

HOW “FREE AND CLEAR” IS A SALE UNDER SECTION 363(f)?

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One of the primary benefits of purchasing assets in bankruptcy is that such assets can be purchased “free and clear” of existing liens, encumbrances and interests under 11 U.S.C. §363(f).

Section 363(f) of the Bankruptcy Code provides:

- (f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if –
 - (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
 - (2) such entity consents;
 - (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on the property;
 - (4) such interest is in bona fide dispute; or
 - (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

11 U.S.C. § 363(f).

I. CLEAR CHANNEL

A recent decision by the Bankruptcy Appellate Panel (“BAP”) of the Ninth Circuit, Clear Channel Outdoor, Inc. v. DB Burbank, LLC (In re PW LLC), 391 B.R. 25 (B.A.P 9th Cir. 2008) (“Clear Channel”), has generated a substantial amount of controversy by taking a very narrow view of the scope of the protections available to a buyer in connection with a “free and clear” sale, and holding that § 363(f) does not permit the stripping of a junior lienholder’s interest in the debtor’s property where the sale price is less than the amount of all claims secured by the debtor’s property.² Equally concerning, the Ninth Circuit BAP also concluded that § 363(m) of the Bankruptcy Code, which is generally understood to moot any appeal of an unstayed and consummated sale to a good faith purchaser, did not preclude the court from ordering junior liens to be reattached to the property transferred even though the sale had already closed.³

In Clear Channel, the debtor owned real estate and was attempting to develop property in Burbank, California. The senior secured lienholder, DB Burbank LLC (“DB”), held a \$40 million claim and a first priority lien on substantially all of the debtor’s assets. Clear Channel Outdoor Inc. (“Clear Channel”) held a junior lien on the property securing a claim of approximately \$2.5 million. Following a default by the debtor, DB commenced foreclosure

proceedings and also sought the appointment of a state receiver. On the eve of foreclosure, the debtor filed for bankruptcy.

A chapter 11 trustee was appointed and eventually filed a motion to sell the debtor's assets free and clear of liens pursuant to §§363(f)(3) and (f)(5). DB became the stalking horse bidder for approximately \$41.4 million plus an \$800,000.00 carve out to the trustee. Clear Channel opposed the sale motion.

DB's credit bid was ultimately successful, and, when the sale closed, there were no excess proceeds remaining to which Clear Channel's lien could attach. The bankruptcy court approved the sale to DB, entered an order confirming the sale and did not stay the order pending appeal. Clear Channel appealed to the BAP to have the sale order reversed and its lien attach to the carve-out amount.⁴

On appeal, the BAP held that §363(m) did not moot Clear Channel's appeal of the sale order, which included provisions making the sale "free and clear" of Clear Channel's junior lien, because the plain text of §363(m) applies only to "an authorization under subsection (b) or (c)" and, therefore, would not apply to the "free and clear" character of the sale under §363(f).⁵ Because §363(m) only referred to a "sale or lease" and not to "use" or "transfer" of property, the panel found that the legislative intent must have been for §363(m) to simply address the essential attributes of a sale, including changes of title, but did not include the "free and clear" terms of the sale which allow for lien stripping.⁶

The BAP then considered whether §363(f)(3) permitted the stripping of Clear Channel's lien because the debtor's property was sold for less than the amount of claims secured by the debtor's property. Although the trustee asserted that the phrase "aggregate value of all liens" referred to the economic value of the such liens, as determined under section 506(a), as opposed to their face value, the BAP concluded that §363(f)(3) did not apply to allow the sale free and clear of Clear Channel's junior lien because the debtor's property was sold for less than the amount of secured claims against the property. The BAP found that if the price at which the estate property is being sold is *equal to or less than* the aggregate amount of all claims held by creditors holding a lien or security interest in the property, section 363(f)(3) does not permit a sale of the property free and clear of the junior lienholder's lien. Therefore, to sell property free and clear under §363(f)(3), the sales price must exceed the total value of all liens on the property.⁷

Finally, the BAP concluded that the "free and clear" provisions of the sale order could not be affirmed under § 363(f)(5) because neither the trustee nor the purchaser had directed the BAP to any legal or equitable proceeding under nonbankruptcy law in connection with which Clear Channel could have been compelled to accept a monetary satisfaction of its interest in exchange for a payment that was less than the full value of its claim.

Following a remand to the Bankruptcy Court for further proceedings, the parties ultimately settled the case, and no further review of the BAP's decision was sought.

II. ISSUES RAISED BY CLEAR CHANNEL

A. 363(m) and Mootness of the Terms of Sale Orders on Appeal

- ❖ If Clear Channel is a correct statement of the law, although the §363 sale itself may not be subject to appeal under §363(m), the most attractive aspect of a §363(f) sale to a potential purchaser -- the “free and clear” terms of the sale -- may be subject to appeal.
- ❖ Clear Channel may encourage disgruntled junior lienholders, or other parties, to challenge the “free and clear” provisions of §363(f) without obtaining a stay pending appeal.
- ❖ A §363 sale may end up costing more with all the subsequent appeals as opposed to a state foreclosure action or other remedies and may discourage purchasers from participating in bankruptcy sales.
- ❖ Because §363 sales may be impeded, senior secured creditors may be more apt to seek relief from the automatic stay to foreclose on their collateral.

B. Valuation of Liens and Property for Purposes of Subsection (f)(3)

- ❖ There is a debate as to the meaning of “aggregate value of all liens” under §363(f)(3) – this phrase can be interpreted to mean either the economic value of the property secured by the liens or the face value of the claims secured by those liens.
- ❖ Some courts have found that because an allowed secured claim can never exceed the value of the property securing the claim, section 363(f)(3) can be used to sell free and clear of out-of-the-money liens or junior lienholders whose liens are not supported by the collateral’s value.⁸
- ❖ Other courts have found that a sale cannot be free and clear under §363(f) if the price of the estate property is equal to or less than the aggregate amount of all claims held by creditors holding a lien or security interest in the property being sold.⁹

C. Power to Undersecured Creditors

- ❖ If Clear Channel is followed by other courts, it may give undersecured creditors an effective veto power over the sale process.

D. What is an “Interest In Property”?

- ❖ The term “interest” is not defined in the Bankruptcy Code even though the terms “claim” and “lien” are defined. See 11 U.S.C. §101(5) and 101(37).
- ❖ Under § 363(f)(3), a “lien” is included as a type of interest – so an interest is presumably something *more* than a “lien,”¹⁰ but does “interest in such property” also encompass “claims”?

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- ❖ If “interests” encompass claims, what kinds of claims are extinguished pursuant to §363(f) sale? Can future claims be extinguished under a §363(f) sale?

1. *The Majority View – Broad Construction of “Interest in Such Property”*

- ❖ A majority of courts have adopted a broad view of “interest in property” to include other obligations that stem from the ownership of property as opposed to being limited to traditional *in rem* interests.¹¹
- ❖ One instance where the issue of defining “interests” arises is with respect to whether §363(f)(5) includes liens as an “interest,” such that a lienholder could be compelled to accept a money satisfaction of its lien, since “liens” are already specifically included in §363(f)(3) as was considered in the Clear Channel case (above).
- ❖ The Sixth Circuit Court of Appeals in Al Perry Enterprises, Inc. v. Appalachian Fuels, LLC, 503 F.3d 538 (6th Cir. 2007) (“Al Perry”) found “interest” to include a “claim” such that pre-petition obligations satisfying the definition of a “claim” under §101(5) could be extinguished in a §363(f) sale.

Al Perry –The plaintiff, Al Perry, acted as a sales agent for the debtor, Bowie, and was paid commission on sales of coal pursuant to several contracts with the debtor. A dispute arose pre-petition on account of a particular contract with the Tennessee Valley Authority (“TVA”) and an agreed judgment was entered by a federal district court whereupon Bowie was required to assume its contractual obligations to the plaintiff even if Bowie were to enter bankruptcy. Bowie eventually entered bankruptcy and the bankruptcy court subsequently approved a §363 sale of substantially all of the debtor’s assets. The plaintiff made no objection to the sale and the bankruptcy court authorized the sale “free and clear of all liens, claims and encumbrances.”

The plaintiff asserted that the purchaser’s voluntary assumption of the purchase and sale of coal between the debtor and the TVA necessarily indicated that the purchaser also assumed the obligation to pay commissions to the plaintiff. The Sixth Circuit held that Perry’s claim to commission was extinguished by the free and clear sale under §363 unless the purchase expressly assumed the obligation as part of the purchase agreement.¹²

In re Autostyle Plastics, Inc., 227 B.R. 797, 800 (Bankr. W.D. Mich. 1998) (“Autostyle”) -- Where a former sales agent’s claims to commission arose from a contract with the debtor which was entered into prior to the filing date, the bankruptcy court found that the right to payment was an “interest in property” which was sold free and clear to the purchaser.

- ❖ Some courts have claimed that a § 363 sale order can affect any claim which can be dealt with under a plan. These courts find that sales conducted by use of the court’s equitable powers in conjunction with § 105(a) can provide a debtor with the same kind of relief

effected by a plan of reorganization under § 1141, which discharges claims against the debtor (except as otherwise provided for in the plan or confirmation order).¹³

- ❖ A §363(f) sale may not necessarily provide protection against future claims that do not arise until the bankruptcy proceeding has concluded (see discussion on Successor Liability below).¹⁴
- ❖ One court, however, found the term “interest” to even encompass future claims and interests:

In re Paris Industries Corp., 132 B.R. 504 (D. Me. 1991) – Plaintiff bought a toboggan from the debtor prior to the petition date, but injured herself while riding the toboggan after the § 363 sale of the debtor’s business. The plaintiff brought a products liability and negligence action against the purchaser of the debtor’s property. The plaintiff claimed that the bankruptcy court could not approve a sale free and clear of claims that might arise in the future, but only to claims then existing.

The district court disagreed and found that preventing a bankruptcy court from approving a sale free and clear of future claims against a subsequent purchaser of the debtor’s assets would significantly impair the bankruptcy court’s ability to administer bankruptcy estates because every §363 sale would then have to be discounted by the purchaser on account of future claims. Moreover, this would create the effect of preferring later filed claims against the purchaser over those who already have filed claims in the bankruptcy case.¹⁵

2. *The Minority View – Narrow Construction of “Interest in Such Property”*

- ❖ A minority of courts have taken the narrow construction of “interest in such property” to mean only traditional *in rem* interests, which include, e.g., liens, mortgages, judgments, etc.
- ❖ These courts have concluded that claims that are simply *in personam* claims against a debtor, and therefore not tied to any specific property of the debtor, are not considered to be “interests in such property” which can be sold free and clear under § 363(f).¹⁶
 - For example, in *In re White Motor Credit Corp.*, the bankruptcy court found that tort claims for injuries that arise after the free and clear sale were *in personam* claims against the debtor because such claims had no specific relation to the debtor’s property. Therefore, section 363 was found to be inapplicable to allow a sale free and clear of such claims.¹⁷
 - This same court, however, found an alternative basis for authorizing the same sale free and clear by resorting to its equitable powers and the authority granted to the court under §1141. Section 1141 authorizes property dealt with by a plan to be disposed of “free and clear of all claims and interests.” The court ultimately found

that a sale pursuant to the court's equitable powers could afford the same degree of relief provided in the context of a confirmed plan of reorganization under §1141, which allows for a discharge of claims against the debtor.

- Similarly, in In re New England Fish Company, where civil rights claimants objected to the debtor's proposed sale of its fish processing business free and clear of their discrimination claims under Title VII, the court found that the civil rights claimants were general unsecured creditors of the debtor's bankruptcy estate because they did not have an interest in the specific property of the estate being sold to the purchaser pursuant to the §363(f) sale. This was because, among other things, at least one class of claimants did not have a judgment lien resulting from the finding of discrimination.¹⁸
- Like White Motor Corp., however, the New England Fish court also authorized the sale free and clear of successor liability claims on alternative grounds because the court found that failure to approve the sale free and clear would result in a chill in bidding or render the sale process impossible.¹⁹

E. The Implications of Clear Channel

The effect of Clear Channel may be unclear at best because upon the Ninth Circuit BAP's remand to the bankruptcy court, the parties settled the matter. Additionally, the effect of Clear Channel is unclear because the Ninth Circuit BAP based its holding, in part, on §363(f)(5), and found that the bankruptcy court was required to find a mechanism or another qualifying proceeding which would compel extinguishing the junior lien without paying such interest in full. The trustee and purchaser had failed to assert the obvious remedy of a foreclosure as a proceeding that would cut off the rights of the junior lienholder without paying the junior lien in full. Had the record been more sufficient, the outcome in Clear Channel may very well have been different.

III. SUCCESSOR LIABILITY CLAIMS

- ❖ Expansive interpretations of the phrase "interest in such property" has led some courts to consider whether future claims for successor liability constitute "interests in such property" that can be stripped away under a §363(f) sale.
- ❖ Successor liability is a judicially crafted exception to the general rule that the sale or transfer of a corporation's assets to another corporation generally does not bring with it liability for the liquidated or unliquidated debts of the selling corporation.
- ❖ Under the laws of most states, a purchaser of assets may be held liable for the debts of, or claims against, its seller only where (1) there is an expressed or implied assumption of liability, (2) the transaction amounts to a consolidation, merger or similar restructuring of the two business entities, (3) the successor is a mere continuation of the predecessor, or (4) the transaction is a fraudulent attempt to avoid the liabilities of the predecessor.²⁰

- ❖ Some courts have found that a “free and clear” sale under §363(f) does not preclude future claims that arise after bankruptcy.
- ❖ For example, in In re Autostyle Plastics, Inc., 227 B.R. 797, 800 (Bankr. W.D. Mich. 1998), the court noted that “a sale free and clear does not include future claims that do not arise until after the conclusion of the bankruptcy proceeding.”
- ❖ In Ninth Avenue Remedial Group v. Allis-Chalmers Corp., 195 B.R. 716, 732 (N.D. Ind. 1996), the court found that the fact that an asset was sold in the context of a bankruptcy proceeding was not determinative of the applicability of successor liability. The court held that a sale free and clear would not include future claims that did not arise until after the conclusion of the bankruptcy proceedings. The court so found because the bankruptcy court could have discharged claims brought against a debtor during the bankruptcy pursuant to its equitable powers, but claims arising after consummation of the bankruptcy proceedings could not be discharged by the bankruptcy court.²¹
- ❖ In In re Fairchild Aircraft Corp., 184 B.R. 910 (Bankr. W.D. Tex. 1995)²², the bankruptcy court held that it did not have the authority to expand the language of §363(f) which allows a sale free and clear of “interests in such property,” which the court interpreted to refer only to *in rem* interests, to enjoin successor liability of *in personam* interests as well simply because precluding successor liability would maximize the estate’s asset value and promote the debtor’s reorganization.
- ❖ By contrast, many bankruptcy courts have also rejected the notion that successor liability claims can be imposed on a purchaser of assets pursuant to a §363(f) sale.²³
- ❖ The issue of stripping successor liability claims has received significant attention after the seminal opinions on the issue by the Fourth Circuit’s Court of Appeals in In re Leckie Smokeless Coal Company, 99 F.3d 573 (4th Cir. 1996) (“Leckie”) and the Third Circuit in In re Transworld Airlines, Inc., 322 F.3d 283 (3d Cir. 2003) (“TWA”).

A. Leckie

In Leckie, chapter 11 debtor-coal operators sought a declaration that purchasers of the debtors’ assets in a §363 sale would not be held jointly and severally liable as successors in interest for the debtors’ financial obligations to fund a benefit plan under the Coal Industry Retiree Health benefit Act of 1992 (the “Coal Act”), even though successors in interest are generally subject to joint and several liability under the Coal Act.

Although several bankruptcy courts had previously limited the scope of “interests in such property” under §363(f) to *in rem* interests²⁴, the Fourth Circuit adopted a broader definition. The court interpreted the term “claim” broadly and found that the term “interest” encompassed the premium payments owed to the plan, which were sold free and clear, because there was a sufficient relationship between the debtors’ obligations under the Coal Act and the debtors’ use of the assets sold. The Fourth Circuit therefore held that, even if the purchasers were considered successors in interest under the Coal Act, the bankruptcy court had the power to extinguish

successor liability under the Coal Act under §363(f)(5). The debtors could, therefore, sell free and clear of any successor liability claims that may arise under the Coal Act.²⁵

B. TWA

In TWA, the bankruptcy court entered a §363(f) sale order extinguishing successor liability asserted against the purchaser, American Airlines, for employment discrimination claims brought against the debtor, TWA, as well as for claims brought against TWA pursuant to a travel voucher program awarded to certain TWA flight attendants in settlement of a gender discrimination action. American Airlines asserted that the claimants could be compelled to accept a money satisfaction of their interests under §363(f)(5) because under a chapter 7 liquidation, the claims would have been converted to dollar amounts and the claimants would have received a distribution similar to that of other general unsecured creditors.

Following the lead of the Fourth Circuit in Leckie, the Third Circuit Court of Appeals found that a sufficient relationship existed between the employment and discrimination claims against the debtor and the debtor's property being sold because the claims arose from the property being sold. Therefore, the successor liability claims constituted "interests in such property" under §363(f) and were extinguished in a free and clear sale to American Airlines. The court also found that the priority scheme of the Bankruptcy Code supported the transfer of the debtor's assets free and clear of the successor liability claims. Allowing successor liability claims would permit general unsecured claimants to seek a recovery against the successor entity while creditors who are entitled to priority under the Bankruptcy Code would be relegated to the limited assets of the bankruptcy estate.²⁶

- ❖ There is also precedent for holding that successor liability may be precluded with respect to sudden injuries occurring after a §363(f) sale but prior to confirmation of a plan, if the claim could have been dealt with under the plan. See, e.g., In re Piper Aircraft Corp., 169 B.R. 766 (Bankr. S.D. Fla. 1994). In such cases, even though the injury arose post-petition, the claim may be regarded as a pre-petition claim because it was caused by a defective product manufactured and sold pre-petition.²⁷
- ❖ Post-Leckie and post-TWA, some courts have declined to expand the term of "interests in such property" to extinguish interests whenever a mere relationship between the claims and the assets being sold can be shown.

In re Eveleth Mines, LLC, 312 B.R. 634 (Bankr. D. Minn. 2004) -- The debtor, a corporation which mined taconite, sold its assets free and clear to a purchaser under § 363. After the sale closed, the Minnesota Department of Revenue ("MDOR") asserted taconite production tax liability against the purchaser which was calculated using an average of previous years' production, which included years of the debtors' operation. The purchaser asserted that any and all tax consequences arising from the debtors' prior production was an "interest" that was extinguished pursuant to the §363(f) sale order.

In declining to adopt the expansive view of "interest" set forth in Leckie and TWA, the court looked to state law to define "interest." The court looked to the

Minnesota Supreme Court's analysis of the taconite production tax scheme, as well as to the fact that no lien existed against the facility sold on account of the purchaser's production tax liability, to determine that no "interest" existed in favor of MDOR on account of the purchaser's tax liability that could be extinguished in a §363(f) sale. Therefore, the court found that the MDOR's assessment against the purchaser did not violate the §363(f) sale order and purchasers were not entitled to declaratory relief.²⁸

- ❖ In the context of environmental claims, in **Ninth Avenue Remedial Group v. Allis-Chalmers Corp.**, 195 B.R. 716 (N.D. Ind. 1996), a district court found that, although an order approving a sale free and clear of all claims might preclude an action against a purchaser for any claim that could have been brought against the debtor during bankruptcy, the sale order could not preclude environmental claims asserted against the purchaser based on the debtor's conduct as a waste generator, if the environmental claims did not arise until after bankruptcy proceedings had concluded. This is because the bankruptcy court could have discharged claims brought against a debtor during the bankruptcy pursuant to its equitable powers, but claims arising after consummation of the bankruptcy proceedings cannot be discharged by the bankruptcy court.²⁹
- ❖ Proper and adequate notice to a party whose interest would be extinguished in a §363(f) sale of substantially all of the debtor's assets seems to be particularly crucial with respect to the issue of successor liability in bankruptcy sales.

In re National Pipe & Plastics, Inc., No. 96-1676 (PJW), 2000 WL 33712292 (Bankr. D. Del. 2000) – A creditor had obtained a judgment against the debtor for defective piping sold by the debtor prior to the commencement of the debtor's bankruptcy case. The debtor then sold substantially all of its assets to a purchaser pursuant to §363 sale.

The creditor did not receive actual notice of the sale and the debtor did not list the creditor on its bankruptcy schedules even though the debtor was aware of the claim. Although the sale order included numerous findings by the bankruptcy court, including, among other things, that sufficient notice had been given, that no further notice was required and that the purchaser was not a successor to the debtor, the bankruptcy court found that the creditor was not given notice of the sale that was "reasonably calculated under all circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present objections" although he was entitled to such notice. The court also found that issues of fact existed precluding summary judgment on the issue of whether the purchaser was the debtor's successor and that several factors supporting successor liability were present between the debtor and the purchaser. This case tends to show that as specific as findings of fact in a sale order may be, such findings will not always preclude the possibility of a collateral attack.

IV. **OTHER LIMITS ON FREE AND CLEAR SALES**

A. **Section 363(f) May Not Provide A Basis to Cure Certain Types of Default**

- ❖ The Ninth Circuit Court of Appeals recently held that section 363 provides no basis to avoid default interest in General Electric Capital Corp. v. Future Media Productions, Inc., 536 F.3d 969 (9th Cir.2008) (“Future Media”), thus further undermining the allure of a sale under § 363.

Future Media - The unsecured creditors’ committee filed a motion to determine whether an oversecured creditor was entitled to interest at a default rate under the terms of its prepetition contract with the debtor. In a previous case before the Ninth Circuit, it had held that because the Bankruptcy Code allowed a debtor to cure defaults pursuant to a Chapter 11 plan, the debtor was allowed to nullify interest owed at the default rate.³⁰ By contrast, the Ninth Circuit held that when an oversecured lender’s claims are paid through a sale of assets under section 363, outside of the chapter 11 plan, the underlying state law governed the applicability and enforceability of default interest.³¹

B. **Limits on the Bankruptcy Court’s Ability to Order a Sale Free and Clear of Transfer Taxes Under §1146**

- ❖ The Supreme Court has recently issued an opinion which limits the bankruptcy court’s ability to order a sale free and clear of transfer taxes under §1146 in Florida Department of Revenue v. Picadilly Cafeterias, Inc., 128 S. Ct. 2326, 171 L. Ed. 2d. 203 (2008) (“Picadilly”).

Picadilly – Picadilly filed for Chapter 11 on October 29, 2003 and prepared to sell its assets as a going concern pursuant to a §363 sale. Picadilly sought an exemption from any stamp taxes on the eventual transfer under §1146(a) of the Bankruptcy Code.³² The sale was approved by the bankruptcy court but, prior to confirmation, Florida filed an objection seeking a declaration that the \$39,200 it was owed on account of stamp taxes was exempt from §1146(a) because the transfer had not been “under a plan confirmed” under Chapter 11.

The Bankruptcy Court granted summary judgment in favor of Picadilly finding that the sale of substantially all of Piccadilly’s assets was a transfer “under” a confirmed plan because the sale was necessary to consummate the plan. The Eleventh Circuit Court of Appeals affirmed on appeal.

In reversing the bankruptcy court’s judgment, the Supreme Court held that §1146(a) only afforded a stamp tax exemption “to transfers made pursuant to a Chapter 11 plan that has been confirmed.” Because Picadilly had transferred its assets before confirmation, Picadilly could not rely on §1146(a) to avoid Florida’s stamp taxes pursuant to a §363 sale.³³

- ❖ A recent bankruptcy court opinion, In re New 118th, Inc., 398 B.R. 791 (Bankr. S.D.N.Y. 2009) (“New 118th”) (Bernstein, C.J.), limited the effect of Picadilly in the

case before it, however, by holding that the transfer of rental property qualified for the exemption from a stamp or similar taxes under § 1146(a) where the sale occurred pre-confirmation but closed post-confirmation. Under applicable state law, the transfer of real property did not actually occur until the deed was delivered and accepted. Therefore, the bankruptcy court found that the standard for exemption set forth in Picadilly was satisfied because the transfer did not occur until after confirmation and the post-confirmation transfer followed a pre-confirmation sale which facilitated the implementation of the plan or which, stated differently, was necessary to consummate the plan.³⁴

C. Certain Defenses May Not Necessarily Be Stripped by a §363(f) Sale

Folger Adam Security, Inc. v. DeMatteis/MacGregor JV, 209 F.3d 252 (3d Cir. 2000) -- The Third Circuit Court of Appeals considered the extent to which affirmative defenses such as recoupment, setoff and other contractual defenses constituted “interests” under §363(f) and whether a debtor’s subsequent sale of accounts receivables in a §363(f) sale stripped such defenses from the receivables.

Although the purchaser of the receivables asserted that the affirmative defenses were similar to claims that could be extinguished free and clear in a §363(f) sale, the Third Circuit found that a defense is not necessarily a claim in the case of recoupment. The Third Circuit distinguished between an affirmative claim, which is brought by a creditor as a potential liability against a purchaser, and a defense such as recoupment, which is raised in response to a purchaser’s claim. The Third Circuit found that although a claim can be extinguished, a defense cannot.

With respect to the right to setoff, however, the Third Circuit found such rights could be extinguished in a §363(f) sale because in section 553(a), the Bankruptcy Code explicitly provides that the right to setoff is preserved “[e]xcept as otherwise provided in this section and in sections 362 and 363 of this title . . .” 11 U.S.C. §553(a). As a result, the Third Circuit found that setoff rights could generally be extinguished in a §363(f) sale pursuant to the statutory text of section 553.³⁵

V. USING § 363(f) TO GET AROUND §365(h)

Section 363(f) sales can also affect rights granted in other provisions of the bankruptcy code, including, without limitation, possessory rights granted to lessees under 11 U.S.C. §365(h). Cases such as the one considered by the Seventh Circuit Court of Appeals in Precision Industries v. Qualitech Steel, SBO, LLC, 327 F.3d 537 (7th Cir. 2003) (“Qualitech”), have questioned whether a free and clear sale under § 363(f) can be used to extinguish possessory interests granted to lessees under § 365(h).

A. Qualitech

The debtor, Qualitech, had previously entered into agreements with the plaintiffs, pursuant to which the plaintiff had agreed to construct a warehouse at Qualitech’s facility and

operate it for a period of 10 years and Qualitech agreed to lease the property underlying the warehouse to the plaintiffs for a period of 10 years.

After Qualitech entered bankruptcy, it sold substantially all of its assets under §363 to its senior pre-petition lenders. The sale order provided that the sale was “free and clear of all liens, claims, encumbrances and interests” except for certain specifically enumerated liens. The sale order also authorized the assumption and assignment of certain liens, but plaintiffs’ lease was not listed. Although the plaintiffs had received notice of the sale, they did not object to the sale.

After the sale, the senior lenders transferred their interest in the purchased assets to a newly formed entity, which assumed the rights of the purchaser under the sale order. The sale closed out without assumption of the plaintiffs’ lease and the lease was eventually *de facto* rejected after unsuccessful negotiations. The plaintiffs challenged the newly formed entity’s right to evict the plaintiffs.

The bankruptcy court rejected the notion that §365(h) preserved the plaintiffs’ possessory rights as lessees and held that the new entity had obtained title to the property free and clear of the plaintiffs’ right to possession. On appeal, the district court reversed the ruling of the bankruptcy court holding that the terms of §365(h) and §363(f) appeared to be in conflict, but that the specific terms of §365(h) prevailed over §363(f).

The Seventh Circuit Court of Appeals held that: (1) the term “any interest” was broad enough to encompass the plaintiff’s leasehold interest; (2) section 365(h) did not supercede section 363(f); (3) section 365(h)’s applicability was limited in scope to lease rejection; and (4) the adequate protection provisions of §363(e) could protect a lessee’s interest. Provided that a lessee has been granted adequate protection for its interest, a §363(f) sale can extinguish a lessee’s possessory interest.³⁶

❖ **Several other courts have reached similar conclusions:**

- **In re MMH Automotive Group, LLC**, 385 B.R. 347 (S.D. Fla. 2008) (“MMH”) - A district court found that an unrecorded billboard lease, of which the purchaser pursuant to a §363(f) sale did not have notice, was extinguished upon the entry of the §363 sale order approving the sale “free and clear of all claims, liens and encumbrances.” The court noted that if Congress had intended the protections of §365(h) to apply without limitation when the property subject to the lease is sold, Congress would have expressly provided that limitation. Therefore, if a trustee meets the standards of section 363(f), section 365(h) will not prevent the property from being sold free and clear of the leasehold interest.³⁷
- **In re Downtown Athletic Club of New York City Inc.**, No. M-47, 2000 WL 744126 (S.D.N.Y. 2000) (“Downtown Athletic”) – the debtor, Downtown Athletic Club, owned a building, the top fifteen floors of which consisted of rooms for accommodation. The remaining floors housed the debtor’s club facilities. The two defendants occupied suites on the accommodation floors

but neither had a lease and neither requested leases until after the debtor's filing for bankruptcy. Neither defendant filed a proof of claim by the bar date.

Pursuant to the plan and confirmation order, the debtor sold the building free and clear of liens, claims, encumbrances and other interests to the plaintiff-purchasers. The purchasers, in turn, agreed to lease the club facilities, located on the non-accommodation floors, back to the debtor with the right to repurchase that portion from the purchaser. The accommodation floors, however, were owned by the plaintiff-purchasers pursuant to the sale.

Prior to the entry of a confirmation order, however, the defendants filed a complaint with the New York State Division of Housing and Community Renewal ("DHCR") alleging violations of the Rent Stabilization Law of the City of New York ("RSL") for overcharge of rent. The debtor then initiated an adversary proceeding for, among other things, an order enjoining the defendants from commencing or continuing any action to obtain any interest in the building, for a declaration that the defendants have no interest in the building and enjoining the defendants from using their rooms in the building. In granting summary judgment to the defendants, the bankruptcy court found that the debtors' obligations under the RSL were non-dischargeable and allowed the defendants to continue to use their rooms pending a determination by the DHCR.

On appeal, the district court noted that the bankruptcy court correctly concluded that the RSL claims were not discharged under §1141(d)(1)(A). The district court reversed the holding below, however, because the bankruptcy court failed to recognize that the section 363 sale at issue extinguished any ongoing leasehold interest of the defendants in the building that could be enforced against the plaintiff-purchasers. The district court first made a distinction between whether a claim was dischargeable under section 1141 and whether property could be sold free and clear under section 363.

Here, because there was a bona fide dispute as to whether the defendants had an interest in the property, the court held that the defendants' right to obtain leases under the RSL were "interests" in the debtor's building which was sold to the plaintiff-purchasers free and clear of the defendants' interests under §363(f)(4).

Moreover, the district court found that §365(h) applied to allow a tenant-lessee to remain in possession only when the debtor-lessor remains in possession of the subject property and rejects the lease, not when the debtor sells the property subject to a leasehold free and clear of that interest under §363(f).³⁸

- ❖ In some cases, a §363(f) sale may even negatively impact a debtor:

2009 New York City Bankruptcy Conference

- **In re Hill**, 307 B.R. 821 (Bankr. W.D. Pa. 2004) -- The bankruptcy court found that whatever possessory interest the Chapter 11 debtor had in a lease with his father, who was also a debtor in a separate bankruptcy proceeding, was extinguished upon the sale of the father's property under §363(f) and therefore not property of the son's bankruptcy estate.³⁹
- ❖ Several lower courts have also held that a debtor cannot use the provisions of §363(f) to get around the rights of tenants under §365(h).⁴⁰

In re Samaritan Alliance, LLC, No. 07-50735, 2007 WL 4162918 at *4 (Bankr. E.D. Ky. Nov. 21, 2007) ("Samaritan")— The bankruptcy court held that §365(h) is still applicable to the context of a §363(f) sale and that a tenant's possessory interest in property and the rights appurtenant thereto, as embodied in a lease, are preserved by §365(h). Therefore, the bankruptcy court found that the tenant had a right to continue in possession of the premises and to operate through the full term of the lease despite the §363 sale.⁴¹

In re Haskell L.P., 321 B.R. 1 (D. Mass. 2005) ("Haskell") - The district court held that the theoretical possibility that a party could be compelled to accept a money satisfaction of its interest under §363(f)(5) was not sufficient to support a sale free and clear of a leasehold interest. The trustee must show that it could actually compel monetary satisfaction. Moreover, the court found that a tenant could not be compelled to accept a money satisfaction for its rejected lease in light of §365(h). The debtor could not achieve by means of a §363(f) sale what the debtor could not directly achieve under §365(h), which was to dispossess the tenant.⁴²

VI. PRACTICE POINTERS

- ❖ Senior lenders should be diligent to carefully draft intercreditor agreements. Such intercreditor agreements usually preclude junior lienors from objecting to the sale. Although such agreements may not bind certain lenders that are not in contractual privity with the senior lender, e.g. holders of mechanics liens, and may not necessarily guarantee that the courts will enforce all of the terms of the intercreditor agreement, senior lenders should take care in drafting such intercreditor agreements to protect their interests to the greatest extent possible.
- ❖ Parties whose interests may be extinguished pursuant to §363 sale should file an appropriate proof of claim in the bankruptcy case, even if the claim amount is for an unliquidated, contingent or unmatured sum as the term "interest" under §101(5)(A) is broadly defined to include such interests.
- ❖ Parties whose interests may be extinguished pursuant to a §363 sale must also be diligent about monitoring the case, carefully review the terms of the proposed sale order to see whether its interests are implicated and timely file any relevant objections to a §363 sale.

- ❖ The debtor and purchaser should ensure that adequate and proper notice is given to all parties in interest entitled to notice of a proposed §363(f) sale.
- ❖ If there is a possibility that future claims may arise, pursuant to which successor liability may be imposed on a purchaser, the purchaser should request certain protections as part of the sale transaction, including, among other things, an indemnification with an escrow.

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² In re PW LLC, 391 B.R. 25, 40-41 (9th Cir. B.A.P. 2008) (“Clear Channel”).

³ Clear Channel, 391 B.R. at 33-36.

⁴ Clear Channel, 391 B.R. at 31-32.

⁵ Clear Channel, 391 B.R. at 35.

⁶ Clear Channel, 391 B.R. at 35.

⁷ Clear Channel, 391 B.R. at 40-41.

⁸ See, e.g., In re Beker Indus. Corp., 63 B.R. 474, 476-77 (Bankr. S.D.N.Y. 1986); In re Terrace Gardens Park P’ship, 96 B.R. 707 (Bankr. W.D. Tex. 1989); In re Oneida Lake Development Inc., 114 B.R. 352 (Bankr. N.D.N.Y. 1990); In re Milford Group, Inc., 150 B.R. 904, 906 (Bankr. M.D. Pa. 1992); In re Collins, 180 B.R. 447, 450-51 (Bankr. E.D. Va. 1995).

⁹ Clear Channel, 391 B.R. at 41; Richardson v. Pitt County, 47 B.R. 999, 1002 (E.D.N.C. 1985); Scherer v. Fed. Nat’l Mtg Ass’n, 159 B.R. 821 (N.D. Ill. 1993); In re Perroncello, 170 B.R. 189 (Bankr. D. Mass. 1994); In re Feinstein Family P’ship, 247 B.R. 502 (Bankr. MD. Fla. 2000); In re Canonigo, 276 B.R. 257 (Bankr. N.D. Cal. 2002); Criimi Mae Servs. Ltd. P’ship v. WDH Howell, LLC, 298 B.R. 527 (D.N.J. 2003).

¹⁰ Clear Channel, 391 B.R. at 42.

¹¹ See, e.g., Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 545 (7th Cir. 2003) (the use of the term “any” before the term “interest” counsels for a broad interpretation of “interest”); In re Leckie Smokeless Coal Co., 99 F.3d 573-581-82 (4th Cir. 1996); In re Trans World Airlines, Inc., 322 F.3d 288-89 (3d Cir. 2003).

¹² Al Perry, 503 F.3d 538, 539-41 (6th Cir. 2007).

¹³ See, e.g., In re White Motor Credit Corp., 75 B.R. 944, 948 (Bankr. N.D. Ohio 1987).

¹⁴ Autostyle, 227 B.R. at 800; Ninth Avenue Remedial Group v Allis-Chalmers Corp., 195 B.R. 716, 732 (N.D. Ind. 1996).

¹⁵ In re Paris Indus. Corp., 132 B.R. 504 (D. Me. 1991).

¹⁶ See, e.g., In re White Motor Credit Corp., 75 B.R. 944 (Bankr. N.D. Ohio 1987); In re New England Fish Co., 19 B.R. 323, 326 (Bankr. W.D. Wash. 1982).

¹⁷ See, e.g., In re White Motor Credit Corp., 75 B.R. 944 (Bankr. N.D. Ohio 1987).

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- ¹⁸ In re New England Fish Co., 19 B.R. 323, 326 (Bankr. W.D. Wash. 1982).
- ¹⁹ In re New England Fish Co., 19 B.R. 323, 326 (Bankr. W.D. Wash. 1982).
- ²⁰ See, e.g., Milliken & Co. v. Duro Textiles, LLC, 451 Mass. 547, 556 (Mass. 2008); Ray v. Alad Corp., 19 Cal. 3d 22 (Cal. 1977); Grant-Howard Assocs. v. General Houseware Corp., 63 N.Y.2d 291, 296 (N.Y. 1984).
- ²¹ Ninth Avenue Remedial Group v. Allis-Chalmers Corp., 195 B.R. 716 (N.D. Ind. 1996).
- ²² Fairchild Aircraft, Inc. v. Cambell, 184 B.R. 910 (Bankr. W.D. Tex. 1995) vacated 220 B.R. 909. This decision was later vacated by the same court on equitable grounds at the request of the purchaser.
- ²³ See, e.g., In re White Motor Credit Corp., 75 B.R. 944, 948 (N.D. Ohio 1987); In re Leckie Smokeless Coal Company, 99 F.3d 573 (4th Cir. 1996); In re Transworld Airlines, Inc., 322 F.3d 283 (3d Cir. 2003); In re All American Ashburn, Inc., 56 BR 186, 190 (N.D. Ga. 1986); In re New England Fish Co., 19 BR 323, 328 (W.D. Wash. 1982).
- ²⁴ See, e.g., Fairchild Aircraft, Inc. v. Cambell, 184 B.R. 910 (Bankr. W.D. Tex. 1995).
- ²⁵ In re Leckie Smokeless Coal Company, 99 F.3d 573 (4th Cir. 1996).
- ²⁶ In re Transworld Airlines, Inc., 322 F.3d 283 (3d Cir. 2003)
- ²⁷ In re Piper Aircraft Corp., 169 B.R. 766 (Bankr. S.D. Fla. 1994).
- ²⁸ In re Eveleth Mines, LLC, 312 B.R. 634 (Bankr. D. Minn. 2004).
- ²⁹ Ninth Avenue Remedial Group v. Allis-Chalmers Corp., 195 B.R. 716 (N.D. Ind. 1996).
- ³⁰ General Electric Capital Corp. v. Future Media Prods., Inc., 536 F.3d 969, 973 (9th Cir. 2008) (citing In re Entz-White Lumber and Supply, Inc., 850 F.2d 1338, 1342 (9th Cir. 1988)).
- ³¹ Future Media, 536 F.3d at 973-74.
- ³² 11 U.S.C. §1146(a) provides:
- (a) The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax.
- ³³ Picadilly, 128 S. Ct. 2326, 2339 (2008).
- ³⁴ In re New 118th, 398 B.R. 791, 794-98 (Bankr. S.D.N.Y. 2009).
- ³⁵ Folger Adam Security, Inc. v. DeMatteis/MacGregor, 209 F.3d 252 (3d Cir. 2000).
- ³⁶ Qualitech, 327 F.3d at 540-48.
- ³⁷ MMH, 385 B.R. at 367-72.
- ³⁸ Downtown Athletic, 2000 WL 744126 at *4.
- ³⁹ Hill, 307 B.R. at 821.

⁴⁰ See, e.g., Haskell, 321 B.R. 1 (D. Mass. 2005); In re Churchill Properties III, Ltd. P'ship., 197 B.R. 283 (Bankr. N.D. Ill. 1996); In re Taylor, 198 B.R. 142 (Bankr. D.S.C. 1996).

⁴¹ Samaritan, 2007 WL 4162918 at *3-*4.

⁴² Haskell, 321 B.R. at 9.