtor-in-possession and hold up the efficient sale of an asset. Junior creditors would be mo-

[77] A creditor must object to the sale to even earn a hearing, but such sales often occur relatively early in the bankruptcy process. Creditors, while on notice, may not have gathered sufficient information to raise an objection or protect their claims. By the time a reorganization plan is assembled, however, these creditors will have had more time for information production and can protect their interests more effectively.

[78] Obviously this may not represent reality, but the assumption isolates the sale-specific agency costs under Section 363. This Note does not attempt to address agency costs of the voting rules in Chapter 11 reorganizations.

tivated to block such a sale if the immediate proceeds are certain not to reach them, but there is some chance that delay might allow appreciation in the value of the asset—increasing the proceeds from the delayed sale to a level that would provide them with some recovery. As argued below, the first of these scenarios is probably not significant. The other two scenarios, however, merit more in-depth analysis.

If a debtor-in-possession sells an asset and uses the funds improperly for personal use or other waste, this contradicts the principles of absolute priority and likely would be barred by the bankruptcy court. Even though there may be a finite risk and cost associated with this classical unfaithfulness to the principal, the assumptions in this Note prevent this type of agency slippage from being considered a component of the decision to sell an asset. As mentioned previously, distributional concerns are not the focus of this inquiry, so this Note does not address issues that prevent funds from a sale from reaching the distributional pool. Rather, this Note focuses on the maximization of a pot of cash from an asset sale, followed by distribution in accordance with absolute priority. The misuse and improper distribution of funds is merely a distributional issue, and, although it may in fact add costs, it must be disregarded in the present framework and dealt with through other means.

Next, it is necessary to analyze the possibility of senior creditors capturing the debtor-in-possession and pressuring it into selling assets at a sub-optimal price. As an example, assume that Beta Corporation has the highest priority claim for $45 million from Acme Corporation.[79] As a self-interested party, Beta Corporation wishes to recover the full value of its claim as quickly as possible. Crucially, Beta Corporation has no interest in maximizing economic efficiency beyond the margin of its own recovery. In an ideal duty to maximize payout to all creditors, debtor management will seek to maximize the value of a Section 363(b) sale in order to create the largest pool of funds possible. If captured by a senior creditor, however, debtor-in-possession management may be encouraged to shirk its responsibility toward the entirety of its creditors in favor of the senior creditor, who often provides post-petition financing to

[79] Alternatively, assume that the class of creditors containing Beta has the highest priority set of claims.

help the corporation continue to operate while in bankruptcy. If Beta Corporation captures Acme's management, Acme may be more inclined to sell a stock asset immediately for $45 million than to delay in hopes of a higher value. If Beta Corporation has pressured the debtor-in-possession into a sale, creditors who think the sale will harm them will raise an objection with the court, and a hearing will ensue. The level of judicial oversight—notice and a hearing—of the Section 363(b) sale process may not be enough to discover and remedy this type of control, however, whereas the plan confirmation and voting procedures in reorganization help prevent this situation from occurring.

The opposite form of agency capture also adds costs to Section 363(b) sales. Creditors who currently expect no return on their claims may know they will not recover anything in an immediate sale of an asset. Imagine that the senior creditor Beta Corporation (which is owed $45 million) desires an asset sale at a $45 million price that is, in fact, the best price available in the market. Junior creditor Contra Corporation, holding a claim for the next $15 million, may seek to manipulate the debtor-in-possession management and argue that if the asset is retained, it will be worth more down the road. Contra wants the possibility of a recovery sufficient to cover *its* claims on Acme, so it may seek to block the current sale, even if there is only a small probability that they will recover anything down the road. These creditors have no downside risk from delay and only stand to gain from the gamble that delay may translate into a future higher value. By fighting for unwarranted delay, such creditors may effectively impose a "hold-up cost" on otherwise beneficial transactions.

It is difficult to precisely predict the risk of each of these forms of agency capture, but it is apparent that the risk is inversely proportional to the level of judicial oversight in a Section 363(b) sale. As the amount of oversight increases (along with court costs), the possibility of counterproductive agency capture decreases, and agency costs are reduced. In order to decrease the possibility of such agency capture to a minimum, a Section 363(b) sale would have to proceed exactly like a reorganization plan approval process, which negates the very benefit of lesser costs imposed by a Section 363(b) sale. Likewise, as judicial oversight decreases and moves more toward a rubber-stamping of these sales, the risk that the debtor is captured and misguided by a creditor increases dramatically, also leading to a very costly situation. As risks of imprecise decisionmaking increase, the costs of promulgating a sale increase and the likelihood of an efficient sale decreases. Thus, the challenge is to determine the precise level of judicial oversight that minimizes the opportunity for agency capture while also minimizing the cost of such oversight.

E. The Complete Framework

The final framework puts together each of the pieces in equation (1), above, clarifying the cost factors involved in choosing between a Section 363(b) sale or continuing toward reorganization. Most discussions compare the benefits of Section 363(b) sales with the costs of reorganization, but the model developed in this Note clarifies that the maximum benefit of the sale is the value of the sale itself, and the other benefits of the process are merely a result of cost savings in avoiding reorganization costs minus the costs incurred in the sale process. Clarifying this relationship and demonstrating how certain factors affect the balance will help in the next Part, which uses the framework to analyze both court decisions and scholarly discussion.

In the table below illustrating the framework, the left-hand side represents factors favoring Section 363(b) sales, while the right-hand side contains factors favoring reorganization instead. If the right-hand side exceeds the left, a Section 363(b) sale is no longer efficient and should not be pursued. Conversely, a simple efficiency result has been derived when the benefits of the sale (shown on the left-hand side) exceed its costs (shown on the right-hand side). In this situation, a debtor-in-possession should sell the asset. The framework is expressed in the following table with all values discounted to present value:

$V_{Sale} > E_{Reorganization} + W_{Sale}$	
▪ Present value of the 363(b) sale ▪ Weighted liquidation costs x Probability (“P”) ▪ Weighted reorganization sale costs x P ▪ Weighted reorganization retention costs x P	▪ Costs of 363(b) sale (court, attorney, sale fee) ▪ Agency costs of 363(b) sale ▪ Value of liquidation sale x P ▪ Value of reorganization sale x P ▪ Value of reorganization retention x P

The framework thus provides a more rule-like calculus than that presently offered by the *Lionel* business justification standard. Most of the *Lionel* factors are incorporated in some manner into the framework, as discussed in the next Part, but this framework highlights the impact that both agency costs and the level of judicial oversight have on the value of the sale. In essence, developing a rule-like approach to Section 363(b) sales has revealed that a narrowly tailored rule likely offers the most efficient manner of identifying cost-effective sales when the frequency of Section 363(b) sales is high.

III. APPLICATIONS AND IMPLICATIONS OF THE FRAMEWORK

In order to test the applicability and flexibility of the above framework, this Part will first assess its descriptive relevance in evaluating several important court decisions regarding Section 363(b) sales. This Part will then use the framework to respond to and support Professor Skeel's normative argument for both increasing the efficiency of sales that do happen and enabling efficient sales in situations where they are presently inefficient because of agency costs.

A. The Framework and Court Decisions

As noted in Section I.B, the first major case to address the implications of Section 363(b) was *In re White Motor Credit Corp.*[80] The bankruptcy court's decision focused on the fact that the debtor-in-possession attempted to sell almost all of its assets outside the plan confirmation process, and the court found this to be contrary to the creditor protection purposes of Chapter 11.[81] Looking at this decision through the lens of the efficient sale framework, the factor explicitly considered most salient by the court was the percentage of assets proposed to be sold. In the framework, the percentage of the asset relative to the entire firm value serves as a factor in determining the costs of the various reorganization options, which contribute to the overall benefit of the sale. It is also a factor determining

[80] 14 B.R. 584 (Bankr. N.D. Ohio 1981).
[81] Id. at 590.

the costs of the Section 363(b) sale itself, because as the size of an asset increases, so does the burden of selling that asset under Section 363(b). Thus, the percentage of assets proposed to be sold essentially appears on both the cost and benefit side and is indeterminate. The efficient sale framework also demonstrates the independent nature of each proposed sale under Section 363(b). If a sale is efficient according to the framework, it should not be rejected merely because it is a high percentage asset. Its sale, no matter how significant a percentage, will be beneficial, and the next asset to be considered in the Section 363(b) sale choice should be evaluated in a similarly independent manner.

Although the framework demonstrates the irrelevance of total asset percentage as a factor supporting the court's logic, it is still possible that the court used the percentage as a proxy for agency costs on the right-hand side of the equation, and these costs may have made the sale inefficient. The bankruptcy court does not clearly articulate its justification for fearing the potential sale of a large percentage of assets under Section 363(b). By itself, this factor does not appear to make a sale less desirable and, in fact, seems irrelevant. Underlying the court's textual argument, however, may be fears of agency costs in the absence of plan confirmation proceedings. These fears may increase as the percentage of assets sold increases. The court may have believed that the proposed sale would either produce a pool of funds for waste, or it may have worried that the pool of funds was insufficient to meet the debtor's obligation to maximize recovery for all creditors. The framework demonstrates that pure concern about the asset percentage is indeterminate as to whether a sale is efficient; this percentage only matters to the extent that it reflects agency costs.

The efficient sale framework also helps describe the components of the *Lionel*[82] business justification standard. Although used by many courts, *Lionel*'s seven-factor standard merely provides relevant considerations, without elaborating upon the mechanism by which each factor may promote or discourage approvability of a Section 363(b) sale. The framework derived in Part II adds direction to these standards, fleshing out specific considerations and

[82] In re Lionel Corp., 722 F.2d 1063 (2d Cir. 1983).

granting them a rule-like influence on one side of the equation or the other.

The first *Lionel* factor is "the proportionate value of the asset [relative] to the estate as a whole."[83] As explained in the *White Motor* discussion above, in the efficient sale framework, the proportionate value is indeterminate. The *Lionel* standard presents this factor for consideration without clarifying whether it makes a sale more or less desirable and without providing any basis for why this factor matters. The framework indicates that this factor, by itself, may not in fact merit consideration in a Section 363(b) sale.

Lionel factors two and six are not clearly represented in the framework, but their implications are strongly felt nonetheless. Factor two is "the amount of elapsed time since the filing,"[84] and none of the time factors in the efficient sale framework explicitly consider this. Time, however, serves as a condition that affects the probability that a reorganization will be successful. As time progresses, conversion to liquidation may become more probable, while the probability of a successful reorganization may diminish. If conversion costs are cheaper than reorganization costs, then this lowers the positive impact that reorganization pathway costs have on the decision to sell, making a sale less valuable and possibly making it inefficient. This is further reinforced by the fact that elapsed time indicates past difficulty implementing a reorganization plan, possibly suggesting contention among the parties. This contention would, in turn, lead to high agency costs that would weigh against permitting the sale.[85]

The sixth *Lionel* factor is concerned with which of the actions permissible under Section 363(b)—use, sale, or lease of the asset—is undertaken.[86] This factor does not fit into the efficient sale framework directly because the framework only concerns itself with the choice to sell an asset. The other two options would lead to retention of the asset and would preserve a choice down the

[83] Id. at 1071.
[84] Id.
[85] The contentiousness of reorganization might weigh in *favor* of permitting the sale, however, if the contention is a result of a hold-up rather than an honest valuation dispute between creditors.
[86] *Lionel*, 722 F.2d at 1071.

road to sell, while taking advantage of temporary situations in order to use or lease it.

The third *Lionel* factor, "the likelihood that a plan of reorganization will be proposed and confirmed in the near future,"[87] directly corresponds to a component of the efficient sale framework. The probability functions in the framework consider the probability of reorganization, but the functions exist on both sides of the framework, making the factor indeterminate on its own. As the probability of reorganization rises, the expected cost of reorganization increases on the benefit side, as does the expected value of the reorganization sale itself on the cost side. Presumably, the value of reorganization exceeds the cost of reorganization, or it would never be approved. A higher probability increases each of these values in lockstep, but as a reorganization sale becomes more imminent, the present value of the sale increases because the sale is going to take place sooner rather than later, thus requiring less of a discount to present value. Most importantly, agency costs due to a sale increase as marginal creditors benefiting from the imminent reorganization sale tend to disfavor a Section 363(b) sale preempting the reorganization. Creditors who anticipate recovery in a reorganization would tend to be more suspicious of a Section 363(b) sale because they would prefer to hold out for recovery under reorganization instead. Thus, the proximity of a plan confirmation will tend to discourage the use of Section 363(b) sales.

The fourth and fifth factors from *Lionel* are likewise incorporated directly into the efficient sale framework. Factor four considers "the effect of the proposed disposition on future plans of reorganization," while factor five weighs "the proceeds to be obtained from the disposition vis-a-vis [sic] any appraisals of the property."[88] As mentioned previously, the choice regarding a future plan of reorganization is independent of the present choice of whether to sell an asset. If it is efficient to sell the asset now, then by definition it would be less beneficial to wait and dispose of it in a wasteful reorganization. The proceeds to be obtained are directly covered by the V_{Sale} and constitute the dominant positive factor in the framework.

[87] Id.

[88] Id.

Finally, the most significant *Lionel* factor, "whether the asset is increasing or decreasing in value,"[89] sits at the center of the efficient sale framework. An asset increasing in value will have a higher value in the future, so if it is liquidated down the road either through Chapter 7 or reorganization, it will yield a higher return than if it was sold in a Section 363(b) sale. Assuming that the rate of increase in value exceeds the relevant discount rate, the present expected value of the asset will be higher under the reorganization pathway than the Section 363(b) sale. This higher value then serves as the dominant factor driving up the right-hand side of the efficient sale equation. Numerically, this will often dominate the cost factors on the left side, and an asset increasing in value should therefore rarely be sold in a Section 363(b) sale.

Conversely, an asset whose value is rapidly decreasing will have a present sale value that is much higher than a future value under the reorganization pathway. Once the future value on the right side is discounted to present value, it becomes obvious that the left side current sale value dominates the equation, making a Section 363(b) sale the optimal decision. If the value of the asset is dropping, time is of the essence, and a speedy Section 363(b) sale is far preferable to a lengthy reorganization.

Finally, an asset whose value is constant represents a much closer case, and the valuation will likely not be the dominant factor in the decision. Such an asset will have an expected liquidation present value slightly lower than the current sale value, but only because of the discount rate. This difference may not be significant enough to overcome the influences of other factors, so it is unlikely to be the most salient factor in determining whether or not a sale is optimal.

Judge Winter's dissent in the *Lionel* decision also serves to illustrate the importance of the efficient sale framework. The *Lionel* court denied the Section 363(b) sale, and if this was indeed an efficient result, the framework indicates that the factors disfavoring a sale in the efficient sale equation must have exceeded the factors favoring a sale. From the importance placed on factor seven, it appears that the dominant consideration in this case was the fact that the stock held by Lionel was not a wasting asset and instead was

[89] Id.

increasing in value.[90] As Judge Winter points out in dissent, however, Lionel had attempted and failed to locate a buyer willing to purchase the stock in a reorganization plan.[91] This factual distinction undercuts the court's decision significantly because it indicates that while the majority considered the value increase, it did not place sufficient emphasis on the lack of a willing buyer.

The efficient sale framework, however, would consider the presence or absence of a buyer without reference to the increasing or decreasing value of the asset over time. Instead of merging the inquiries, the efficient sale framework separates the inherent price fluctuation of the asset from the likelihood that the asset will be disposed of in any particular way after the choice not to sell has been made. Recall as well that this choice of disposition is not asset-specific but is a firm-wide choice. If there is no willing buyer under a reorganization plan, the probability that the asset would be sold through reorganization will be lower. Hence, a high asset value under a reorganization sale will be less significant because it represents a scenario with reduced probability and reduced expected value. Where the probability of a reorganization sale decreases, the probability of either a Chapter 7 liquidation sale or retention of the asset in a Chapter 11 reorganization must increase accordingly. Where the reorganization sale offered a higher asset value than either of these two options, the reduced expected value of the reorganization sale lowers the right-hand side of the equation, making the sale more likely to be efficient.[92] Additionally, costs of reorganization voting and hold-up—factors favoring a Section 363(b) sale—may further drive up the left-hand side and indicate the sale's efficiency.[93] While the factual distinction was appar-

[90] See id. at 1071–72.

[91] Id. at 1072 (Winter, J., dissenting).

[92] For example, if there initially was a 25% chance of a reorganization sale yielding \$50 million, a 50% chance of Chapter 7 liquidation sale yielding \$40 million, and a 25% chance of retaining the asset in a reorganization yielding \$45 million, the expected value is \$43.75 million. Where there is no willing buyer under a reorganization sale, the likelihood of such a sale goes down, so perhaps it will drop to 10%. The other probabilities must increase. If they do so in the same proportion relative to each other, then a liquidation sale has a 60% probability and the reorganization retention now has a 30% probability. The expected value has decreased to \$42.5 million.

[93] Judge Winter addresses the hold-up possibility as follows: "This . . . pleases the equity holders who, having introduced no evidence demonstrating a disadvantage to the bankrupt estate from the sale of the Dale stock, are now given a veto over it to be

ently sufficient to drive Judge Winter to dissent, the efficient sale framework does not offer conclusive evidence that the majority's decision was in fact incorrect. More specifically, the majority may have indeed reached the correct result, but the multi-factor test that guided their decision did not address the nuance that a reorganization sale may not have actually been likely, a factor that the efficient sale framework finds important. In light of the efficient sale framework, future courts may consider the factual context more carefully and should not be influenced excessively by the potential value of a low-probability future event.

In a descriptive sense, the efficient sale framework appears consistent with the judicial results in both *White Motor* and *Lionel*, but shows that these opinions may not have fully articulated the reasons behind the courts' disapproval of the sales. Specifically, agency costs are critical, yet the courts have not addressed these head-on, nor have they conducted an in-depth analysis of what they consist of and how prevalent they may be. Further, the impact of the choice not to sell an asset must be fully understood and considered in verifying and approving an asset sale. The efficient sale framework normatively urges more careful consideration of the impact of all options other than Section 363(b) sales and, most importantly, agency costs.

B. The Framework's Application to Contemporary Scholarship

While many practitioners have addressed Section 363(b) sales in law review articles and other treatises, few scholars have discussed them in depth, and a majority of the detailed articles have consisted of far more summary than critique.[94] This Section addresses one of the best normative arguments from the limited scholarship

used as leverage in negotiating a better deal for themselves in a reorganization." *Lionel*, 722 F.2d at 1072 (Winter, J., dissenting). He recognized the price similarity by noting that "the Dale stock can be sold now at or near the same price as it can be sold later." Id.

[94] See, e.g., Bodoh et al., supra note 55; C.R. Bowles & John Egan, The Sale of the Century or a Fraud on Creditors?: The Fiduciary Duty of Trustees and Debtors in Possession Relating to the "Sale" of a Debtor's Assets in Bankruptcy, 28 U. Mem. L. Rev. 781 (1998); John J. Hurley, Chapter 11 Alternative: Section 363 Sale of all of the Debtor's Assets Outside a Plan of Reorganization, 58 Am. Bankr. L.J. 233 (1984); Philip A. Schovanec, Bankruptcy: The Sale of Property Under Section 363: The Validity of Sales Conducted Without Proper Notice, 46 Okla. L. Rev. 489 (1993).

in this area and tests its arguments against the implications of this Note's analysis.

In his article investigating the nature of Chapter 11 voting rules in comparison to state-law corporate voting rules, Professor David Skeel devotes twelve pages to an analysis of decisionmaking incentives in Section 363(b) sales.[95] While he recognizes that the post-*Lionel* business justification standard essentially requires enhanced scrutiny by the courts, Professor Skeel also presents an argument that the courts are not the most effective decisionmakers in the context of Section 363(b) sales.[96] Enhanced judicial scrutiny serves to minimize the effect of improper management decisionmaking incentives, but it introduces an entirely new layer of difficulty:

> Unfortunately, judges have even worse decisionmaking incentives than managers: because judges have no financial interest in the enterprise and are immune from the market forces that constrain the agency costs of decisionmaking by managers, they are much less suited to play the role of final arbiter with respect to a crucial business decision than to perform traditionally judicial functions, such as policing misbehavior.[97]

In noting these problems with judicial scrutiny, Professor Skeel argues instead that such a decision "should be decided by a vote, rather than by a judge."[98] Hence the cynical perspective on preconfirmation sales—that they are merely an opportunity for management misbehavior—does indeed lend itself to judicial inquiry, but when Section 363(b) sales are preferred by all interested parties, it may no longer be efficient for the judge to make the inquiry.

Accordingly, Professor Skeel argues for a vote instead of judicial scrutiny, and, indeed, if all parties to the reorganization voted, that would achieve a result consistent with contractual obligations under reorganization. However, the costs of voting absent cramdown, a mechanism for approving a reorganization plan without approval of all classes of creditors,[99] would probably limit the debtor's ability

[95] David Arthur Skeel, Jr., The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, 78 Va. L. Rev. 461, 494–505 (1992).
[96] Id. at 496–98.
[97] Id. at 497.
[98] Id. at 498.
[99] See 11 U.S.C. § 1129(b) (2000) (amended 2005); see also supra note 16.

to effectively sell assets.[100] Instead, the vote should be limited to the "class of creditors who are identified as the true residual owners of the firm."[101] The best class, according to Professor Skeel, is the class of unsecured creditors, because they will typically be the firm's residual owners—if anyone gets an ownership stake down the road, it will be them—and these creditors will typically have the most appropriate incentives to approve an asset sale if and only if it is beneficial to the firm as a whole.[102] The opportunity for strategic behavior by the unsecured creditors would be limited by their inability to propose Section 363(b) sales—that duty remains with the debtor-in-possession management.[103] Additionally, the cost of voting for a single classification (just the unsecured creditors) is significantly less than the cost of a multi-class vote.[104]

The efficient sale framework offers insight into the practicality and benefits of Professor Skeel's proposal. In the terms of the framework, the enhanced judicial scrutiny that Professor Skeel sees as problematic increases the court costs under Section 363(b), which increases the overall costs of a Section 363(b) sale, thereby favoring reorganization and driving up the likelihood that a sale will be inefficient. Likewise, if judges indeed have "worse decisionmaking incentives than managers" in some areas, as Skeel argues,[105] this leads to an increase in agency costs, which also drives up the likelihood that a sale will be inefficient.

In order to remedy the increase in costs cutting against the approval of Section 363(b) sales, Professor Skeel's proposal calls for a reduction in these court costs and a reduction in agency costs, all accomplished through the addition of a limited voting cost. If one adds a voting cost that gives a more faithful agency response than a management-driven decision, agency costs will decrease. Likewise, if this is done in a manner not requiring extensive haggling in a hearing before the bankruptcy court, court costs will be reduced.

[100] Skeel, supra note 95, at 499.

[101] Id. at 500.

[102] Id. at 500–01.

[103] See id. at 501 n.149.

[104] Cf. id. at 501 n.150 (describing the costs of conducting a vote as opposed to merely providing notice and a hearing). Although a vote would be more expensive than notice and a hearing, a single-class vote would be less costly than a multi-class vote.

[105] Id. at 497.

To analyze this, start with a simplified version of the framework's right-hand side, a version that focuses on costs only, where "LHS" stands for the factors on the left-hand side of the equation favoring a Section 363(b) sale:

$$\text{(3)}\ \ \text{LHS} > \text{Constants} + (C_{\text{Sale}} + C_{\text{Court}} + C_{\text{Counsel}} + C_{\text{Agency}})$$

Skeel's proposal adds a voting cost, $C_{\text{Sale Voting}}$, to this right hand side, with the aim that it will reduce the C_{Court} and C_{Agency}. It will only be worth adding this cost if the decrease in the other costs is greater than the increased costs of adding voting procedures. Hence:

$$\text{(4)}\ \ C_{\text{Sale Voting}} < (C_{\text{Court Initial}} - C_{\text{Court Final}}) + (C_{\text{Agency Initial}} - C_{\text{Agency Final}})$$ [106]

As Professor Skeel addresses, the benefit of full voting would be the minimization of agency costs, but this would come at a potentially high cost, and the expense may not be worth the benefit. In terms of the efficient sale framework, full voting would achieve the perfect agency of a reorganization confirmation, but would involve all of the same costs. This would make the costs of a sale and the costs of reorganization equal, meaning that the only efficient sales would be those where the asset is increasing in value. Instead, a corporation should select a form of partial voting, the optimal level of which would achieve an acceptable reduction in agency costs at a minimal cost. This can be expressed by defining the following parameters:

$$\text{(5)}\ \ C_{\text{Agency Initial}} - C_{\text{Agency Final}} = \Delta C_{\text{Agency}}$$

$$\text{(6)}\ \ C_{\text{Sale Voting Full}} > C_{\text{Sale Voting Partial}}$$

The cost of full voting is only worth incurring if the marginal cost incurred in moving from partial to full voting is less than the savings accomplished by the corresponding decrease in agency costs:

[106] A numerical illustration of equation (4) may be helpful. A \$500 increase in the cost of voting would be worthwhile if it also caused court costs to drop from \$500 to \$100 and agency costs to drop from \$600 to \$200. \$500 < (\$500 – \$100) + (\$600 – \$200). \$500 < \$800. The implementation of voting garners a net savings of \$300.

(7) $C_{\text{Sale Voting Full}} - C_{\text{Sale Voting Partial}} < (\Delta C_{\text{Agency Full}} - \Delta C_{\text{Agency Partial}})$.[107]

Professor Skeel's normative solution is that having the limited classification of unsecured creditors vote on pre-confirmation sales reduces the agency costs and court costs while adding a minimal amount of voting cost to the equation. Therefore, the simplified framework now looks like:

(8) $\text{LHS} > \text{Constants} + (C_{\text{Sale}} + C_{\text{Court}} + C_{\text{Counsel}} + C_{\text{Agency}} + C_{\text{Sale Voting Partial}})$.

When equation (4), above, holds, equation (8) illustrates that Professor Skeel's proposal has reduced the cost factors favoring a reorganization, lowering the threshold for an efficient sale to occur. This fits with his thesis that sometimes Section 363(b) sales are in every party's best interests and should be encouraged. The reduction in agency costs through his voting solution helps eliminate the risk of management irresponsibility or capture. If, in accordance with his suggestion, management merely has the power to propose a sale that must be voted on by the unsecured creditors, the costs of agency are reduced, and there is less need for courts to provide a high level of scrutiny. Lowered court scrutiny then further increases the speed and efficiency with which a sale may be propagated.

The efficient sale framework corroborates Professor Skeel's argument that a decrease in court and agency costs leads to a more efficient system of Section 363(b) sales. While his argument that unsecured creditors are the most effective agents for these types of sales may be contested,[108] it is clear that the appropriate agency relationship must reduce costs more than it raises the costs of adjudicating a Section 363(b) sale. Hence, perfect agency at high cost

[107] A numerical illustration of equation (7) may be helpful. If full voting costs $1000 and partial voting costs $200, full voting will only be rational if the reduction in agency costs due to the voting change exceeds $800. Otherwise, partial voting will be the optimal choice.

[108] The voting scheme, even while it reduces the type of agency cost where secured creditors capture the debtor-in-possession, may actually increase the type of agency cost where unsecured creditors hold up an otherwise efficient sale. Empirical analysis of these agency-cost issues may reveal a more optimal solution.

may throw the baby out with the bathwater, destroying the efficiency of a Section 363(b) sale. Further research must be completed to determine the ideal mix of voting cost and benefits, but Professor Skeel's arguments, coupled with the efficient sale framework, serve to demonstrate that a minimalist voting procedure of some sort may improve the Section 363(b) sale landscape from the current enhanced scrutiny of the business justification standard.

CONCLUSION

Incorporating the efficient sale framework into the court's decisionmaking calculus adds a rule-like perspective to the analysis of Section 363(b) sales. Presently, the business justification standard consists of relatively high-cost, ex post judicial inquiry in a hearing, which, according to Professor Skeel, is not precisely tuned to recognize and correct agency problems. This judicial imprecision has been corroborated by this Note's investigation of both *Lionel* and *White Motor*, because the courts did not directly discuss the potential agency problems that likely drove most of their discomfort with the sales. In light of the difficulties of the present standard, and the higher frequency with which Section 363(b) sales occur in a modern bankruptcy, this Note has presented a rule-like calculus that both aids debtors in deciding whether to sell or retain an asset and aids courts in determining whether a sale should be approved. While the business justification standard was designed in part to avoid having the court "shackled with unnecessarily rigid rules,"[109] such rigid rules may have become beneficial now that the frequency of such sales has increased.

This inquiry began with two divergent stories about how Section 363(b) sales could be seen to operate. On one view, such sales offer immense benefits by increasing the recovery obtainable for certain assets. The contrary view focuses on the potential for agency problems that would make overuse of Section 363(b) sales abhorrent to the bankruptcy system as a whole. The efficient sale framework produced in this Note merges those two views into a binocular vision of the costs and benefits of Section 363(b) sales. Simply put, some sales are efficient and should be encouraged, while others should be barred from occurring; the efficient sale framework at-

[109] In re Lionel Corp., 722 F.2d 1063, 1069 (2d Cir. 1983).

tempts to add a rule-like structure to distinguish the two. Normatively, sales should only occur when the value created by the sale exceeds the value that would be created if reorganization were chosen. The benefits of a rapid sale, especially for an asset declining in value, are great. The risks of debtor mismanagement and improper agency, however, may be just as large. Bankruptcy law should seek to maximize the efficiency of the disposal of each and every asset, and therefore such sales should be encouraged whenever they can be accomplished efficiently.

This Note has argued that agency costs for Section 363(b) sales must be minimized, but in a way that does not add oversight costs that outweigh their benefits. Professor Skeel has suggested a rule-like voting methodology for minimizing both agency costs and court oversight. Separating the sale recommendation power from the sale approval power and granting these rights to management and unsecured creditors, respectively, help minimize the risk of some of the agency problems articulated in the limited scope of the framework. If the assumption of perfect distribution in light of absolute priority is further relaxed, more agency costs enter into the calculation. Professor Skeel's suggestions, then, would have an even larger impact and would help increase the likelihood of producing efficient sales by minimizing the effect of agency costs.

The purpose of this Note has been to push theoretical analysis of Section 363(b) sales in a more rigorous direction. Agency costs are a significant issue that have lurked in the background of many court decisions on Section 363(b) sales but have been discussed thoroughly by scholars only in the context of the operation of full-scale Chapter 11 reorganizations. The goal of this Note has been to contribute to further investigation and review into the precise nature of agency costs specific to a situation such as a Section 363(b) sale. At a minimum, it is clear that these costs must be minimized, but in order to accomplish this, it will be necessary to rigorously investigate their true operation and intricacies.