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Chip Away at the Stone: The Validity of Pre-Bankruptcy Clauses Contracting Around Section 363 of the Bankruptcy Code

ABOUT THE AUTHOR: Matthew P. Goren earned his J.D. from New York Law School in 2006. The author would like to thank Professor Karen Gross for her patience, guidance, and confidence. The author would also like to thank his parents who remind him that "Education is not preparation for life; education is life itself." John Dewey (1859–1952).

Capitalism without Bankruptcy is like Christianity without Hell.[1]

If pornography is the unavoidable byproduct of a society permitting freedom of speech, then bankruptcy is the unavoidable byproduct of a market economy.[2] Bankruptcy is the darker side of the American dream, the side no one wishes to talk about or experience for themselves. For this reason, there will always be a stigma attached to bankruptcy,[3] an inherent shame, and perhaps a sense of failure.[4] But like it or not, bankruptcy is a "necessary evil."[5]

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1. Frank Borman, Chairman of Eastern Airlines 1976–1986; *see* Alexander L. Taylor III, *The Growing Bankruptcy Brigade*, TIME, Oct. 18, 1982, at 90.

2. *See, e.g.,* Bruce G. Carruthers & Terence C. Halliday, *Professionals in Systematic Reform of Bankruptcy Law: The 1978 U.S. Bankruptcy Code and the English Insolvency Act 1986*, 74 AM. BANKR. L.J. 35, 35 (2000) ("The transitional economies adopt bankruptcy law as part of a larger set of institutional reforms needed to transform a command economy into a market economy."); Julia M. Metzger & Samuel L. Bufford, *Exporting United States Bankruptcy Law: The Hungarian Experience*, 21 CAL. BANKR. J. 153, 159 (1993) ("As Hungary and other Eastern European countries are making the transition to a market economy, they are finding that both bankruptcy liquidation and reorganization are important parts of the economic and legal structure that is necessary to make such a system work effectively."); Mark E. Monfort, *Reform of the State-Owner Enterprise and the Bankruptcy Law in the People's Republic of China*, 22 OKLA. CITY U.L. REV. 1067, 1078 (1997) ("Not only does the passage of the Bankruptcy Law appear to have an historical basis to support its passage, but it reflected a recognition that a bankruptcy law is an efficient mechanism employed by a market economy to deal with business failure."); Hope W. Olsson, *The RTC Intrusion into Bankruptcy: A Crisis Solution at the Expense of Equity?*, 42 BUFF. L. REV. 893, 914 (1994) ("Bankruptcy is a proven framework within which the economy deals equitably and predictably with financial crises of individual entities, and Chapter 11 is a powerful tool for the orderly reorganization of businesses experiencing financial difficulties.").

3. The Bankruptcy Code expressly recognizes the fact that a bankruptcy filing is accompanied by some sort of stigma. For example, under the former Bankruptcy Act, the debtor was labeled a "bankrupt," but that was changed to "debtor" to soften the stigma attached. ALAN N. RESNICK, BANKRUPTCY LAW MANUAL § 2:5 & n.3 (5th ed. 2005). Furthermore, if there was no stigma attached, there would be no need for section 525, which protects debtors against discriminatory treatment. 11 U.S.C. § 525 (2000).

4. Many in government today, however, do not believe this to be the case, but rather believe that bankruptcy has lost any stigma it once had. For example, Senator Charles E. Grassley (R-IA) recently sent out a press release that stated: "It's time to promote responsible borrowing while also ensuring the safety net offered by bankruptcy. It was not intended to be a convenient financial planning tool where deadbeats get out of paying their debt scott-free [sic] while honest Americans who play by the rules have to foot the bill." Press Release, Senator Charles E. Grassley, Grassley Renews Effort to Reform Bankruptcy Code (Feb. 2, 2005) [hereinafter Grassley Press Release] (on file with author). Such a statement clearly demonstrates a lack of a belief that a bankruptcy filing carries any significant stigma as a deterrent to abusive filing. Acting on his belief, on February 1, 2005, Senator Grassley introduced S. 256, the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005." This act attempts to remedy what some believe to be widespread filing abuse by instituting a "means test" and creditor counselling. *See* S. 256, 109th Cong. (2005). For an in-depth look on how the new legislation, which was signed into law by President George W. Bush on April 20, 2005, affects the existing Bankruptcy Code, see Robin Jeweler, *The "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," S. 256, in the 109th Congress*, Congressional Research Serv. Rep. RL32765 (Feb. 9, 2005). *See also* John E. Matejkovic & Keith Rucinski, *Bankruptcy "Reform": The 21st Century's Debtors' Prison*, 12 AM. BANKR. INST. L. REV. 473, 497 n.89 (2004) (citing Michelle Cottle, *The Right to Default: When Did Bankruptcy Become an Accepted Fixture of Everyday Life?*, WASH. MONTHLY, Mar. 1997, at 14, 16 ("No longer is filing bankruptcy tantamount to sewing a scarlet 'B' on all your clothing.")); Matejkovic & Rucinski, *supra*, at 497 n.90 (citing Alan Greenspan, Chairman of the Federal Reserve Bank, as stating that consumer bankruptcies are "soaring because Americans have lost their sense of shame").

Over the past decade, the bankruptcy filing rate has more than doubled; in 2004 alone there were approximately 1.6 million filings.[6] Some view this sharp increase as a clear sign of widespread bankruptcy filing abuse,[7] while others see it as a combination of factors, including consumer credit issues, job loss, and medical expenses.[8] No matter the origin, however, this increase has caused creditors to seek out new and creative ways to protect themselves and their collateral.[9]

While it is natural in bankruptcy to focus on the post-petition relationship of debtors and creditors, bankruptcy issues loom in the background of every drafted agreement.[10] The increasing complexity of contracts and the rise in bankruptcy petition filings have caused creditors to become increasingly proactive in their contracts, including clauses that attempt to contract around the Bankruptcy Code in an effort to better protect their positions in the event of a bankruptcy.[11] While courts generally favor out-of-court settlements,[12] it does not necessarily follow that they favor pre-petition agreements to waive bankruptcy protections that bind third parties. Some courts have already had occasion to rule on the validity and enforceability of some of these pre-bankruptcy contractual provisions, such as

5. *See, e.g.,* Chai Rachel Feldblum, *The Art of Legislative Lawyering and the Six Circles Theory of Advocacy*, 34 McGEORGE L. REV. 785, 804 (2003).

6. *See, e.g.,* Terry Savage, *Pass Bankruptcy Bill, But Remember Debtors*, CHI. SUN-TIMES, Mar. 21, 2005, at 71.

7. *See* Grassley Press Release, *supra* note 4.

8. A number of groups have spoken out in protest against the new legislation. Specifically, a group of 120 bankruptcy and consumer law professors joined together to write a letter to Senators Arlen Specter (R-PA) and Patrick Leahy (D-VT) to protest the proposed legislation. The professors claimed that "[t]he bankruptcy filing rate is a symptom. It is not the disease. Some people do abuse the bankruptcy system, but the overwhelming majority of people in bankruptcy are in financial distress as a result of job loss, medical expense, divorce, or a combination of those causes." Letter from Professors of Bankruptcy and Commercial Law, to Senators Arlene Specter and Patrick Leahy (Feb. 16, 2005) (on file with author) (citing TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT (2001); Marianne Culhane & Michaela White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing for Chapter 7 Debtors,* 7 AM. BANKR. INST. L. REV. 27, 28 n.8 (1999)).

9. *See* Jeffrey W. Warren & Wendy V.E. England, *Pre-petition Waiver of the Automatic Stay is Not Per Se Enforceable*, AM. BANKR. INST. J., Mar. 1994, at 22, 22 ("Practically every loan modification or business workout agreement drafted today contains a series of boilerplate 'bankruptcy waiver' provisions.").

10. *See* David S. Kupetz, *The Bankruptcy Code is Part of Every Contract: Minimizing the Impact of Chapter 11 on the Non-Debtor's Bargain*, 54 BUS. LAW. 55, 56 (1998) ("The Bankruptcy Code [ ] embodies the power to alter contractual rights and is itself part of every contract . . . contract drafters should consider including provisions that specify, to the extent permitted, how the parties' respective rights will be affected by the commencement of a Chapter 11 bankruptcy reorganization case.").

11. *See* Warren & England, *supra* note 9.

12. *See, e.g.,* L. Louis Mrachek & C. Craig Eller, *Agreements for Relief from the Automatic Stay: Part I*, FLA. B.J., Apr. 1995, at 48, 49 (citing *In re* Cheeks, 167 B.R. 817, 819 (Bankr. D.S.C. 1994) ("Perhaps the most compelling reason for enforcement of the forbearance agreement is to further the public policy in favor of encouraging out of court restructuring and settlements."); *see also infra* text accompanying notes 76–83.

subordination agreements[13] and automatic stay waivers.[14] These decisions, however, have led to circuit splits and ambiguity in the law.[15] With the enforceability of these clauses still in question, creditors will undoubtedly search for new and even more sophisticated language and new clauses to replace those deemed unenforceable.

An interesting context in which to view these issues is asset sales in Chapter 11 cases. As debtors sell assets outside the ordinary course of business to fund reorganization plans or obtain a quick shot of capital, section 363 of the United States Bankruptcy Code is playing a more prominent role in Chapter 11 cases. Certain provisions of the recently enacted Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[16] make it appear likely that this trend will continue, not only in reorganizations, but in liquidations as well.[17]

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13. *See In re* Amret, Inc., 174 B.R. 315 (Bankr. M.D. Ala. 1994) (holding that a pre-petition subordination agreement between the bank and subsidiary was enforceable with respect to post-petition loan agreement).

14. *See In re Cheeks*, 167 B.R. 817 (holding that a pre-petition waiver of the automatic stay of section 362 was valid and enforceable). *But see In re* Pease, 195 B.R. 431 (Bankr. D. Neb. 1996) (holding that pre-petition waivers of the automatic stay were per se invalid and unenforceable); *but see also infra* Part II and text accompanying notes 56–103.

15. *See, e.g., In re* Desai, 282 B.R 527 (Bankr. M.D. Ga. 2002); *In re* Club Tower, L.P., 138 B.R. 307 (Bankr. N.D. Ga. 1991). *But see In re* Fallon, 244 B.R. 589 (Bankr. E.D. Pa. 2000); *In re* Sky Group Int'l, Inc., 108 B.R. 86 (Bankr. W.D. Pa. 1989).

16. Pub. L. No. 109-8, 119 Stat. 23 (codified in scattered sections of 11 U.S.C.).

17. Anne Urda, *Auctions Point to a Changing Bankruptcy Market*, BANKR. LAW 360, Sept. 20, 2006 (on file with the New York Law School Law Review). See also Stevens & Lee, P.C., *How the New Bankruptcy Code will Accelerate the Trend to Conduct 363 Sales: Unsecured Creditors May be Left with Crumbs*, BANKR. CLIENT ALERT, Oct. 20, 2005, at 1, where the author posits that seven specific changes made to the Bankruptcy Code via the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 will lead to an increased utilization of section 363 to sell substantially all of an estate's assets rather than going through the more difficult journey of completing a successful reorganization. These seven factors include: (1) less time that management is in control of the process due to the new eighteen month limit on the debtor's exclusive right to file a plan; (2) a new administrative expense for the value of any goods received by the debtor within twenty days before the commencement of the case; (3) the expansion of the right to reclaim goods shipped while the buyer was insolvent, including increasing the reach-back period from ten to forty-five days and eliminating the ability to deny reclamation by granting an administrative expense or lien; (4) a new limit of 210 days on the debtor's deadline to assume or reject leases, with a damage claim for leases that are assumed and subsequently rejected capped at two-year's rent, but subject to administrative expense status; (5) the bolstering of the rights of utilities, including the requirement that adequate assurance of payment be a cash deposit, a letter of credit, a certificate of deposit, a surety bond, a prepayment of utility consumption or another form of agreed security; (6) the expansion of the grounds to convert the case to Chapter 7, dismiss the case, and appoint a Chapter 11 trustee or examiner; and (7) new limits on Key Management Retention Programs ("KERP"s) and severance packages.

KERPs were programs that provided for payments to be made to retain key employees of a reorganizing debtor firm. They provided attractive bonuses for qualified individuals who would forgo lucrative outside offers and be willing to stay with a struggling firm through the reorganization period. Due in a large part to public outcry over the sometimes staggering amounts involved in KERPs plans, BAPCA recently amended section 503 to outline specific procedures and limitations that an individual must sufficiently demonstrate before becoming eligible for a payment from a KERPs program. For an extensive review of

As it is relied upon more often by debtors, creditors are apt to turn their attention to section 363 and attempt to add contractual provisions addressing the use and sale of property in Chapter 11 bankruptcies.[18] For example, a creditor may seek to avoid the strictures of section 363 by contractual agreement that provides that in the event of a bankruptcy filing, where a decision is made to sell an asset to help fund a reorganization, the debtor would be required to sell selected assets that have become property of the bankruptcy estate to a pre-determined creditor or a third party at a pre-established "fixed" price.[19]

This note will discuss the policy rationales both for and against enforcement of such provisions, and will clearly demonstrate that the arguments against enforcement overwhelmingly outweigh those favoring it.[20] Part I discusses section 363 in general;[21] specifically, it examines subsections (b), (l), and (n) to determine if section 363 itself sheds any light on the validity of contractual provisions that attempt to circumvent it. As will be seen, section 363 itself does very little to help answer this question. Part II then examines the policy rationales behind somewhat analogous contract provisions that have been employed to circumvent the automatic stay of section 362. By examining both the factors and policies various courts weigh in determining whether to enforce such stay waivers, parallels can be drawn to provisions that attempt to "fix" section 363 auctions.

While there are undoubtedly arguments in favor of enforcing section 362 waivers, such as the Bankruptcy Code's policy of favoring out-of-court settlements and freedom to contract,[22] this note concludes that these policies do not hold true when applied to section 363 sales.

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some of BAPCA's changes to the Bankruptcy Code, see Peter S. Fishman, *Not So Fast: Asset Sales Under the New Section 363*, 24 AM. BANKR. INST. J. 12 (2005).

18. Stevens & Lee, P.C., *supra* note 17, at 2 ("[C]reditors will have to be even more vigilant now that the 2005 Amendments have come into effect. To mitigate the risks associated with 363 sales, it is recommended that creditors consider moving more aggressively at an earlier stage in the case . . . .").

19. For example, such a provision might be worded as follows:

    In the event that Borrower is the subject of any insolvency, bankruptcy, receivership, dissolution, reorganization or similar proceeding, federal, state, voluntary or involuntary, under any present or future law or act, and a decision is made to sell the property identified as ____________ (the "Property"), pursuant to Section 363(b) of title 11 of the United States Code (the "Bankruptcy Code"), Lender is entitled to have first right to purchase the Property from Borrower for $_________ as consideration (the "Sale"); Borrower hereby consents that if a decision is made to sell the Property, it shall forgo any formal bidding or auction process required by Section 363 of the Bankruptcy Code and agree to the fair and equitable terms of the Sale, and to not contest any motion by Lender for court approval of these terms.

20. *See infra* text accompanying notes 57–103.

21. 11 U.S.C. § 363 (2000).

22. *See* Mrachek & Eller, *supra* note 12, at 49.

I. SECTION 363 — USE, SALE, OR LEASE OF PROPERTY

A. Section 363(b)

Section 363 of the Bankruptcy Code outlines a trustee or debtor-in-possession's rights and powers to use, sell, or lease property of the estate.[23] While it applies to both liquidations and reorganizations,[24] it is most often invoked by companies that need to sell assets to get an influx of capital to either fund their reorganization plans or to allow them to continue to operate their businesses while they are strapped for capital. Due to the realities of bankruptcy, such as losing customers and suppliers, many debtors rely completely on section 363 to sustain adequate cash flows to finance their reorganization plans.[25] As one bankruptcy professional explains, "A distressed company on the brink of insolvency often looks to asset sales as a solution to its financial problems. A strategic asset sale may provide the company with needed cash to either continue its operations, restructure, or just get past a temporary liquidity crunch."[26]

In relevant part, section 363(b)(1) provides: "The trustee, after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate."[27] Simply put, section 363(b) permits a trustee to sell or lease property that the debtor normally would not touch, such as machinery, equipment, or even factories. Unlike asset sales in the ordinary course of business,[28] which occur everyday without court approval, non-ordinary course sales

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23. *See* COLLIER BANKRUPTCY MANUAL ¶ 363.01 (Lawrence P. King ed., 3d ed. 2004) [hereineafter COLLIER]

24. *Id.* ¶ 363.02; Stevens & Lee, P.C., *supra* note 17.

25. In recent years however, there has been a shift from reorganizations of companies to liquidations of their assets in Chapter 11 bankruptcy cases. Many bankruptcy observers suggest that secured creditors are using section 363(b) to liquidate their collateral under the guise of reorganization. *See* Hon. C. Ray Mullins et al., *Have Reorganization Plans Become Dinosaurs? Pushing the Envelope in Liquidation of the Estate: Section 363 and Beyond,* AM. BANKR. INST. S.E. WORKSHOP (2004); *see also* Stevens & Lee, P.C., *supra* note 17 (noting a recent trend in Chapter 11 cases to conduct sales of entire businesses under section 363, rather than to reorganize these businesses under a Chapter 11 plan. One of the major reasons behind this trend is that pre-petition secured lenders, who become defensive debtor-in-possession or cash collateral lenders, are interested in lending enough to keep the particular business alive until it can be sold as a going concern — a shorter period with less risk than a full-fledged reorganization).

26. *See* Ronald L. Leibow et al., *Distressed Asset Sales: Selling and Acquiring Assets from the Debtor Estate*, *in* 27TH ANNUAL CURRENT DEVELOPMENTS IN BANKRUPTCY & REORGANIZATION 75 (PLI Comm. Law & Practice Course Handbook Series No. 5989, 2005); *see also* Horse Haven, Inc. v. Stephens, Nos. 89-2071, 89-2075, 1990 WL 86386, at *1 (4th Cir. June 19, 1990) ("The rule embodied in subsection 363(b) is necessary to protect the creditor's interests in the assets of the estate.").

27. 11 U.S.C. § 363(b) (2000); *see* COLLIER, *supra* note 23.

28. 11 U.S.C. § 363(c)(1) states:

> If 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.

require twenty days notice be given to the debtor, trustee, and all creditors to give them opportunity to object to the sale[29] (although notice does not necessarily entail a hearing[30]). Since contracting out likely only arises with major asset sales, this discussion focuses solely on sales outside of the ordinary course of business.

In general, for a non-ordinary course section 363(b) sale to be approved, a debtor must show: (1) a sound business reason exists for the sale; (2) there has been adequate and reasonable notice to interested parties; (3) the sale price is fair and reasonable; and (4) the proposed buyer is proceeding in good faith.[31] Assuming all four of these requirements have been met, the question remains whether one can "fix" a section 363(b) sale in advance by pre-petition agreement.

Section 363(b) itself tells us nothing more about the validity of pre-petition waivers. While the language of section 363(b) is silent on whether it may be varied by private agreement, in sharp contrast to other provisions of the Bankruptcy Code that specifically prohibit waivers,[32] nothing certain may be concluded from this silence. Most sections of the Bankruptcy Code do not contain express anti-waiver provisions, and the drafters' intent cannot be deciphered with any certainty from their silence. For example, there is nothing written in the Bankruptcy Code specifically prohibiting one from waiving the right to file

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29. Rule 6004 of the Federal Rules of Bankruptcy Procedure implements the notice requirement of § 363(b)(2) and provides that notice of a proposed non-ordinary course sale must also be given pursuant to Federal Rule of Bankruptcy Procedures Rules 2002(a)(2), (c)(1), (i), and (k). FED. R. BANKR. P. 6004(a). Rule 2002 requires twenty days notice of the proposed sale be given to the debtor, trustee, all creditors and indentured trustees, unless otherwise authorized by the court. FED. R. BANKR. P. 2002(a)(2). In addition, Rule 6004(b) requires any objections to a proposed sale not subject to the provisions of subdivisions (c) and (d) thereof be filed and served not less than five days before the date set for the action, unless otherwise authorized by the court. FED. R. BANKR. P. 6004(b).

30. 11 U.S.C § 102(1)(B) (2000), which provides rules of construction for the phrase "after notice and a hearing," states that:

> "after notice and a hearing," or similar phrase — authorizes an act without an actual hearing if such notice is given properly and if—
> (i) such hearing is not requested timely by a party in interest; or
> (ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act.

31. *See* Leibow et al., *supra* note 26, at 80–81; *see also In re* Lionel Corp., 722 F.2d 1063, 1070 (2d Cir. 1983):

> The history surrounding the enactment in 1978 of current Chapter 11 and the logic underlying it buttress our conclusion that there must be some articulated business judgment, other than appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business before the bankruptcy judge may order such disposition under § 363(b).

See also In re Bethlehem Steel Corp, No. 02 Civ. 2854 (MBM), 2003 WL 21738964, at *10 (Bankr. S.D.N.Y. July 28, 2003); *In re* Ionosphere Clubs, Inc., 100 B.R. 670, 674–76 (Bankr. S.D.N.Y. 1989); *In re* Highway Equipment Co., 61 B.R. 58, 60 (Bankr. S.D. Ohio 1986).

32. For example, section 1307 provides an absolute right of conversion by expressly stating that any waiver of the right to convert a case filed under another chapter of the Code to Chapter 13 is unenforceable. 11 U.S.C. § 1307(a) (2000). Section 1307 also provides for a similar absolute right to dismiss a Chapter 13 case. 11 U.S.C. § 1307(b) (2000). The statute makes it clear that no matter the consideration, a waiver of either of these rights, pre- or post-petition, is unenforceable.

for bankruptcy in the first place, but most would agree that, despite the absence of such language, this right is unwaivable.[33] Thus, the absence of an anti-waiver provision in section 363(b) is relatively meaningless.

Unfortunately, the case law addressing section 363(b) is equally unrevealing. There have been no cases to date addressing the issue of pre-petition agreements contracting around section 363, and the limited case law actually addressing section 363 in general is ambiguous and reveals nothing about how a court might rule on this issue. There have, however, been a number of cases addressing *post*-petition agreements involving section 363.[34]

Post-petition agreements between debtors and creditors used to initiate the section 363 bidding process are commonly dubbed "stalking horse agreements." The purpose of these stalking horse agreements can be explained as follows:

> [A] debtor often faces serious difficulties attempting to dispose of assets for a fair value. Parties who otherwise might be interested in making an offer for an asset of the estate may be unwilling to do so knowing that their time and effort could be wasted if a third party were to appear at a hearing and offer more. The result is that the debtor simply may be unable to attract any opening offer. Even if an expression of interest or bid is made, the debtor may be unable to convince the bidder to participate and run the risk of being outbid.[35]

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33. *See, e.g.*, *In re* Citadel Properties, Inc., 86 B.R. 275, 275 (Bankr. M.D. Fla. 1988); *In re Club Tower L.P.*, 138 B.R. 307, 311 n.1. Many, however, offer an opposing point of view. In *United States v. Kras*, 409 U.S. 434, 446 (1973), the Supreme Court held that the requirement of a filing fee to participate in the bankruptcy system was not unconstitutional, as bankruptcy was a privilege and not a fundamental right like the First Amendment. The court held that "bankruptcy legislation is in the area of economics and social welfare . . . . There is no constitutional right to obtain a discharge of one's debts in bankruptcy." *Id.* This sentiment has been echoed by other individuals who argue that people may contract around the opportunity to file for bankruptcy, as bankruptcy is "not a right but rather a privilege accorded to an honest debtor, who, among other things, satisfies bankruptcy statutory obligations." Hon. Joe Lee, 4 Bankr. Serv. L. Ed. § 39:10 (2005) (quoting *In re* Hecht, 237 B.R. 7, 9 (Bankr. D. Conn. 1999)).

34. For example, in *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004), the Seventh Circuit Court of Appeals affirmed the reversal of certain pre-reorganization transfers made pursuant to a post-petition critical vendor transfer order. In doing so, however, the court stated "it is prudent to read, and use, § 363(b)(1) to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code." *Id.* at 872. This sentiment suggests that courts recognize private agreements are drafted anticipating bankruptcy and that waivers of section 363 should be enforced.

    In *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983), however, the Fifth Circuit reversed a district court's approval of a pre-petition agreement between an airline and its creditors proposing to settle and compromise all claims and potential litigation. There, the court declared that a "debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets." *Id.* at 940. In that case, the Fifth Circuit specifically held that a debtor and the trial court could not circumvent the requirements of section 363 by private agreement. It would then logically follow that a court would not permit a debtor and a creditor to do so either. This, however, is not necessarily the case, as courts routinely endorse private stalking-horse agreements to jump-start section 363 auctions.

35. Lee R. Bogdanoff, *The Sale of Assets Outside of a Plan of Reorganization under the Bankruptcy Code*, *in* FOURTH ANNUAL PRIVATE EQUITY FORUM: LEGAL & FINANCIAL STRATEGIES FOR

A stalking-horse agreement is a post-petition agreement where a bidder agrees to make the first bid in a section 363 sale. In exchange for this commitment setting the price floor for a target asset and conducting the necessary due diligence work, a stalking-horse purchaser receives certain financial guarantees and incentives from the debtor,[36] such as break-up fees,[37] topping fees,[38] and overbid requirements.[39] However, just because courts have endorsed the use of post-petition stalking-horse agreements,[40] it does not follow that they should endorse the use of pre-petition waiver agreements because there are major distinctions between the two.

First, it is true that stalking-horse bidders get some guarantees that if they are not the winning bid, they will be compensated for their work. But unlike pre-petition section 363 agreements, the purpose of stalking horse agreements is not to insure that the stalking-horse is the ultimate winner of the property that they bid on. The process is actually designed to encourage future bidding and set a price floor to protect the asset value for the estate. Courts have been quite outspoken that stalking-horse agreements should not be used to "chill" prospective bidders' interests.[41] However, a private pre-petition section 363 agreement,

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DEALMAKING IN THE CURRENT MARKET 586 (PLI Corp. Law & Practice Course Handbook Series No. B0-01FF, 2002).

36. *See* Robert Keach, *Stalking-Horse Lenders and Good Faith*, AM. BANKR. INST. J., June 2004, at 28 ("Increasingly, the financing allegedly necessary to preserve asset value and/or continue operations is being supplied by the stalking-horse bidder with whom the putative debtor-in-possession (DIP) has negotiated both sale and financing terms pre-petition."); Leibow et al., *supra* note 26, at 85; Mullins et al., *supra* note 25; Bret Rappaport & Joni Green, *Calvinball Cannot be Played on this Court: The Sanctity of Auction Procedures in Bankruptcy*, 11 J. BANKR. L. & PRAC. 189 (2002).

37. *In re* APP Plus, Inc., 223 B.R. 870, 874 (Bankr. E.D.N.Y. 1998):

> Break-up fees are the fees paid to the proposed purchaser of assets by the seller, in the event that the transaction contemplated fails to be consummated for various reasons delineated in the purchase agreement, including the seller's acceptance of a later bid. Typically, the break-up fee covers reimbursement of the disappointed purchaser's out-of-pocket expenses related to the proposed acquisition and/or compensation for the time, efforts, resources, lost opportunity costs and risks incurred by the disappointed purchaser.

38. *See* Mullins et al., *supra* note 25 (stating that topping fees are calculated or determined as a percentage of the amount by which the approved bid exceeds the original bid. As a result, topping fees do not add a preset cost to the purchase price and they are paid only in the event the "stalking-horse" bid is unsuccessful).

39. *See* Bogdanoff, *supra* note 35, at 586–87. The author explains that "[i]n substance, an agreement is reached between the debtor and a 'stalking horse' bidder to establish rules, in advance of sale, setting forth minimum amounts over bidders must offer above the initially proposed purchase price (the 'upset price')." *Id.* at 586. As a result, the stalking horse bidder is somewhat protected against incremental bids. *Id.* at 586–87.

40. *See, e.g.*, *In re* Med. Software Solutions, 286 B.R. 431 (Bankr. D. Utah 2002); *In re APP Plus*, 223 B.R. 870; *In re* Integrated Res., Inc., 147 B.R. 650 (Bankr. S.D.N.Y. 1992) ("Break-up fees are important tools to encourage bidding and to maximize the value of the debtor's assets."); *In re* Del. & Hudson Ry. Co., 124 B.R. 169 (Bankr. D. Del. 1991).

41. *See, e.g., In re* President Casinos, Inc., 314 B.R. 784, 786 (Bankr. E.D. Mo. 2004) ("Structured bid procedures should provide a vehicle to enhance the bid process and should not be a mechanism to chill

even for fair market value, would have this exact effect. Once word got out about the private arrangement, whether it was enforceable or not, other prospective bidders would withdraw their bids, seeing it as not worth the time and effort of due diligence to participate. Thus, the rationale behind the use of post-petition stalking-horse agreements does nothing to support the use of pre-petition section 363 waivers.

Those seeking to justify the enforcement of pre-petition section 363 waivers will likewise find no support in other corresponding subsections of section 363.

B. Section 363(l) – Ipso Facto Clauses

Like other provisions of the Bankruptcy Code, section 363(l) invalidates *ipso facto* clauses — clauses that modify a party's rights upon filing for bankruptcy.[42] Specifically, section 363(l) states, in pertinent part, that:

> [T]he trustee may use, sell or lease property under subsection (b) or (c) of this section, . . . , *notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title concerning the debtor, or on the appointment of or the taking possession by a trustee in a case under this title or a custodian, and that effects, or gives an option to effect, a forfeiture, modification, or termination of the debtor's interests in such property*.[43]

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prospective bidders' interests."); *see also* Keach, *supra* note 36 (discussing the real possibility that "stalking-horse" bidding could lead to an unfair advantage for the "stalking horse," which has good faith implications).

42. *See, e.g.,* 11 U.S.C. § 541(c) (2000), stating:

> (1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2) or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—
>
> (A) that restricts or conditions transfer of such interest by the debtor; or
>
> (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

See also 11 U.S.C. § 365(e) (2000):

> (1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—
>
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
>
> (B) the commencement of a case under this title; or
>
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

43. 11 U.S.C. § 363(l) (2000) (emphasis added).

Thus, section 363(l) invalidates clauses that work to terminate or modify a debtor's interest in property upon filing for bankruptcy.[44] For example, in *Riggs National Bank of Washington v. Perry*,[45] the Fourth Circuit held that a "default-upon-filing" clause in an automobile installment contract, which stipulated that a purchaser would be deemed in default in the event he filed for bankruptcy, was unenforceable as matter of law. The Fourth Circuit opined that enforcement of such a clause "would clearly intrude upon [the fresh start] policy since any such default would deprive the debtor of the advantages of the Code's liquidation procedures . . . ."[46]

Although pre-petition agreements contracting around section 363 would be conditioned on the commencement of a bankruptcy proceeding, such clauses do not actually fit the definition of an *ipso facto* clause and, therefore, section 363(l) does not apply. *Ipso facto* clauses address provisions that forfeit, terminate, or modify a debtor's interest in property of the estate. In contrast, a pre-petition clause fixing a section 363 sale does not involve the modification of a debtor's rights — it simply pre-arranges the price and purchaser of an asset in a sale that would be happening regardless. Since the ultimate decision to sell an asset would still lie with the debtor, there would be no termination or modification of any rights. Thus, although courts continue to broadly interpret what qualify as *ipso facto* clauses,[47] no answers lie in section 363(l).

C. Section 363(n)

Section 363(n) allows the trustee to avoid a strategic asset sale when it is determined the price fetched at auction was fixed by collusion among bidders.[48] For a sale to be avoided under subsection (n), it must be determined that the

44. *See, e.g.*, *Pease*, 195 B.R. at 434, in the context of a waiver of the automatic stay, the United States Bankruptcy Court of the District of Nebraska held that "[s]ection 363(l) invalidates contractual provisions purporting to waive the automatic stay because enforcement of such a waiver deprives the debtor in possession of the ability to use, sell or lease the Bank's collateral." Similarly, in *In re Nat'l Gypsum Co.*, 118 F.3d 1056, 1067 n.18 (5th Cir. 1997), the Fifth Circuit noted that a pre-petition arbitration agreement whereby a creditor and a debtor agreed to arbitrate the actual amount the creditor would be paid on a claim in the event of bankruptcy — effectively contracting out of a bankruptcy court's power to adjust claims among different classes of creditors — would essentially be an *ipso facto* clause and would plainly be unenforceable.

45. 729 F.2d 982 (4th Cir. 1984).

46. *Id*. at 984–85.

47. *See In re* Ry. Reorganization Estate, Inc., 133 B.R. 578, 583 (Bankr. D. Del. 1991) (citing *In re* Rose, 21 B.R. 272, 276 (Bankr. D.N.J. 1982)) ("Today courts continue to read the Code's *ipso facto* sections broadly to effectuate code policy and in recognition that '[b]ankruptcy matters are also inherently proceedings of equity.'").

48. *See* COLLIER, *supra* note 23, at ¶ 363.11; *see also* 11 U.S.C. § 363(n) (2000), which states, in pertinent part:

> The trustee may avoid a sale under this section if the sale price was controlled by an agreement among potential bidders at such sale, or may recover from a party to such agreement any amount by which the value of the property sold exceeds the price at which such sale was consummated, and

agreement actually *controlled* the price of the sale, as compared to merely *affecting* it.[49] In determining whether or not to set aside a sale, courts look to (1) the integrity of the sale,[50] and (2) the best interests of the estate.[51] Unfortunately, section 363(n), like section 363(l), also cannot be used to invalidate section 363 waivers, as the underlying principles behind subsection (n) do not apply to pre-petition waivers.

First, section 363(n) was designed to prevent *post*-petition collusion; not *pre*-petition agreements.[52] Second, in addition to being post-petition, the behavior among bidders envisioned in section 363(n) is subversive; some sort of secret

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> may recover any costs, attorneys' fees, or expenses incurred in avoiding such sale or recovering such amount.

49. *See id*. (citing Lobe Star Indus., Inc. v. Compania Naviera Perez Compac, 42 F.3d 747, 752 (2d Cir. 1994) ("The influence on the sale price must be an intended objective of the agreement, and not merely an unintended consequence. . . .")).

50. An examination of the integrity of a section 363 sale is really an examination of good faith. This was addressed in *In re Abbotts Dairies of Pennsylvania, Inc.*, 788 F.2d 143 (3d Cir. 1986), where the Third Circuit reversed and remanded the dismissal of an appeal regarding possible collusion between the purchaser and estate. Specifically, the court recited:

> The requirement that a purchaser act in good faith . . . speaks to the integrity of his conduct in the course of the sale proceedings. Typically, the misconduct that would destroy a purchaser's good faith status at a judicial sale involves fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders.

The *Abbotts* court identified fraud, collusion, and an attempt to take unfair advantage of other bidders as three factors that may destroy the good faith of a section 363 sale. In *In re Edwards*, 228 B.R. 552 (Bankr. E.D. Pa. 1998), where the debtor objected to a Chapter 7 trustee's motion to approve the sale of debtor's stock and partnership interest, the court stated that "[s]ection 363(n) complements the court's authority to withhold approval of sales lacking in good faith by reason of finding collusion between the purchaser and other bidders by granting the trustee express power to avoid a sale 'if the sale price was controlled by *an agreement among potential bidders at sale* . . . .'" (emphasis added). The court clearly stated that section 363(n) addresses *post*-petition agreements among bidders to control the price of a section 363 sale, which would be considered collusion and destroy a sale's good faith. It does not necessarily follow that a *pre*-petition agreement between the seller and bidder would be considered collusion and destroy a section 363 sale's good faith.

51. *See In re* Hat, 310 B.R. 752, 760 (Bankr. E.D. Cal. 2004).

> This court agrees with the bankruptcy court in *In re Fehl*, 19 B.R. 310, 311–12 (Bankr. N.D. Cal. 1982) regarding the three factors to consider in circumstances such as this:
>
> 1. The integrity of the trustee's sale.
> 2. The 363(i) rights of the [spouse].
> 3. The preservation of the best interests of the estate.
>
> *Id.* at 758.

While the court lists three factors, this note discusses only two. The second factor, section 363(i) rights, refers to property owned by the debtor and another party, frequently a spouse. In such instances, according to subsection (i), the spouse or co-owner "may purchase such property at the price at which such sale is to be consummated." 11 U.S.C. § 363(i) (2000). This means simply that the co-owner has a statutory right of first refusal. While this adds an interesting twist to the scenario we have been examining above, it is beyond the scope of this paper.

52. *See* COLLIER, *supra* note 23, at ¶ 363.11.

under-the-table dealing.[53] There is no fraud or collusion in a section 363 waiver, where the debtor and creditor freely enter into an agreement in full public view. And finally, to avoid a sale under section 363(n), courts generally employ a business judgment standard to determine whether a sale was in the best interests of the estate,[54] which is accompanied by a strong presumption of validity. This standard, however, is applied to post-petition decisions to sell assets — decisions that are made in the present when the debtor has a full understanding of its current financial situation. Such a presumption of validity is not appropriate for pre-petition section 363 waivers, when the debtor has no way of knowing what the future holds for the estate.[55] Moreover, the debtor not only lacks the foresight to knowingly make such a waiver, but he also lacks the legal capacity to do so. As was explained in *In the Matter of Pease*, "[p]rior to the commencement of the bankruptcy case, the debtor entity has the capacity to enter into an agreement binding upon the debtor under applicable nonbankruptcy law. Upon the commencement of a Chapter 11 bankruptcy case, the debtor becomes a 'debtor

53. *See In re Hat*, 310 B.R. at 756 (where wife entered into secret agreement with potential bidder whereby she would receive a three percent commission for exercising her section 363(i) right of first refusal and purchase winery for another potential bidder); Landscape Props., Inc. v. Vogel, 46 F.3d 1416, 1419 (8th Cir. 1995) (where trustee claimed that purchaser paid potential bidder $350,000 to withdraw bid, thereby allowing purchaser's bid to be highest and winning bid); *In re* Eads, 135 B.R. 380, 382 (Bankr. E.D. Cal. 1991) (where debtor alleged that collusive sale led to as much as $800,000 being siphoned from the Chapter 11 estate).

54. *See In re* Lionel Corp., 722 F.2d 1063, 1070 (2d Cir. 1983):

> The history surrounding the enactment in 1978 of current Chapter 11 and the logic underlying it buttress our conclusion that there must be some articulated business justification, other than appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business before the bankruptcy judge may order such disposition under section 363(b).

See also In re Bethlehem Steel Corp., 2003 WL 21738964, at *10–11; *In re* Angelika Films 57th, Inc., Nos. 97 Civ. 2239 (MBM), 97 Civ. 2241 (MBM), 1997 WL 283412, at *5 (S.D.N.Y. May 29, 1997); *In re* Highway Equip. Co., 61 B.R. 58, 60 (Bankr. S.D. Ohio 1986).

55. While one might argue that a pre-petition section 363 waiver is in the best interests of the estate as it preserves asset value and guarantees a certain return for the asset, a stronger argument is to the contrary — that enforcement of a pre-petition section 363 waiver is not in the best interests of the estate. The pre-petition and post-petition debtors are different legal entities they have different fiduciary duties and responsibilities. One of the duties of the post-petition debtor is to maximize the bankruptcy estate to repay creditors. Allowing pre-petition agreements to circumvent section 363 would completely eliminate the bidding process and prevent recovering possibly larger returns on assets. Even if a pre-petition agreement was simply crafted more similar to a stalking-horse bid, where the pre-petition bidder would receive incentives but there would still be an actual auction, such an agreement may still have a chilling effect on the bidding process. If the agreement called for high break-up fees or topping costs, the pre-petition bid may actually discourage bidding, rather than encourage it as stalking-horse bids are meant to do. Thus, a pre-petition agreement contracting around section 363 may work to deflate asset value by discouraging "higher and better" offers. But see *In re Edwards*, where the debtor objected to the trustee's sale of his interest in a partnership on the grounds that an agreement between bidders constituted collusion, the court held that "[a]bsent a showing that the agreement actually did deprive the estate of fair value for the assets, the sale should be confirmed." 228 B.R. 552, 566 (Bankr. E.D. Pa. 1998). Under this interpretation, if section 363(n) governed pre-petition clauses attempting to fix section 363 sales, such clauses would not be struck down absent a showing that there were actual bidders ready and willing to pay more for the asset.

in possession' with a fiduciary duty to creditors . . . ."[56] The law views the pre-petition debtor and the post-petition debtor-in-possession as separate and distinct legal entities, with vastly different responsibilities and conflicting fiduciary duties. Therefore, the debtor cannot bind the debtor-in-possession and the business judgment rule should not be applied to evaluate pre-petition section 363 waivers.

As the text of section 363 and its various subsections provide no definitive answer as to the enforceability of clauses that attempt to contract around it, the discussion now turns to a similar type of provision that courts have already had an opportunity to rule upon: waivers of the automatic stay of section 362.

II. SECTION 362 — THE AUTOMATIC STAY

Section 362 provides that the filing of a petition for relief under the Bankruptcy Code operates as a stay applicable to all entities against virtually any action against the debtor. This "breathing spell" provided by section 362 is the fundamental principle of the American bankruptcy system.[57] Recently, however, it is becoming common practice to see automatic stay waivers as a part of most lending agreements.[58] An example of such a clause is as follows:

> In the event Borrower is the subject of any insolvency, bankruptcy, receivership, dissolution, reorganization or similar proceeding, federal or state, voluntary or involuntary, under any present or future law or act, lender is entitled to the automatic and absolute lifting of any automatic stay as to the enforcement of its remedies under the Loan Documents against the Security, including specifically, but not limited to the stay imposed by Section 362 of the United States Federal Bankruptcy Code, as amended; Borrower hereby consents to the immediate lifting of any such automatic stay, and will not contest any motion by Lender to lift such stay; Borrowing Parties expressly acknowledge that (a) there is no equity in the security after consideration of the amount owed Lender and (b) the Security is not now, and will never be necessary to any plan of reorganization of any type.[59]

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56. 195 B.R. at 433. This same point was addressed by the National Bankruptcy Commission in its 1997 report. "Beyond the problem of prepetition agreements affecting equality of distribution, it is questionable whether the prepetition debtor has the legal capacity to make decisions about the application of the bankruptcy laws that are binding on the bankruptcy estate." NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS, FINAL REPORT 487 (1997) [hereinafter FINAL REPORT].

57. *See* KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM 41 (1997).

58. *See In re* Powers, 170 B.R. 480, 482 (Bankr. D. Mass. 1994) (citing Warren & England, *supra* note 9) ("It has been said that 'practically every loan modification or business workout agreement drafted today' contains bankruptcy waiver provisions, including [waivers of the automatic stay].").

59. *See* Irving D. Labovitz, *A Review of Current Cases and Developing Trends Considering the Efficacy of Section 362 Automatic Stay Waivers in Commercial Mortgages, . . . or "What Do You Have to Lose*"?, 103 COM. L.J. 271, 272 (1998) (citing *In re* Hudson Manor Partners, No. 91-81065HR, 1991 WL 472592 (Bankr. N.D. Ga. Dec. 31, 1991).

While many professionals recommend including such provisions in lending agreements,[60] courts have taken vastly different approaches in determining whether they should be enforced.[61] Some courts have found stay waivers to be per se unenforceable,[62] while others have held just the opposite.[63] The modern trend, however, seems to be that of the court in *In re Powers*,[64] where the existence of a section 362 waiver was held to be a "primary factor"[65] in determining whether "cause" existed to lift the stay under section 362(d).[66] All

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60. *See, e.g.*, Arthur Lindquist-Kleissler, Esq. & Nancy D. Miller, *Chapter 7 and 13 Bankruptcy for Small Business*, 020504 ABI-CLE 459 (2004) (suggesting that lenders should negotiate pre-petition waivers of the automatic stay even though in the end, it may not be enforceable); *see also* Jerry Markowitz, *A Review of the Availability of Certain Contractual Provisions That May Be Employed to Assist Landlords in Asserting and Enforcing Bargained-for Rights*, 041802 ABI-CLE 355 (2002) (suggesting that a landlord might consider including provisions where a debtor-to-be waives the protection of the automatic stay).

61. *See, e.g., In re Pease*, 195 B.R. 431 (holding that waivers of the automatic stay are *per se* unenforceable); *see also In re Powers*, 170 B.R. 480 (holding that the existence of a pre-petition agreement waiving the automatic stay is a "primary element" to consider in determining whether there is "cause" to lift the stay under section 362(d)). *But see In re Cheeks*, 167 BR 817 (holding that pre-petition agreement waiving the automatic stays are valid and enforceable).

62. *See In re Pease*, 195 B.R. 431; *In re* Deb-Lyn, Inc., No. 03-00655-GVL1, 2004 WL 452560 (N.D. Fla. Feb. 20, 2004); *In re Fallon*, 244 B.R. 589; *In re* Jenkins, 181 B.R. 33 (Bankr. E.D. Pa. 1995); Farm Credit of Central Fl. v. Polk, 160 B.R. 870 (Bankr. M.D. Fla. 1993); *In re Sky Group Int'l*, 108 B.R. 86.

63. *In re Desai*, 282 B.R. 527; *In re* South East Financial Assoc., Inc., 212 B.R. 1003 (Bankr. M.D. Fla. 1997); *In re* University Commons, L.P., 204 B.R. 80 (Bankr. M.D. Fla. 1996); *In re* Atrium High Point Ltd., 189 B.R. 599 (Bankr. M.D.N.C. 1995); *In re Cheeks*, 167 B.R. 817; *In re Club Tower*, 138 B.R. 307; *In re Citadel Properties*, 86 B.R. 275; *In re* Gulf Beach Dev. Corp., 48 B.R. 40 (Bankr. M.D. Fla. 1985); *In re* Phila. Athletic Club, 20 B.R. 322 (Bankr. E.D. Pa. 1982).

64. *In re Powers*, 170 B.R. 480.

65. *See In re* Graves, 212 B.R. 692 (1st Cir. 1997); *In re* Shady Grove, 216 B.R. 386 (Bankr. D. Md. 1998); *In re Powers*, 170 B.R. 480; *In re* Psychotherapy & Counseling Ctr., 195 B.R. 522 (Bankr. D.C. 1996); *see also* Labovitz, *supra* note 59, at 283 ("If any trend can be discerned from this nominal body of recent cases, it appears that the Compass and Shady Grove standards may well portend the future.").

66. *See* 11 U.S.C. § 362(d) (2000), which states in part:

> On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—
>
> (1) for cause, including the lack of adequate protection of an interest in property of such party in interest;
>
> (2) with respect to a stay of an act against property under subsection (a) of this section, if—
>
> (A) the debtor does not have an equity in such property; and
>
> (B) such property is not necessary to an effective reorganization; or
>
> (3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period)—
>
> (A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or
>
> (B) thee debtor has commenced monthly payments to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured

courts, however, universally agree that section 362 waivers are not self-executing.[67]

Section 362 and section 363 have a number of similarities. For example, both sections are administrative provisions found in Chapter 3, making them generally applicable to all types of filings. Both sections work to aid debtors by providing time and space to recover, and permitting the debtor to be the primary architect of what happens to its assets. And finally, both sections also directly benefit creditors — section 362 by preventing a race to the courthouse by creditors, which maximizes the net recovery to all, and section 363 by preventing the piecemeal dismantling of the estate. While these two provisions share similarities in purpose and function, the factors and policy rationales employed by courts in section 362 waivers do not hold true in section 363 waivers.[68]

A. Factors Determining Enforceability

In deciding whether to grant relief from the automatic stay based on a section 362 waiver, courts have considered the following factors: (1) the consideration given for the waiver; (2) the sophistication of the party making the waiver; (3) the likelihood of a successful reorganization; (4) whether the creditor will be prejudiced by unenforcement; and (5) whether other parties will be affected by the waiver.[69] These final two factors, prejudice to creditors and the binding effect on third parties, demonstrate precisely why section 363 waivers should not be enforced.

1. Prejudice to the Creditor

To justify enforcement of their stay waivers, creditors will often try to claim severe prejudice if their waivers are not enforced because they would be relegated to the status of general unsecured creditors.[70] Similarly, where new value was given as consideration for the stay waiver, a creditor might also try to claim prejudice if that waiver were rendered unenforceable. These arguments, however, are unpersuasive.

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statutory lien), which payments are in an amount equal to interest at a current fair market rate on the value of the creditor's interest in the real estate.

67. *See South East Fin.*, 212 B.R. at 1005; *In re Pease,* 195 B.R. at 432; *In re Sky Group Int'l*, 108 B.R. at 88–89.

68. *See* 11 U.S.C. §§ 362, 363. Admittedly, this will not be an exact parallel as there is no corresponding subsection in section 363 to section 362(d) where a creditor may apply for relief from the stay.

69. *See In re Desai*, 282 B.R at 532.

70. *See, e.g., In re* Frye, 320 B.R. 786, 794 (Bankr. D. Vt. 2005) (examining the possible prejudice that might befall a creditor if an automatic stay waiver was not enforced), *subsequent determination*, 323 B.R. 396 (Bankr. D. Vt. 2005) (relief from automatic stay granted), *order amended*, 2005 WL 1113823 (Bankr. D. Vt. May 7, 2005); *In re Powers*, 170 B.R. at 484 (recognizing prejudice as a factor to be considered in weighing enforcement of an automatic stay).

In the event an automatic stay waiver is rendered unenforceable, a creditor remains entitled to its legally established share of property of the estate — the same share to which it was always entitled. If a creditor is secured, assuming its interest is perfected, it will eventually be able to retake its collateral or proceeds. If the creditor is unsecured, then it will eventually share *pro rata* in the estate with all the other similarly situated creditors. Prejudice and not being permitted to unfairly leapfrog ahead of other creditors with the same, or even higher priorities, do not mean the same thing.

In a section 363 context there would be even less of an argument to claim prejudice. If such a provision was not enforced it would not mean that the putative purchaser had lost the property it hoped to acquire. Rather, the putative purchaser would still have the same rights as everyone else to bid on targeted property. Since the creditor would still be free to bid on the property at auction, and could even conceivably end up purchasing the property for the same price set in the waiver, there is no valid argument to claim prejudice. Losing an advantage it was never entitled to in the first place is not prejudice. Furthermore, if the putative purchaser wanted additional guarantees to ensure they would win at auction, nothing is stopping them from entering into a pre-*auction*, rather than a pre-*petition*, agreement, with the debtor to become a stalking horse bidder as previously discussed.[71]

2. *The Effect on Third Parties*

The effect of enforcement of a section 363 waiver on other creditors is, perhaps, the most important factor for purposes of this discussion.[72] It is widely understood that section 362 waivers are not enforceable against third parties;[73] they pertain only to the specific parties of the agreement and the identified collateral. The stay remains in effect, prohibiting all other parties from descending upon the debtor. They do, however, clearly affect third parties because they reduce the size of the bankruptcy estate and favor certain creditors over others.

This is where section 362 and section 363 part company, and is one of the foremost reasons against enforcement of section 363 waivers. Enforcing a section 363 pre-petition sale agreement would not just bind contracting parties, it would deprive all other parties of the right to bid at auction for property of the estate. In addition, because creditors are an integral part of every reorganization,[74] en-

71. *See supra* text accompanying notes 35–41.

72. *See In re South East Fin.*, 212 B.R. 1003; *In re Atrium*, 189 B.R. 599.

73. *See In re South East Fin.*, 212 B.R. at 1005 ("Nonetheless, such waivers are not self-executing and are not binding on third parties."); *In re Atrium,* 189 B.R. at 607 ("A waiver by the debtor cannot bind third parties.").

74. 11 U.S.C. § 1102(B)(1) (2000):

> A committee of creditors appointed under subsection (a) of this section shall ordinarily consist of the persons, wiling to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee, or of the members of a committee organized by creditors before the

forcing such an agreement would deprive them of any right to participate in the decision to sell property of the estate. The Creditors' Committee, which by statute has the authority to consult with the debtor or trustee on the administration of the estate, would be stripped of any opportunity to comment on asset sales.[75] Thus, this factor strongly weighs against enforcement of section 363 waivers.

In addition to these factors which courts examine regarding specific stay waivers, the overarching policy rationales that courts also examine similarly show no support for section 363 waivers.

3. *Implicated Policy Rationales*

i. **Encouraging Out-of-Court Settlements**

Many courts that have found automatic stay waivers to be valid and enforceable cite encouraging out-of-court settlements as the "most compelling reason for enforcement."[76] Their theory is that out-of-court settlements are faster and more cost-efficient than litigation.[77]

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commencement of the case under this chapter, if such committee was fairly chosen and is representative of the different kinds of claims to be represented.

75. 11 U.S.C. § 1103.

76. *See In re Cheeks*, 167 B.R. at 819 ("Bankruptcy courts may be an appropriate forum for resolving many of society's problems, but some disputes are best decided through other means."); *In re Club Tower*, 138 B.R. at 312 ("Workouts and restructurings should be encouraged among debtors and creditors . . . . In order to facilitate this goal, pre-petition agreements should be enforced against a borrower who later files for bankruptcy. To hold otherwise could make lenders more reticent in attempting workouts with borrowers outside of bankruptcy.").

77. The seminal, oft-cited case that laid down this policy of favoring out-of-court settlements was *In re Colonial Ford, Inc.*, 24 B.R. 1014 (Bankr. D. Utah 1982), and it was in the context of an out-of-court prepackaged workout or "prepack," and not an automatic stay waiver.

A prepackaged bankruptcy is a form of consensual Chapter 11 restructuring whereby the terms of a reorganization are negotiated and accepted by creditors before a proceeding is commenced in the bankruptcy court. *See* John D. Ayers et al., *Out-of-court Workouts, Prepacks and Pre-arranged Cases: A Primer*, 24 AM. BANKR. INST. J. 16 (2005) (discussing the advantages and disadvantages of prepackaged bankruptcies (prepacks), partial prepacks (where debtor solicits certain classes of creditors before filing for chapter 11 and others post-petition), and pre-arranged or pre-negotiated bankruptcies (where prior to commencement of a case, debtor discusses some sort of reorganization with a small number of creditors, who agree to said terms, but are insufficient in numbers to confirm such a plan, which is usually memorialized in writing)).

The idea behind "prepacks" and the policy of favoring out-of-court settlements is that they are efficient, economical, and sensible. They are efficient as they avoid the time consuming formalities of the bankruptcy system; similarly, they are economical because they circumvent the costly delays of formal bankruptcy structure; and they are sensible because they incorporate input from all parties-in-interest in good faith and candor, with the alternative being costly litigation. *See In re* TS Industries, 117 B.R. 682 (Bankr. D. Utah 1990); *In re Colonial Ford*, 24 B.R. at 1016; 2 BAXTER DUNAWAY, LAW OF DISTRESSED REAL ESTATE § 29:86 (2004); Paul Baisier & David Epstein, *Postpetition Lending Under Section 364: Issues Regarding the Gap Period and Financing for Prepackaged Plans*, 27 WAKE FOREST L. REV. 103, 107–109 (1992); Timothy R. Pohl & Rena M. Samole, *Out of Court Restructurings and Prepackaged Plans*, *in* DEALING WITH SECURED CLAIMS & STRUCTURED FINANCIAL PRODUCTS IN BANKRUPTCY CASES 330 (PLI Comm. Law & Practice Course Handbook Series No. 3172, 2004). As was recently stated in an article in the American Bankruptcy Institute Journal: "Pre-packaging

There must, however, be some limits to this policy of encouraging out-of-court settlements if we are to justify having a Bankruptcy Code at all,[78] especially when there is some doubt whether enforcing bankruptcy waivers even promotes efficiency at all.[79] In 1997, the National Bankruptcy Commission, an independent commission created to investigate bankruptcy related issues,[80] stated that allowing pre-petition waivers of bankruptcy provisions may actually discourage, rather than encourage, out-of-court settlements.[81] The Commission reported that:

> [W]aivers of bankruptcy rights do not necessarily promote efficiency. Because one cannot agree with a creditor to waive the right to file for bankruptcy in advance, and waivers of specific bankruptcy rights are not self-executing, waivers are not an efficient device to avoid litigation. Even if waivers were not invalid per se, parties still would find themselves in bankruptcy court litigating over the enforceability of particular clauses based on the circumstances of each case. It may be expedient to proceed with a lift-stay motion solely on the statutorily-provided grounds rather than having the court do a retrospective analysis of the validity of the waiver. Instead, any "efficiency" created by waivers is due to the leverage they wield for one creditor, not due to the overall promotion of out-of-court workouts.[82]

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a chapter 11 reorganization enables a debtor to minimize the impact to its ongoing business operations by combining many of the best aspects of out-of-court workouts — cost-efficiency, speed, flexibility and cooperation — with the binding effect and structure of a conventional bankruptcy." Ayers et al., *supra*, at 16.

Aside from outlining the advantages of out-of-court settlements, the *Colonial Ford* court also offered proof that it was both the intent of the Bankruptcy Code and the legislature to favor such settlements. The court stated, "Section 305(a)(1) reflects a policy, embodied in several sections of the Code, which favors 'workouts': private, negotiated adjustments of creditor-company relations." *In re Colonial Ford*, 24 B.R. at 1015.

78. *See* Kupetz, *supra* note 10, at 69 n.71 (1998) (citing FINAL REPORT, *supra* note 56, at 487); *see also* Victor Brudney, *Corporate Bondholders and the Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1867 n.148 (1992) (recognizing the usefulness of out-of-court workouts, but believing that they may significantly dilute the procedural and substantive protection that the Bankruptcy Act offers to bondholders). The author states:

> In any event, the policy of the Bankruptcy Act to encourage voluntary work-outs in preference to reorganization under the Act does not justify the use of prepackaged plans to evade the negotiating power given to creditors . . . or to dilute the supervisory duties of the bankruptcy court (however skimpily performed) over the substance of a plan or the process (including committee structure) by which it is approved and enforced.

Id. (citation omitted).

79. *See* William J. Burnett, *Prepetition Waivers of the Automatic Stay: Automatic Enforcement Equals Automatic Trouble*, 5 J. BANKR. L. & PRAC. 257, 258 (1996); FINAL REPORT, *supra* note 56, at 486–87.

80. FINAL REPORT, *supra* note 56, at 486–87.

81. *Id.*

82. *Id.*

As a section 363 waiver would presumably not be self-executing, parties would still be forced to submit the clause for court approval. A policy of selective enforcement would undoubtedly lead to more time consuming and costly litigation. Just as the debate over enforcement of automatic stay waivers has led to circuit splits, allowing pre-petition agreements to "fix" section 363 sales would lead to an onslaught of litigation to challenge the enforceability of these clauses or sales.[83] Because selective enforcement of section 363 waivers would lead to more litigation, it would be counterproductive to the economic and efficiency benefits of the out-of-court settlement to permit them. Therefore, enforcement of section 363 waivers cannot be justified on this basis.

ii. Freedom to Contract

A second over-arching policy frequently cited favoring enforcement of stay waivers is the concept of freedom to contract. Many authorities believe that bankruptcy is a natural part of every contract, as a possibility that hangs over every credit transaction,[84] and therefore, the provisions of the Bankruptcy Code should be freely waiveable like other contract rights.

Thomas Kelch and Michael Slattery address this topic in *The Mythology of Waivers of Bankruptcy Privileges*.[85] The authors posit that "properly analyzed under the law of contractual waiver, bankruptcy privileges should be freely waivable given satisfaction of certain requisites of the law of contract."[86] Kelch and Slattery offer an alternative whereby a provision of the Bankruptcy Code would be freely waivable unless there was a strong policy against enforcement, designed for the general public, which was literally compelled by the language of the statute.[87]

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83. *See supra* text accompanying notes 61–66.

84. *See* Thomas G. Kelch & Michael Slattery, *The Mythology of Waivers of Bankruptcy Privileges*, 31 IND. L. REV. 897 (1998); Kupetz, *supra* note 10; *see also* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 55–56 (1992) [hereinafter Rasmussen, *Debtor's Choice*]:

> A creditor's treatment in a bankruptcy proceeding is not something that the creditor considers only after it has extended credit to the firm. Similarly, bankruptcy is not an unknown disease that the affected parties must confront only after the firm's financial difficulties have become apparent. The fact of the matter is that the possibility of bankruptcy hangs over every decision to lend money to a firm. It is a contingency of which both parties are aware.

85. Kelch & Slattery, *supra* note 84.

86. *Id.* at 898. The authors believe that depression-era courts are responsible for creating this myth that bankruptcy privileges cannot be waived. They categorize this as "paternalism towards borrowers in a time of emergency," and suggest that such a policy has little to do with current economic conditions. *Id.* at 915.

87. *Id.* at 926:

> Therefore, it needs to be recognized that not only must a strong public policy for the benefit of the general public be found to invalidate a waiver of bankruptcy privileges but also the underlying policy must be based on existing law and precedent. In addition, the underlying policy must be a

While it is undeniably true that bankruptcy is a part of every contract, the freedom to contract argument in favor of enforcing pre-petition stay waivers holds no weight because it is a well known fact that bankruptcy modifies existing contractual rights.[88] "Upon commencement of a bankruptcy case by a party to a contract, the implicit provisions of the contract embodying the Code are activated, and the Code may interfere with and override the ordinary exercise of contractual rights."[89] This idea was specifically addressed by the court in *In the Matter of Pease*, which pointed to section 502 to demonstrate how the Bankruptcy Code disallows certain claims that would be enforceable under non-bankruptcy law. The court also pointed to sections of the Bankruptcy Code that specifically render *ipso facto* provisions unenforceable, such as section 363(l), which has been previ-

"well defined and dominant public policy against contract enforcement" and be literally compelled by the statute.

There is a movement by other professionals to go even further than Kelch and Slattery. This group, led by Professors Robert Rasmussen and Alan Schwartz, believes that the Bankruptcy Code should be recharacterized from a mandatory system of redistribution, where the Code provisions are unwaivable, to a default option, which would be freely waivable when private contracts are unworkable. *See* Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice,* 1994 U. ILL. L. REV 1 (1994) [hereinafter Rasmussen, *Essay*]; Rasmussen, *Debtor's Choice*, *supra* note 84; Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1840–44 (1998).

They also point to the fact that mandatory rules are generally viewed as the exception rather than the norm, and since bankruptcy should not concern itself with community interests there is no justification for mandatory rules. Schwartz, *supra*, at 1840–44 ("A mandatory bankruptcy rule is justifiable if the rule (1) is necessary to protect the integrity of the system itself, or (2) enhances ex post efficiency when the parties cannot reach the efficient outcome on their own."); Rasmussen, *Debtor's Choice*, *supra* note 85, at 63.

This group believes that the only goal of a bankruptcy system should be that of maximizing wealth for the parties in interest, and that such a system should pay no attention to community interests. *See, e.g.,* Rasmussen, *Essay*, *supra*, at 19 ("The modern economic conception of bankruptcy law comports with the goal of maximizing societal wealth."); Schwartz, *supra*, at 1850 ("A bankruptcy system's pursuit of goals additional to wealth maximization apparently is either ineffectual or counterproductive."). See Schwartz, *supra*, at 1817, where the author suggests that it is unnecessary to protect communities' interests in mass markets as they usually do not suffer from the majority of bankruptcy filings due to the vast competition and substitute vendors in the marketplace. He goes on to suggest that "community protection is important only when an insolvent firm would be difficult for a community to replace. Bankruptcy law should not attempt to protect communities even in this case, however, for efficiency and equity reasons." *Id.*

Finally, these authors suggest that this goal of maximizing wealth cannot be accomplished through a one-size fits all state-run system. Professor Rasmussen claims that "[t]here is no reason to think that a single bankruptcy regime would be appropriate for all firms or that those affected by the bankruptcy term of the credit contract should not be able to select the term of their choosing." Rasmussen, *Debtor's Choice*, *supra* note 84, at 53.

In general, this group of professionals believes that as bankruptcy is a part of every agreement the influence of contract law in bankruptcy should increase, and the "substantive lesson is that bankruptcy systems should contain fewer barriers to free contracting than they do now." Schwartz, *supra*, at 1812.

88. *But see* Rasmussen, *Essay*, *supra* note 87, at 18 ("The modern economic account of bankruptcy law argues that bankruptcy law should be viewed as term of the contract between a debtor and those who provide it with money or services."); Schwartz, *supra* note 87, at 1850 ("[T]he state should permit parties to contract for the bankruptcy system they prefer.").

89. Kupetz, *supra* note 10, at 57.

ously discussed.[90] There is no better example, however, of the Bankruptcy Code's power to alter contractual provisions than section 365,[91] which permits the debtor to reject, assume, or assign executory contracts as he/she/it chooses. Contracts that were perfectly valid and enforceable prior to bankruptcy can be rejected, which relegates the party seeking enforcement to the position of an unsecured creditor. Additionally, section 365 has the power to further modify contractual rights by rendering *ipso facto* and anti-assignment clauses invalid as well.[92]

In 1997, the National Bankruptcy Commission specifically called for the Bankruptcy Code to be redrafted to include, except as otherwise provided, an express prohibition of pre-petition waivers of bankruptcy rights.[93] In response to supporters of the freedom of contract argument, the Commission rightly pointed out that such an argument "presumes from the outset that all parties were represented at the bargaining table and unanimously agreed to the remedies set forth, relatively unlikely circumstances for most business dealings."[94] The Commission noted that "[b]ankruptcy is designed to provide a structure to deal with unforeseeable events with third party consequences that cannot be replaced by two-party arrangements."[95]

The recommendations of the Commission were not limited to waivers of the automatic stay, and as such they directly apply to section 363 waivers.[96] Because

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90. *In re Pease*, 195 B.R. at 434. The *Pease* court cites numerous sections to demonstrate how the Bankruptcy Code substantively alters the contractual rights and remedies of parties in interest. Specifically, the court stated, "the Bankruptcy Code extinguishes the private right of freedom to contract around its essential provisions. This conclusion follows from the comprehensive nature of the Bankruptcy Code and its underlying purpose of providing a nationally uniform collective remedy to debtors and creditors." *Id.* The court pointed to sections 108, 554, 546, 548, 363, 364, 365, 1123, 1124, 1129, 1222, 1225, 1322, and 1325 as other examples of how the Bankruptcy Code alters contractual rights. *Id*.

91. 11 U.S.C. § 365 (2000).

92. 11 U.S.C. §§ 365(e), (f) (2000).

93. FINAL REPORT, *supra* note 56, at 478–87. Recommendation 2.4.5, subtitled *Prebankruptcy Waivers of Bankruptcy Code Provisions*, states:

> Section 558 of the Bankruptcy Code should provide that except as otherwise provided in title 11, a clause in a contract or lease or a provision in a court order or plan of reorganization executed or issued prior to the commencement of a bankruptcy case does not waive, terminate, restrict, condition, or otherwise modify any rights or defenses provided by title 11. Any issue actually litigated or any issue resolved by consensual agreement between the debtor and a governmental unit in its police or regulatory capacity, whether embodied in a judgment, administrative order or settlement agreement, would be given preclusive effect.

Id. at 478.

94. *Id.* at 486.

95. *Id.*

96. *Id*. at 485. The Commission specifically pointed out that their findings and recommendations regarding pre-bankruptcy waivers were not limited to waivers of the automatic stay, as inevitably new forms will evolve.

> The Recommendation contains generic language because the waivers at issue do not exclusively involve the automatic stay or any other specific provision, and lawyers are sufficiently creative to

bankruptcy looms as a possibility in every lending agreement, parties are well aware of the fact that the Bankruptcy Code modifies contractual rights. An argument that pre-petition 363 waivers should be enforceable based upon the general freedom to contract is unpersuasive because the Bankruptcy Code has long had the power to alter contracts. Parties would be better served by using this knowledge to solidify their positions in the event of bankruptcy (i.e., becoming secured lenders or priority creditors, or accurately pricing their loans based on the risk their lender will file for bankruptcy) rather than attempting to circumvent the provisions of the Code. Drafting contracts as if the Code were expressly incorporated into the agreement would serve parties better in the long run than risking it all trying to contract around it.[97] Since it is well known to all parties that the Bankruptcy Code modifies contractual rights, any argument favoring enforcement of a section 363 waiver based on the concept of freedom to contract is unpersuasive.[98]

> devise alternative approaches to accomplish the same result. Thus, the statute should address the principle of prohibiting prebankruptcy waivers and not limit this directive to any specific form of waiver. Because waivers also appear in prior plans of reorganization, dismissal orders, and potentially in other court orders, it is important that such prebankruptcy waivers be made ineffective when presented in those forms.

Id.

97. See Kupetz, *supra* note 10, at 57, where the author suggests the inclusion of a number of provisions in any contract or lending agreement as "each contract is made as if the Code were expressly incorporated in the contract."

98. In addition to the two policies discussed above, many courts cite a third policy in favor of enforcing automatic stay waivers, which is not discussed, and that is that a waiver of the automatic stay is fundamentally different than a waiver of the opportunity to file for bankruptcy. *See In re Club Tower*, 138 B.R. at 311; *see also* Kelch & Slattery, *supra* note 84, at 908 ("Bankruptcy law provides a number of privileges. Waiver of any one of these privileges does not amount to waiver of all of them."). Kelch and Slattery go on to say that "[w]hile it is true that some privileges are of more value to some debtors than others, this does not affect the existence and general value of all of the privileges." *Id.*

    No matter which side of the circuit split over the enforceability of section 362 waivers a court falls, all of these courts universally agree that a waiver of the right to file for bankruptcy is invalid and contrary to public policy. This argument was central to the waiver considered in *In re Club Tower*. In that case, the court held that "relief from the stay is significantly different from a provision which prohibits a debtor from filing a bankruptcy petition and thus this there is no violation of public policy [through enforcement]." 138 B.R. at 311. The court cited three specific reasons for its finding. First, by agreeing to waive the stay, the debtor was not estopped from filing for relief in general. Second, by agreeing to an automatic stay waiver the debtor only waived a single benefit of the Bankruptcy Code, and there was no provision within the Bankruptcy Code that guaranteed the stay would be in effect throughout the case. And third, the *Club Tower* court stated that enforcement was called for because the debtor still retained the benefits of the automatic stay as to other creditors. *Id.*

    None of these policy rationales, however, translate to a justification for the enforcement of a section 363 provision. By enforcing a section 363 waiver, the debtor would be deprived of any opportunity to sell the targeted property at a higher price to other creditors. In addition, the potential bidders would be deprived of any and all opportunity to bid on such assets. Thus, in this instance, the waiving of this one protection of the Bankruptcy Code amounts to a waiver of all protections granted by section 363 and not merely a single benefit. Therefore, unlike automatic stay waivers, the fact that section 363 waivers are fundamentally different from waiving the right to file for bankruptcy does not justify their enforcement.

Finally, after debunking the policies used to justify enforcement of section 363 waivers, and establishing that the debtor lacks the legal capacity to make such a waiver pre-petition, and demonstrating how such a waiver would unfairly bind third parties, if further proof is needed to demonstrate that pre-petition section 363 waivers should not be enforced, enforcement of such provisions would clearly ignore the dual purposes of the Bankruptcy Code.[99]

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99. Authorities also cite to the fact that allowing enforcement of pre-petition waivers of the automatic stay will inevitably lead to such provisions becoming boilerplate language as a policy against enforcement. *See, e.g.,* Burnett, *supra* note 79.

If, however, these waivers are consistently enforced, then eventually all banks and lenders will require their borrowers to waive their rights to the automatic stay in standardized loan and forbearance documents. An automatics stay waver might become a permanent boilerplate clause, buried in all organic loan documents and financing agreements. Effectively, section 362 could be transformed from one of the most crucial provisions in today's Bankruptcy Code to mere historical footnote, irrelevant for all Chapter 11 reorganizations. The concern is that if pre-petition waivers of bankruptcy rights are routinely enforced, they will give an unconscionable advantage to creditors, which will force debtors to sign away rights in order to get financing. In addition, the National Bankruptcy Commission reported that if pre-petition waivers were routinely enforced, creditors may become more insistent that waivers be signed early if there were any signs of financial distress. This could further discourage pre-bankruptcy workouts as it would make the workout unattractive for sophisticated debtors, perhaps prompting them to file Chapter 11 immediately. FINAL REPORT, *supra* note 56, at 451–607.

In addition, such boilerplate language would risk injury to less sophisticated and generally smaller creditors as larger creditors would essentially cut them out of the section 363 bidding process. Thus, if such provisions became boilerplate, creditors would in essence be divesting smaller creditors of their rights. A pre-packaged Chapter 11 at least recognizes smaller creditors' rights, and requires their vote before a plan, which may involve a sale of assets, is set into motion. Boilerplate language would divest smaller creditors of any of their rights under section 363.

While Professor Kelch argues that this fear of boilerplate language is just another myth, and that expanding markets and increased competition among lenders make it unlikely that such waivers will become standardized, one need only attend a CLE meeting to realize that the practice of including pre-petition waivers in any agreement, whether enforceable or not, is already being encouraged. Kelch & Slattery, *supra* note 84, at 911:

> Myth No. 6: Waivers Give Unconscionable Advantage to Creditors . . . The assumption [that enforcement of pre-petition waivers will lead to boilerplate language] is not supported by evidence, anecdotal or otherwise. Given the expanded lending markets, new types of lending programs, and greater competition in lending that have arisen in the past twenty years, is it not at least as likely that enforceable waivers of bankruptcy privileges would be mere bargaining chips in debtor-lender negotiations?

For example, in materials prepared for the American Bankruptcy Institute's Twentieth Annual Spring Meeting in 2002, the contributors suggest that "[a] landlord might also consider including provisions to which a debtor-to-be waives the protection of the automatic stay if the debtor files for bankruptcy." Markowitz, *supra* note 60.

The inclusion of section 363 waivers as a standard business practice would force debtors to make decisions about the value of their assets and a strategy for reorganization before they even commenced the business venture that had yet to fail. Such boilerplate language would inevitably lead to poor business decisions that could doom business reorganizations before they are even commenced. As such, the fear that section 363 waivers could become boilerplate language is very real, and is yet another reason that section 363 waivers should not be enforced.

iii. The Dual Purposes of the Code

In *In re Sky Group International, Inc.*,[100] where a pre-petition agreement between the debtor and creditor was held not to be self-executing, the court stated that the legislative history of the Bankruptcy Code makes it clear that the automatic stay has a dual purpose of protecting both the debtor *and* creditors. The legislative hearings of the House of Representatives on the automatic stay explain this dual purpose.

> [The automatic stay] gives the *debtor* a *breathing spell* from his creditors. It stops all collection efforts, all harassment, and all foreclosure action. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.
>
> *The automatic stay also provides creditors protection*. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. *Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally*. A race of diligence by creditors for the debtor's assets prevents that.[101]

The Bankruptcy Code exists to give debtors some breathing room — enabling them to regroup and hopefully get a fresh start. But it also exists to provide an orderly forum to repay all creditors. Individual creditors should not be able to alter the statutory rights of other creditors by pre-petition agreement as it undermines the orderly distribution of assets and ignores the equity principal of treating similarly situated creditors alike. A pre-petition section 363 waiver deprives all other creditors of any right to bid on the targeted property. The fact that a debtor receives fair market value for an asset does not change the fact that the legislative purpose of the Bankruptcy Code serves more than just the debtor. Enforcing such a waiver ignores community interests and jeopardizes the likelihood of successfully reorganizations.[102]

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100. 108 B.R. 86 (Bankr. W.D. Pa. 1989); *see also In re Farm Credit*, 160 B.R. at 873 ("The stay prevents certain creditors from gaining a preference for their claims against the debtor and, in general, avoids interference with the orderly liquidation or rehabilitation of the debtor."); *In re Deb-Lyn*, 2004 WL 452560, at *2 (citing *In re Farm Credit*, 168 B.R. at 873) (following the rationale of the *Farm Credit* court stating that the policy of holding pre-petition waivers of the automatic stay as unenforceable is "consistent with the purposes of the automatic stay to protect the debtor's assets, provide temporary relief from creditors and promote equality of distribution among the creditors by forestalling a race to the court house").

101. 108 B.R. at 88–89 (citing H.R. Rep. No. 95-595, 95th Cong. 340 (1977), *reprinted in* 1977 U.S.C.C.A.N. 5787, 5963, 6296–97) (emphasis added).

102. *See, e.g.*, Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994). See GROSS, *supra* note 57, for an in-depth discussion of the history of the bankruptcy code, its provisions, and recommendations for reform that reflect an appreciation for the community interests of the Code, as well as an appreciation for equality of outcome over equality of treatment.

William Burnett, in *Prepetition Waivers of the Automatic Stay: Automatic Enforcement Equals Automatic Trouble*, states that "the legislative comments [of the Bankruptcy Code] indicate a concern about bankruptcy's impact on the community and applaud the Code's ability to 'protect the investing public, protect jobs, and help save troubled business.'"[103] Allowing enforcement of pre-petition waivers that "fix" property of the estate sales would ignore these interests. They would not be in the best interests of the debtor, who may not have the sophistication or knowledge to effectively make such a decision. Furthermore, it could hardly be argued that a pre-petition sale was made in good faith as is required by section 363 when it was reached by *sub rosa* agreement, cutting off any opportunity of other bidders to participate. Even if such an agreement were made in full view of the public, enforcement of such an agreement puts a debtor in a situation where it may have to sell important assets to a party that strategically may not be in the best interests of the reorganization.

All of these aforementioned reasons demonstrate how pre-petition section 363 waivers jeopardize successful reorganizations, which put employees, equity holders and other creditors all at risk. Thus, circumventing the Bankruptcy Code by enforcing section 363 waivers ignores the community interests that the Bankruptcy Code was designed to protect, and ignores the *dual* purposes of the Code.

III. CONCLUSION

The Bankruptcy system exists to protect debtors and creditors alike. As lending agreements become more and more complex, creditors are seeking new proactive means of protecting their investments and leapfrogging other creditors in bankruptcy priority. As Chapter 11 proceedings grow in complexity, section 363 of the Bankruptcy Code has become increasingly important to debtors to effectuate successful reorganizations. Waivers of bankruptcy protections are already commonly used, and a next logical extension of this will be the practice of including pre-petition agreements whereby the debtor agrees to sell assets to the lender in the event of a bankruptcy filing at a prearranged fixed price.

The recent amendments to the Bankruptcy Code were perhaps the most sweeping reforms of insolvency law in the last thirty years. With all of the changes to the Bankruptcy Code, however, the amendments to section 363 fail to address the possible existence of pre-petition clauses that attempt to fix sales outside the ordinary course of business.[104] The amendments to section 363 re-

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103. Burnett, *supra* note 79, at 263*; see also In re South East Fin.*, 212 B.R. 1003.

104. The amendments to section 363 read as follows:

> Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005), struck out the period at the end and inserted the following:
>
> > except that if the debtor in connection with offering a product or a service discloses to an individual a policy prohibiting the transfer of personally identifiable information about individuals to persons that are not affiliated with the debtor and if such policy is in effect on the date of the

main silent on the issue of whether section 363 may be varied by private agreement.

By examining section 363 itself and drawing policy comparisons to waivers of the automatic stay, it becomes clear that a halt must be called to the erosion of bankruptcy protections. There are policy rationales in favor of enforcing section 362 waivers; however, these policies do not translate to waivers of section 363. The courts that have found waivers of section 362 to be enforceable have done so citing the fact that they are not binding on third parties. This, however, is not the case with section 363 waivers.[105] Agreements that contract around the provisions of section 363 deprive all other potential bidders of the opportunity to participate in the section 363 auction, and deprive the estate of any opportunity to make a more current decision regarding its best interests. These pre-petition agreements deal with unforeseeable events that have third party consequences, which cannot be permitted.[106]

This fundamental difference is the crux of the matter and the reason section 363 waivers should not be enforced. Even if such pre-arranged sales bring fair value to the estate, their mere existence would have a chilling effect on section 363 sales. Potential bidders would be discouraged from participating in auctions and possible higher and better offers would be lost. Furthermore, binding debtors to agreements they lack legal capacity, knowledge and foresight to enter into is

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commencement of the case, then the trustee may not sell or lease personally identifiable information to any person unless —

(A) such sale or such lease is consistent with such policy; or

(B) after appointment of a consumer privacy ombudsman in accordance with section 332, and after notice and a hearing, the court approves such sale or such lease —

(i) giving due consideration to the facts, circumstances, and conditions of such sale or such lease; and

(ii) finding that no showing was made that such sale or such lease would violate applicable nonbankruptcy law.

Subsec. (d). Pub.L.109-8, § 1221(a), struck out "only to the extent not inconsistent with any relief granted under section 362(c), 362(d), 362(e), or 362(f) of this title" at the end of the subsection and inserted "only (1) in accordance with applicable nonbankruptcy law that governs the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust; and (2) to the extent not inconsistent with any relief granted under subsec. (c), (d), (e), or (f) of section 362."

Subsec. (o). Pub.L. 109-8, § 204(1), (2), added a new subsec. (o) and redesignated former subsec. (o) as subsec. (p). Subsec. (o) now states:

Notwithstanding subsection (f), if a person purchases any interest in a consumer credit transaction that is subject to the Truth in Lending Act or any interest in a consumer credit contract (as defined in section 433.1 of title 16 of the Code of Federal Regulations (January 1, 2004), as amended form time to time), and if such interest is purchased through a sale under this section, then such person shall remain subject to all claims and defenses that are related to such consumer credit transaction or such consumer credit contract to the same extent as such person would be subject to such claims and defenses of the consumer had such interest been purchased at a sale not under this section.

Subsec. (p). Pub.L. 109-8, § 204(1), redesignated former subsec. (o) as subsec. (p).

105. *See supra* text accompanying notes 72–75, 93–98.

106. *See supra* text accompanying notes 72–75, 93–98.

unconscionable and jeopardizes the success of reorganizations. Parties that cry out in favor of efficiency and the freedom to contract must realize that enforcement of such clauses will lead to hasty decision-making and unfavorable agreements.[107]

The Bankruptcy Code works to guarantee the proper functioning of the credit economy. Its rules and provisions work to limit any ripple effect of past failures, and ensure that past failures do not amount to fatalities. The Code, however, cannot function properly if parties are permitted to chip away at its protections and contract around its provisions.

107. *See* Stevens & Lee, P.C., *supra* note 17.