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The Latest Opinion On Asset Sales Under Section 363

Law360, New York (January 30, 2013, 6:11 PM ET) -- A recent opinion[1] by the United States Bankruptcy Court for the Eastern District of New York could have a significant impact on how parties negotiate damages provisions in asset purchase agreements in bankruptcy.

The Brown Publishing Company and its affiliates (the "debtors") filed Chapter 11 bankruptcy petitions on April 30, 2010. On May 4, 2010, the debtors filed a motion to sell substantially all of their assets in a transaction under Section 363 of the Bankruptcy Code, to Brown Media Corporation ("BMC") as the stalking horse bidder, subject to higher and better offers at an auction conducted pursuant to bidding procedures approved by the bankruptcy court (the "Brown sale procedures"). (Certain facts, which are interesting but ultimately irrelevant to this discussion, are omitted.)

The bankruptcy court's order approving the Brown sale procedures includes a provision that permits the debtors to retain the good faith deposit of the successful bidder at the auction, if the successful bidder ultimately fails to close the asset sale. Using its leverage as the stalking horse bidder, BMC was able to negotiate that it did not have to submit a good faith deposit. The bankruptcy court, however, later required BMC to do so because all other potential bidders were required to pay a deposit as part of the price of admission to the auction. BMC therefore made a good faith deposit of $765,000, or 5 percent of its proposed purchase price.

The following provision of the Brown sale procedures, allowing the debtors to retain the successful bidder's good faith deposit in the event such bidder fails to close the asset sale, should be familiar to bankruptcy practitioners through the United States:

… if the Successful Purchaser fails to close the Sale, the Successful Purchaser's Good Faith Deposit shall be retained by the Debtors on accounts (sic) of damages suffered by it (sic) as a result of such failure to close, without prejudice to the Debtors' ability to seek to recover additional damages from the Successful Purchaser.

Provisions nearly identical to the one quoted above are ubiquitous in bidding procedures. In the context of asset sales under Section 363 of the Bankruptcy Code, debtors customarily retain the good faith deposit of the winning bidder in the event that party breaches its obligation to close the transaction. Such provisions also commonly provide for a reservation of the debtor's right to seek additional damages. Further, these provisions ordinarily are found in the bidding procedures (to place all potential bidders on notice) and in the underlying asset purchase agreement (to bind the purchaser). Because bidding procedures are approved by, and delineated in, court orders, almost everyone labors under the belief that bidding procedures are enforceable. And, for the most part, in most cases, they are enforceable.

The Brown sale procedures also provide that, if the successful bidder at the auction fails to close the transaction, the debtors are authorized to sell the assets to the next highest bidder. This feature is also ubiquitous in bidding procedures.

BMC was the successful bidder at the auction and failed to close, in violation of its obligations under the asset purchase agreement. The debtors then closed the sale of the assets to the next-highest bidder at the auction and retained BMC's good faith deposit as damages (presumably as permitted under the bidding procedures). The debtor's retention of the deposit set the stage for BMC to file a demand for the return of its deposit, to which the Chapter 7 trustee (the debtors' case converted from Chapter 11 to Chapter 7 in the meantime) responded by suing BMC for breach of contract.

Question: If the Brown sale procedures expressly provide that the Debtors shall retain the deposit in the case of a breach by BMC, and if BMC breached by failing to close, what's the problem? Answer: This case involves an unusual (or at least rare) set of circumstances — as a result of subsequent negotiations, the back-up bidder paid more for the purchased assets than the amount of BMC's "winning" bid.

The bankruptcy court flatly rejected the trustee's argument that the estate is entitled to keep BMC's deposit as liquidated damages. Instead, the bankruptcy court reviewed some recent (and some not so recent) decisions on liquidated damages and determined that the rule permitting the nonbreaching party to retain a deposit cannot be applied without examining the contract at issue.

In contracts for the sale of real estate, where liquidated damages provisions are common and commonly enforced (for reasons that are specific to real estate, such as the uniqueness of property and remarketing costs), the bankruptcy court concluded that enforcing liquidated damages provisions is appropriate (unless there are circumstances that make it inappropriate). In the case of an auction of assets other than real estate, the bankruptcy court believed that the grounds for enforcing liquidated damages provisions are not apposite. On this score, the bankruptcy court wrote:

In the context of an auction sale, as in the case before this Court, parties participate knowing that they would be bound by their bids. There is generally a successful bidder and next successful bidder and the amount of their bids are known. While it is not often that the successful bidder fails to close, when this does occur, the next successful bidder is in place for closing to occur quickly without the need for further marketing of the assets and uncertainty on the part of the seller. Even rarer is a scenario where the ultimate purchase price from the next successful bidder would be greater than that of the original successful bid. Nevertheless, the difference between the original successful bid and the final purchase price is capable of a determination as to value whereas that may not be the case in a real estate transaction.

So, having found that liquidated damages provisions should not be blindly enforced, the bankruptcy court went on to consider the interplay between a liquidated damages provision and actual damages provision in the same agreement. Here, following the accepted view of recent decisions in other cases, the bankruptcy court decided that the presence of the actual damages provision (recall, the Brown sale procedures reserved the debtors' right to seek damages in addition to the amount of BMC's deposit, which the bankruptcy court said is tantamount to an actual damages clause) means the liquidated damages provision must be "read out" of the agreement.

Finally, the bankruptcy court considered whether the trustee could assert any actual damages from BMC's failure to close. Seeing as the ultimate purchase price realized by the debtors from the back-up bidder was greater than the amount BMC would have paid, the debtors did not suffer actual damages.

The bankruptcy court appears to have recognized the conundrum of its decision, and offers the following practical guidance for parties to follow in future asset sales under section 363 of the Bankruptcy Code:

… if sellers at a section 363 sale want to have a liquidated damages provision, they should be clear and up-front about such a provision and limit themselves only to the fixed amount or percentage of such damages without providing for the ability to also seek actual damages if the actual damages exceed the fixed amount or percentage. Potential bidders or buyers who participate in such sales knowing that the good faith deposit would be forfeited as liquidated damages should they, as the successful bidder or purchaser, fail to close would expect to be bound by the terms of the sale and/or contract.

While this guidance provides some (cold) comfort to lawyers and their clients, the enforceability of these types of provisions is, and will probably remain, fluid for the foreseeable future. Anyone selling or participating in an asset sale under Section 363 of the Bankruptcy Code would be wise to understand and consider the impact of this latest opinion on the subject.

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[1] The Brown Publishing Co., Liquidating Trustee v. Brown Media Corp., Adversary Proceeding No. 12-8215 (Eisenberg, J.) (Jan. 22, 2013)