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IS A "SOUND BUSINESS PURPOSE" ALWAYS ENOUGH?

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Chapter 11 of the Bankruptcy Code trusts a debtor in possession to operate its business. In general, a debtor in possession "is free to use, sell[,] or lease property of the . . . estate in the operation of the debtor's business."[1] This discretion is "at the heart" of the powers of a debtor in possession,[2] and courts are reluctant "to interfere, or to permit other parties in interest to interfere, in the making of routine, day-to-day business decisions."[3] Therefore, a court will not disturb a transaction if

1. the transaction is in the ordinary course of business and
2. the debtor in possession articulates a business purpose for the transaction.[4]

Not all transactions are in the ordinary course or free from scrutiny, however.

The "Sound Business Purpose" Standard

Section 363(b)(1) of the Bankruptcy Code permits a debtor in possession, "after notice and a hearing, [to] use, sell, or lease . . . property of the estate" outside "the ordinary course of business."[5] Section 363(b)(1) does not empower a debtor in possession:[6] Section 363(b)(1)

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1 First Fid. Bank, N.A. v. Jason Realty, L.P. (In re Jason Realty, L.P.), 59 F.3d 423, 426 (3d Cir. 1995).

2 In re DeLuca Distrib. Co., 38 B.R. 588, 592 (Bankr. N.D. Ohio 1984).

3 7 COLLIER ON BANKRUPTCY ¶ 1108.07[1] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. rev. 2009) (citing Cent. States Se. & Sw. Areas Health & Welfare & Pension Funds v. Columbia Motor Express, Inc. (In re Columbia Motor Express, Inc.), 33 B.R. 389, 393 (M.D. Tenn. 1983)).

4 See In re Nellson Nutraceutical, Inc., 369 B.R. 787, 797 (Bankr. D. Del. 2007) ("[I]f the Court determines that a transaction is in the ordinary course of a debtor's business, the Court will not entertain an objection to the transaction, provided that the conduct involves a business judgment made in good faith[,] upon a reasonable basis[,] and within the scope of authority under the Bankruptcy Code. Put another way, the Court will not disturb a transaction within the ordinary course of business if 'the trustee can articulate reasons for his conduct (as distinct from a decision made arbitrarily or capriciously).'" (quoting In re Curlew Valley Assocs., 14 B.R. 506, 513, 513 n.11a (Bankr. D. Utah 1981)) (citation omitted)).

5 11 U.S.C. § 363(b)(1).

limits its power. Section 363(b)(1) requires "notice and a hearing,"[7] but not approval of a court,[8] before a debtor in possession transacts outside the ordinary course. That is, Section 363(b)(1), which does not contain a standard by which a court could evaluate a transaction,[9] simply ensures that parties in interest receive due process.[10]

That said, courts, including U.S. Courts of Appeals, have inferred such a standard from the Bankruptcy Code.[11] The standard is "flexible":[12] in evaluating a transaction, a court has "considerable,"[13] though not unfettered,[14] discretion. Under the standard, a court should approve a transaction only if

1. the debtor in possession articulates a "sound business purpose" for the transaction and

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6 See Calvert v. Bongards Creameries (In re Schauer), 835 F.2d 1222, 1225 (8th Cir. 1987) (describing 11 U.S.C. §§ 363(b)(1) and 704 as "enabling statutes that give the trustee the authority to sell or dispose of property if the debtors would have had the same right under state law").

7 Section 102(1) of the Bankruptcy Code defines "notice and a hearing."

8 See 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 [11 U.S.C. §] 363, [FED. R. BANKR. P.] 2002, and [FED. R. BANKR. P.] 6004 does not require court approval. . . . Pursuant to [11 U.S.C. §] 102(1), absent a request for a hearing[,] [a] sale will take place without court order." (citation omitted)).

9 See Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063, 1069 (2d Cir. 1983) ("[11 U.S.C. § 363(b)] seems on its face to confer upon the bankruptcy judge virtually unfettered discretion to authorize the use, sale[,] or lease, other than in the ordinary course of business, of property of the estate.").

10 See Marcus Hook Dev. Park, Inc. v. T.A. Title Ins. Co. (In re Marcus Hook Dev. Park, Inc.), 143 B.R. 648, 660 (Bankr. W.D. Pa. 1992) ("The obvious purpose of th[e] mandatory prior notice [that 11 U.S.C. § 363(b)(1) requires] is to satisfy constitutional requirements where one's interest in property will be adversely affected as a result of judicial action.").

11 See, e.g., Institutional Creditors of Cont'l Air Lines, Inc. v. Cont'l Air Lines, Inc. (In re Cont'l Air Lines, Inc.), 780 F.2d 1223, 1226 (5th Cir. 1986) (stating that "the . . . requirement of justifying a proposed transaction" is "implicit in [11 U.S.C.] § 363(b)").

12 ASARCO, Inc. v. Elliot Mgmt. (In re ASARCO, L.L.C.), 650 F.3d 593, 601 (5th Cir. 2011).

13 Dai-Ichi Kangyo Bank, Ltd. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.), 242 B.R. 147, 152-53 (D. Del. 1999).

14 See In re Lionel Corp., 722 F.2d at 1071 ("As we shall see, the new Bankruptcy Code no longer requires such strict limitations on a bankruptcy judge's authority to order disposition of the estate's property; nevertheless, it does not go so far as to eliminate all constraints on that judge's discretion.").

2. that purpose justifies the transaction.[15]

In general, the purpose of a transaction is to benefit the estate,[16] but a court does not assume that every transaction does so;[17] instead, a debtor in possession must show that its transaction would benefit the estate.[18] Then, in determining whether the shown benefits of a transaction justify it, a court, after considering all relevant facts,[19] must find that

1. the consideration that the estate would receive is "fair and reasonable" and
2. the counterparty is proceeding in good faith.[20]

If a court finds that a "sound business purpose" justifies a transaction and "notice and a hearing" was provided to parties in interest, then the court should defer to the business judgment of the debtor in possession[21] and approve the transaction.

A New Standard?

Courts have applied this standard for decades.

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[15] In re Montgomery Ward Holding Corp., 242 B.R. at 153.

[16] See In re Trans World Airlines, Inc., 2001 WL 1820326, at *11 (Bankr. D. Del. Apr. 2, 2001) ("[A] sale under [11 U.S.C.] 363(b) is intended to benefit the estate by minimizing loss of value to the estate.").

[17] See In re MF Global Inc., 467 B.R. 726, 730 (Bankr. S.D.N.Y. 2012) ("**If** a valid business justification exists, **then** a strong presumption follows that the agreement," or transaction, "was negotiated in good faith and is in the best interests of the estate . . . ." (emphasis added)).

[18] See In re Montgomery Ward Holding Corp., 242 B.R. 147, 155 (D. Del. 1999) ("As this Court . . . ha[s] recognized, the debtor [in possession] carries the burden of demonstrating that a use, sale[,] or lease will assist the debtor's reorganization . . . .").

[19] See In re Lionel Corp., 722 F.2d at 1071 ("In fashioning its findings [that a sound business reason for a transaction], a bankruptcy judge . . . should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors[,] and equity holders, alike.").

[20] See In re Del. & Hudson Ry. Co., 124 B.R. 169, 176 (D. Del. 1991) ("Once a court is satisfied that there is a sound business reason or an emergency justifying [a] pre-confirmation sale, the court must also determine that the trustee has provided the interested parties with adequate and reasonable notice, that the sale price is fair and reasonable, and that the purchaser is proceeding in good faith.").

[21] See Myers v. Martin (In re Martin), 91 F.3d 389, 395 (3d Cir. 1996) ("Indeed, under normal circumstances, the court would defer to the trustee's judgment so long as there is a legitimate business justification." (citing Fulton State Bank v. Schipper (In re Schipper), 933 F.2d 513, 515 (7th Cir. 1991))).

But in 2005, Congress amended the Bankruptcy Code by adding Section 503(c)(3),[22] which provides:

> **(c)** Notwithstanding [Section 503(b)], there shall neither be allowed, nor paid—
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> **(3)** other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition.[23]

Like Section 363(b)(1), Section 503(c)(3) limits the power of a debtor in possession; however, unlike Section 363(b)(1), Section 503(c)(3) contains a standard by which a court could evaluate a transaction. Section 503(c)(3) prohibits a transaction if it is

1. "outside the ordinary course of business" and
2. "not justified by the facts and circumstances of the case."[24]

This raises an interesting question: does this new standard differ from the one that courts inferred from the Bankruptcy Code?

Conflicts Between the Courts

Simply put, courts disagree on the answer.

Some courts, including the U.S. Bankruptcy Court for the Southern District of New York, have held that Section 503(c)(3) codifies the old standard.[25] In In re Dana Corp.,[26] Judge Lifland

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22 See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 331, 119 Stat. 23, 102 (2005) (adding subsection (c) to 11 U.S.C. § 503).

23 11 U.S.C. § 503(b)(3).

24 11 U.S.C. § 503(c)(3).

approved two transactions under Section 503(c)(3) because the debtors in possession "presented him with uncon[tro]verted evidence that" the transactions were

1. "fair and reasonable" and

2. "well within the[] business judgment [of the debtors in possession]."[27]

Then, in In re Dewey & LeBoeuf LLP,[28] Judge Glenn, citing In re Dana Corp., explained that "[t]he requirement that a transaction be 'justified by the facts and circumstances of the case" is the same as the business judgment standard under [S]ection 363(b)."[29] At least one other court has joined Judges Lifland and Glenn: in In re Patriot Coal Corp.,[30] the U.S. Bankruptcy Court for the Eastern District of Missouri, also citing In re Dana Corp., stated:

> Any transfer made outside the ordinary course of business for the benefit of officers, managers[,] or consultants hired after the date of the filing of the petition must be justified by the facts and circumstances of the case, which ordinarily means that the business judgment standard of Section 363(b) applies.[31]

As Judge Glenn often writes: "[c]ourts have held that the 'facts and circumstances' language of [S]ection 503(c)(3) creates a standard no different than the business judgment standard under [S]ection 363(b)."[32]

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[25] See In re Borders Grp., Inc., 453 B.R. 459, 473-74 (Bankr. S.D.N.Y. 2011) ("Courts have held that the 'facts and circumstances' language of [11 U.S.C. §] 503(c)(3) creates a standard no different than the business judgment standard under [11 U.S.C. §] 363(b).").

[26] 358 B.R. 667 (Bankr. S.D.N.Y. 2006).

[27] Id. at 584.

[28] 2012 WL 3065275 (Bankr. S.D.N.Y. July 30, 2012).

[29] Id. at *4.

[30] 492 B.R. 518 (Bankr. E.D. Mo. 2013).

[31] Id. at 530-31.

[32] E.g., In re Borders Grp., Inc., 453 B.R. at 473-74.

But other courts, including the U.S. Bankruptcy Court for the Northern District of Texas, have held otherwise.[33] In In re Pilgrim's Pride Corp.,[34] Judge Lynn held that Section 503(c)(3) does more than simply codify the old standard.[35] She read Section 503(c)(3) as imposing a tougher standard because

1. "read[ing] [S]ection 503(c)(3) as requiring nothing not already required by [S]ection 363(b)(1) would violate th[e] principle of construction" that "Congress is presumed to intend that independent sections of the [Bankruptcy] Code will have independent, differing impacts" and

2. "Congress intended . . . court[s] to play a more critical role in assessing transactions . . . that fall within the ambit of [S]ection 503(c)(3)."[36]

The U.S. District Court for the District of New Hampshire, the only appellate court to construe Section 503(c)(3), has agreed with Judge Lynn.[37] In GT Advanced Techs. Inc. v. Harrington,[38] Judge McCafferty, citing In re Pilgrim's Pride Corp., held that Section 503(c)(3) "directs courts to give more scrutiny to the business judgment of debtors than is permitted under the . . . business judgment test [under Section 363(b)(1)]."[39] In short, courts have held that Section 503(c)(3) imposes a more demanding standard than the one that courts have applied for decades.

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33 See, e.g., In re Pilgrim's Pride Corp., 401 B.R. 229, 236 (Bankr. N.D. Tex. 2009) ("The court agrees with the conclusion reached in this latter group of cases that the test of [11 U.S.C. §] 503(c)(3) should not be equated to the business judgment rule as applied under [11 U.S.C. §] 363(b)(1).").

34 401 B.R. 229 (Bankr. N.D. Tex. 2009).

35 See Id. at 236 ("The court agrees . . . that the test of [11 U.S.C. §] 503(c)(3) should not be equated to the business judgment rule as applied under [11 U.S.C. §] 363(b)(1).").

36 Id. at 236-37.

37 See GT Advanced Techs. Inc. v. Harrington, 2015 WL 4459502, at *7 (D.N.H. July 21, 2015) ("This court is persuaded by [In re Pilgrim's Pride Corp., 401 B.R. 229] that 11 U.S.C. § 503(c)(3) directs courts to give more scrutiny to the business judgment of debtors than is permitted under the . . . business judgment test [of 11 U.S.C. § 363(b)(1)].").

38 2015 WL 4459502 (D.N.H. July 21, 2015).

39 Id. at *7.

Finally, the U.S. Bankruptcy Court for the District of Delaware has joined both sides. Judge Walrath has ruled that Section 503(c)(3) simply reiterates the standard that courts applied before Congress added the provision to the Bankruptcy Code:

> [Section 503](c)(3) was meant to provide a standard, albeit not as clear, for any other transfers or obligations outside the ordinary course of business.
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> I agree that the including transfers made to officers, managers[,] or consultants hired after the petition date is not exclusive. That's clear from other provisions in the Bankruptcy Code.
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> So I do read [Section 503](c)(3) to be the catch-all and the standard under [Section 503](c)(3) for any transfers or obligations made outside the ordinary course of business are those that are justified by the facts and circumstances of the case. Nothing more – no further guidance being provided to the Court by Congress, I find it quite frankly nothing more than a reiteration of the standard under [Section] 363 and – well, [Section] 363 under which courts had previously authorized transfers outside the ordinary course of business and[,] that is, based on the business judgment of the debtor, the court always considered the facts and circumstances of the case to determine whether it was justified. And I'll do the same in this case.[40]

In contrast, Judge Carey has construed Section 503(c)(3) as requiring "something" more than would otherwise be required:

> Well, [Section 503(c)(3)] says something different and I've – I will say [that] I've interpreted it to mean something above the business judgment standard but maybe not much farther above it. I mean, I don't know how else to describe it.
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> And I guess someday if I get a chance to write on it or read the wisdom of others on the topic, you know, I may form

[40] Hr'g Tr. at 86:11-87:4, In re Nobex Corp., Case No. 05-20050 (CSS) (Bankr. D. Del. Jan. 30, 2006), ECF No. 194.

> a firmer view in my mind about precisely what it means. But you know, that language was used and that's what Congress chose.[41]

Judges Shannon[42] and Sontchi[43] have avoided the fray. Thus, in Delaware, as well as elsewhere, what Section 503(c)(3) requires is unclear.

Conclusion

In sum:

1. Courts disagree on whether Section 503(c)(3) simply reiterates the standard that courts applied before Congress added Section 503(c)(3) to the Bankruptcy Code.

2. The U.S. Bankruptcy Court for the District of Delaware has not decided whether the standards are identical, and two judges have expressed conflicting views in oral rulings.

3. In the future, a "sound business purpose" could be insufficient to justify a transaction if Section 503(c)(3) controls.

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41 Hr'g Tr. at 40:20-41:2, In re Dura Auto. Sys., Inc., Case No. 06-11202 (KJC) (Bankr. D. Del. Apr. 25, 2007), ECF No. 1170.

42 See Hr'g Tr. at 114:9-14, In re Longview Power, LLC, Case No. 13-12211 (BLS) (Bankr. D. Del. Dec. 18, 2013), ECF No. 684 ("So the one question that remains is what is the appropriate standard? And I, I think that there is no answer in this jurisdiction, at least in terms of, of a published decision, and it will remain that way. I've said [that] I've previously ducked this question, and I'm ducking it today.").

43 See In re Foothills Tex., Inc., 408 B.R. 573, 579 n. 25 (Bankr. D. Del. 2009) ("[11 U.S.C. § 503(c)] provides that the standard under [11 U.S.C. §] 503(c)(3) governing a payment that . . . is made to managers and consultants, who are not necessarily insiders, is different on its face from that which applies to payments made to directors and control persons, who are insiders. The former must be 'justified by the facts and circumstances of the case' while the latter must satisfy the business judgment test under [11 U.S.C. §] 363 (provided [11 U.S.C. §§] 503(c)(1) and (2) are not applicable). Whether there is any substantive difference between the two standards and, if so, what constitutes 'justified by the facts and circumstances of the case' is an issue for another day.").