

Protecting the validity of 363 sales free and clear of liens after Clear Channel

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OVERVIEW

Last year’s Ninth Circuit Bankruptcy Appellate Panel decision in Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC),³ has already generated much commentary—most of it critical.⁴ The debtor was a property developer whose assets were fully encumbered by the liens of a senior creditor and a junior creditor (Clear Channel). After filing a Chapter 11 petition, the trustee sought to sell its assets via § 363. The senior creditor agreed to act as a stalking horse bidder by making a credit bid of \$41,434,465 that included a carve out for certain administrative expenses. In addition to authorizing the sale procedures, the bankruptcy court entered a separate order authorizing the sale free and clear of liens pursuant to § 363(f)(3) and (f)(5) over Clear Channel’s objection. Although three other nonconforming bids were received, the highest was only \$25.25 million, so the credit bid won the day. The court confirmed the sale, found the senior creditor to

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³ 391 B.R. 25 (B.A.P. 9th Cir. 2008).

⁴ See, e.g., Corrine Ball, “Clear Channel”: A Sea Change in 363 Sales? 241 N.Y.L.J. 5 (April 23, 2009) (“Rather than show deference to a long line of cases and the avowed purpose of avoiding rigid application of absolute priority, the court limited the usefulness of 363 sales by engaging in a statutory analysis that is at best debatable, and at worst could be paralyzing.”); Frank A. Oswald and Andy Winchell, Missing the Forest for the Trees in § 363: How the Ninth Circuit’s Bankruptcy Appellate Panel Neglected the Big Picture in the Clear Channel Decision, 4 Norton Bankr. L. Advisor 2 (2009) (“Although numerous aspects of the decision are defensible, the overall effect of the opinion adds uncertainty into an area where little had existed previously and where the predictability of outcomes can assist in maximizing the value of estate assets.”); Joel H. Levitin, Stephen J. Gordon and Richard A. Stieglitz, Jr., Ninth Circuit BAP Dresses Down Lienstripping, 27 Am. Bankr. Inst. J. 1, 53 (October 2008) (noting the opinion’s unfairness to senior secured creditors).

be a good-faith purchaser, and declined to issue a stay pending appeal. Clear Channel appealed the sale order and the confirmation order to the Ninth Circuit Bankruptcy Appellate Panel.⁵

In its opinion, the B.A.P. essentially made two points. First, the lien-stripping provisions of a § 363(b) sale order are not protected from reversal or modification on appeal.⁶ Second, under § 363(f)(5), the bankruptcy court must make a specific finding identifying a legal or equitable proceeding—other than a bankruptcy cramdown—in which the junior lienholder could be compelled “to release its lien for payment of an amount that was less than full value of [its] claim.”⁷ The B.A.P. remanded the case to the bankruptcy court to give the parties a chance “to identify a qualifying proceeding[.]”⁸ As a result of the holdings, the property in Clear Channel “remain[ed] subject to the junior lien after the sale, when the negotiations, asset purchase agreement and the bankruptcy court’s sale order all contemplated that the sale would be ‘free and clear’ of all liens, claims and encumbrances.”⁹

The court in Clear Channel was, of course, interpreting § 363. When discussing 363 sales free and clear of liens, four subsections come into play: 11 U.S.C. § 363(b), (f), (k), and (m). Subsection (b) provides the general authorization for the trustee to “use, sell, or lease, other than in the ordinary course of business, property of the estate” after notice and a hearing.¹⁰

Lienstripping arises under subsection (f), which authorizes the sale of property

free and clear of any interest in such property of an entity other than the estate only if—

⁵ 391 B.R. at 31-32.

⁶ Id. at 36.

⁷ Id. at 45-6. The court also held that the carve out amount paid by the senior creditor was not part of the sale proceeds and was, thus, not subject to Clear Channel’s lien. Id. at 46-7.

⁸ Id. at 47. The parties dropped the issue after remand, so the bankruptcy court never reached the question of whether a qualifying proceeding existed. Kenneth N. Russak, Section 363 Real Estate Sales Are Still Feasible After Clear Channel, 32 L.A. Lawyer 10, 13 (March 2009).

⁹ Corinne Ball, “Clear Channel”: A Sea Change in 363 Sales? 241 N.Y.L.J. 5 (April 23, 2009).

¹⁰ 11 U.S.C. § 363(b)(1).

- (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 such 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

Subsection (k) authorizes creditors to credit bid their claims.¹² Subsection (m) creates statutory mootness by providing that the validity of the sale to a good faith purchaser cannot be disturbed on appeal in the absence of a stay pending appeal.¹³

Debtors and creditors have various reasons for favoring § 363 sales. Debtors often want to “generat[e] unencumbered funds to pay” various fees, administrative expenses, and trade creditors.¹⁴ In addition, they may want to “minimiz[e] the deficiency owed by the estate” or provide an opportunity for interested entities “to buy the collateral for a price greater than the lender’s perception of value.”¹⁵ Lenders, on the other hand, generally are seeking the fastest resolution that will allow them to avoid liability, obtain clear title, and maximize their recovery.¹⁶

The objectives of both debtors and creditors are impaired if the parties cannot rely on the finality of a § 363 sale, including any provisions to strip off liens pursuant to § 363(f).¹⁷

11 Id. § 363(f).

12 Id. § 363(k).

13 Id. § 363(m).

14 Kenneth N. Russak, Section 363 Real Estate Sales Are Still Feasible After *Clear Channel*, 32 L.A. Lawyer 10 (March 2009).

15 Id.

16 Id. See also, Thomas Moers Mayer, Section 363 Sales: Is the System Working? Written materials prepared for the Southeast Bankruptcy Law Institute, at p.26 (April 24, 2009).

17 Clear Channel indicates a credit bid to purchase property free and clear of nonconsenting junior liens “if it is to be authorized at all, is only proper if part of a plan of reorganization that has survived the time-consuming and expensive plan confirmation process.” Russak, supra note 14, at 12. “Clear Channel would appear to raise a

“Taken literally, Clear Channel means that a bankruptcy court cannot ever convey clean title to a purchaser unless every known lienholder consents under Section 363(f)(2) or the order is entered without objection—and no lienholder files an appeal.”¹⁸ Consequently, at a minimum, buyers may delay closing on sales until the time to appeal has run.¹⁹ More drastically, “any cautious senior lienor will avoid using the bankruptcy court to sell its collateral, and any cautious buyer of collateral will insist on taking title through state court foreclosure.”²⁰

MOOTNESS

Upon a casual reading, § 363(b), (f), (k), and (m) “collectively would seem to provide in bankruptcy court the basic minimum relief available in a state court foreclosure sale—transfer of property free and clear of liens to a good faith purchaser, including a senior mortgagee who has bid in its lien, without fear of subsequent challenge.”²¹ And, in fact, prior to the Clear Channel decision, bankruptcy practitioners generally understood the mootness provision of subsection (m) to apply not only the validity of the sale but also to any liens stripped off the property pursuant to subsection (f).²²

The Clear Channel analysis: The court in Clear Channel discussed three possible grounds for mootness: constitutional, equitable, and statutory. First it set forth the standard of constitutional mootness, which arises “only if it is impossible to grant relief.”²³ In Clear

significant hurdle for lenders and borrowers seeking to use the 363 sale strategy to obtain a prompt resolution of a loan if the collateral is burdened by the claims of out-of-the-money junior creditors.” Id.

¹⁸ Mayer, supra note 16, at 16.

¹⁹ Id.

²⁰ Id. at 17. The author further notes that he has “already heard from one title company that it will not provide a clean title insurance policy to a purchaser under section 363 if an appeal is pending.” Id.

²¹ Id. at 5.

²² See 3 Collier on Bankruptcy ¶ 363.11 (15th ed. rev’d 2009).

²³ 391 B.R. at 33.

Channel, the court determined it could grant relief—though possibly the relief would be “difficult or inequitable”—by reversing the sale in full or by reinstating the liens that had been stripped off.²⁴

Unlike constitutional mootness, equitable mootness raises concerns about “the consequences of the remedy and the number of third parties who have changed their position in reliance on the order that is being appealed.”²⁵ The BAP listed “numerous and complex” changes that occurred following the sale, including transfer of title and control of the property, assumption of executory contracts and unexpired leases, and execution of documents related to the sale.²⁶ In addition, the court acknowledged third parties had acted in reliance on the sale.²⁷ The court found the relevant actions were sufficient to protect the sale under principles of equitable mootness, but not the stripping off of Clear Channel’s liens.²⁸

The court reached a similar conclusion after analyzing statutory mootness. It began by noting that § 363(m) provides that an appeal “does not affect the validity of a sale” authorized by subsection (b), but it says nothing about the validity of provisions to sell the property at issue free and clear of liens pursuant to subsection (f).²⁹ Instead, subsection (m) protects “only changes of title or other essential attributes of a sale” as well as transfer of possession of the property.³⁰ Mere sales terms, including lienstripping, are not protected.³¹ This particular conclusion has led some commentators to question why the court did not consider a clean title to

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Id.

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Id. (quoting Darby v. Zimmerman (In re Popp), 323 B.R. 260, 271 (B.A.P. 9th Cir. 2005)).

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Id. at 33-4.

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Id. at 34.

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Id.

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Id. at 35.

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Id.

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Id. at 35-6.

be an “essential attribute” of a sale.³² “[A]n asset subject to liens is a very different asset than one free and clear of liens.... Is it not sophistry to suggest that the “validity of the sale” of an Escalade is not affected by an appellate court ruling that instead you get a Volkswagen?”³³

The B.A.P. has also been criticized for suggesting “that the senior lender assumed the risk of having the lien-stripping aspect of the sale overturned on appeal[.]”³⁴ While it is true that senior lenders always risk the bankruptcy court’s refusal to allow lienstripping, the creditor at that point still has the option to seek stay relief to sell the property outside of bankruptcy.³⁵ “However, once the sale was approved and closed, the senior lender had little reason to expect that the lien would be reinstated on appeal 12 months later.”³⁶ The fact that the court cited no cases with similar results indicates the outcome in Clear Channel “is so rare and unexpected that there appears to be no decisional authority supporting it”³⁷

Overcoming the mootness problem: Thus far, Clear Channel stands alone in expressly excluding lienstripping provisions from the protection of subsection (m). Obviously, it creates the greatest problems for practitioners in the Ninth Circuit. One commentator has argued that Clear Channel directly conflicts with existing precedent from the Ninth Circuit Court of Appeals.³⁸ However, that case—In re Robert L. Helms Construction & Development—never

³² Shirley S. Cho and Bennet L. Spiegel, Clear Channel Muddies the Waters of § 363(m) Mootness Protection, 26 No. 2 Bankr. Strategist 1 (December 2008).

³³ Id. (quoting Judge Haines, Clearing the Channel: Navigating the Sale Waters After Clear Channel, written materials to accompany Sept. 3, 2008 Insolvency Law Committee Webinar, at 11).

³⁴ Frank A. Oswald and Andy Winchell, Missing the Forest for the Trees in § 363: How the Ninth Circuit’s Bankruptcy Appellate Panel Neglected the Big Picture in the Clear Channel Decision, 4 Norton Bankr. L. Advisor 2 (2009).

³⁵ Id.

³⁶ Id.

³⁷ Id.

³⁸ Cho and Spiegel, supra note 32 (citing In re Robert L. Helms Const. & Dev. Co., Inc., 110 F.3d 1470, 1475 (9th Cir. 1997)).

directly addresses or analyzes the issue, so it may not offer a very effective means of avoiding Clear Channel.³⁹

Outside of the Ninth Circuit, Clear Channel opens a door for junior lienholders to challenge lienstripping on appeal. This has the makings for an interesting argument in the Eleventh Circuit. Traditionally, the Eleventh Circuit Court of Appeals has applied rigid rules of statutory construction.⁴⁰ However, in 2007, when confronted with the issue of whether the stamp tax exemption in § 1146(c)—which uses the language “under a plan confirmed”—applies to pre-confirmation sales, the court took a different approach.⁴¹ In Piccadilly, the court found the language ambiguous and declined to impose a post-confirmation requirement so long as the sale was contemplated by a later-confirmed plan because such a requirement “ignores the practical realities of Chapter 11 reorganization cases.”⁴² The Supreme Court, however, was not persuaded by the policy arguments and reversed.⁴³ In doing so, it expressly said that responding to “practical realities” is Congress’s job.⁴⁴ Thus, even if the Eleventh Circuit were to find some ambiguity in § 363(m), the Supreme Court’s opinion in Piccadilly might render it (and other circuit courts) less inclined to consider “practicalities” in its statutory analysis.

³⁹ The only issue actually discussed on appeal was whether an option contract was an executory contract. 110 F.3d at 1472-74. The court made a brief note in its conclusion that the validity of the buyer’s “free and clear title on the property, pursuant to § 363(f)(4), was not affected by these proceedings, and therefore its appeal is moot.” Id. at 1475 (citing 11 U.S.C. § 363(m)). The decision was later vacated *en banc* as to the executory contract issue, although court reiterated that the buyer “owns the Double Diamond ranch free and clear of the option.” In re Robert L. Helms Const. & Dev. Co., Inc., 139 F.3d 702, 704 (9th Cir. 1998).

⁴⁰ See Bracewell v. Kelley (In re Bracewell), 454 F.3d 1234, 1246 (11th Cir. 2006) (admonishing judges not to rewrite statutes for the purpose of improving them); Gordon v. Novastar Mortg., Inc. (In re Hedrick), 524 F.3d 1175, 1186-87 (11th Cir. 2008) (stating a court must assume Congress means what it says in a statute).

⁴¹ Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc., 484 F.3d 1299, 1304 (11th Cir. 2007).

⁴² Id.

⁴³ Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc., 128 S. Ct. 2326, 2338-39 (2008).

⁴⁴ Id. at 2339. Notably, the Court never decided whether the provision was ambiguous. But it did conclude the more natural reading of “under a plan confirmed” is “post-confirmation.” Id.

There is still room for an argument that the plain language of § 363(m) prevents an appellate court from reattaching liens, but it might not be an easy sell. The statutory language expressly contemplates modification of a sale authorization, but states that any such modification will not affect the validity of the “sale.” The question then becomes how to define a sale. Clear Channel incorporated only essential attributes of the sale into the definition, such a title and possession. However, the trustee or senior creditor can argue that a title free from encumbrances also is an essential attribute. It is essential not only because it affects a buyer’s willingness to enter into the transaction, but also based on the language of the Bankruptcy Code. “[S]ubsection (f) does not exist independently of subsection (b)” and “its authority is derived from subsection (b)” that it is necessarily is an inseparable component of a § 363(b) sale.⁴⁵ By adopting such a rule the court would not cut off relief to junior lienholders, who can “protect any value they perceive in their collateral beyond that established by the market [by] pay[ing] off the senior lender in full and credit-bid[ding] their own claims.”⁴⁶

LIENSTRIPPING

If Clear Channel’s ruling on mootness gains acceptance among other courts, senior lienholders will have to fortify their positions under § 363(f). This means making “a strong record at the bankruptcy court level that there is a legal and factual basis for selling assets free and clear of liens.”⁴⁷ Subsection (f) offers five alternatives for doing so.

Allowed under applicable nonbankruptcy law: This is a fairly straightforward provision. If nonbankruptcy law permits a sale free and clear of liens, the Bankruptcy Code will,

⁴⁵ Cho and Speigel, supra note 32. See also, Joel H. Levitan, Stephen J. Gordon and Richard A. Stieglitz, Jr., Ninth Circuit BAP Dresses Down Lienstripping, 27 Am. Bankr. Inst. J. 1, 53 (October 2008).

⁴⁶ Levitan, Gordon and Stieglitz, supra note 45, at 53.

too. “Essentially, this recognizes that there is no reason to limit preexisting rights and remedies in a liquidation or reorganization to benefit creditors and parties in interest.”⁴⁸ The sort of sales covered by this provision may include, for example, certain sales under Article 9 of the Uniform Commercial Code.⁴⁹

Consent: Obtaining the consent of all affected parties is probably the surest way to protect the lienstripping provisions in a sale order. The court would have no reason to interfere with “a consensual transaction that will benefit the estate.”⁵⁰ However, as Clear Channel demonstrates, gaining consent from out of the money junior creditors may provide a false comfort.

Sale price greater than aggregate value of liens: Subsection (f)(3) is the only provision restricted to interests that are liens rather than to interests in general. When proceeding under this requirement, the definition of “value” muddies the water. Courts generally take two approaches. Under one view, courts interpret “value” through the lens of § 506(a), to conclude it means the economic value of the collateral.⁵¹ Other courts, including Clear Channel hold “value” means the amount of debt secured by the lien, such that the sale price must “exceed the face amount of all liens.”⁵² Critics of the Clear Channel approach note that it limits application of subsection (f)(3) “to situations in which a debtor has equity in the property to be sold,” which effectively eliminates the possibility of a credit bid.⁵³ However, even if a sale pursuant to subsection (f)(3) does draw a credit bid, the court must consider whether it is the value

⁴⁷ Oswald and Winchell, supra note 33.

⁴⁸ George W. Kuney, Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process, 76 Am. Bankr. L.J. 235, 244 (Spring 2002).

⁴⁹ See Collier on Bankruptcy, supra note 22, at ¶ 363.06[2] (citing U.C.C. § 9-320).

⁵⁰ Kuney, supra note 48, at 245.

⁵¹ See Collier on Bankruptcy, supra note 22, at ¶ 363[4][a] (collecting cases).

⁵² Id.; Clear Channel, 391 B.R. at 40-41.

equivalent of a cash bid, since the lender “pays the successful bid price by crediting the debt owed to the lender, not by coming out of pocket with actual cash.”⁵⁴

Interest in bona fide dispute: By permitting sales to proceed free and clear of interests that are in bona fide dispute, the Bankruptcy Code “allows productive assets subject to deadlocking disputes to be transferred to a third party so that they can remain economically productive while the original parties may continue to litigate or otherwise proceed to resolve their dispute.”⁵⁵ To prove a bona fide dispute, the proponent of the sale generally must provide evidence of “an objective basis for either a factual or a legal dispute as to the validity of the debt.”⁵⁶ It is worth noting that courts have allowed creditors holding disputing liens to make credit bids.⁵⁷

Judicial proceeding compels acceptance of money satisfaction: The court in Clear Channel made two significant points as to subsection (f)(5). It held that the “money satisfaction” referenced in that paragraph meant not simply that the lien could be satisfied by cash, but that it could be satisfied by payment of less than the full value of the claim.⁵⁸ In addition, it held that bankruptcy courts could not simply ignore the requirement for a judicial proceeding on the ground that “all liens, by definition are capable of being satisfied by money.”⁵⁹ The court must identify an applicable proceeding.⁶⁰

53 Ball, supra note 9.

54 Russak, supra note 14, at 12.

55 Kuney, supra note 48, at 247.

56 Daniel J. Carragher, Sales Free and Clear: Limits on § 363(f) Sales, 26 ABI Inst. J. 16, 52 (July/August 2007) (collecting cases).

57 Id. at 53 (citations omitted).

58 391 B.R. at 42.

59 Id. at 45.

60 Id. at 45-46.

As to Clear Channel's insistence that the proceeding compel payment of less than the amount of the debt, it is important to note that no such language appears in subsection (f)(5). The court wrote those words into the statute in part to prevent its interpretation subsection (f)(3)—which deals solely with liens—from becoming superfluous.⁶¹ If subsection (f)(5) were read too broadly, “[t]he specific provisions of paragraph (3) would never need to be used, since all liens would be covered, regardless of any negative or positive relationship between the value of a creditor’s collateral and the amount of its claim.”⁶² Thus, under the Clear Channel approach, subsection (f)(3) applies to strip off liens only when there is equity in the property and (f)(5) applies to liens when there is no equity. An alternative to the B.A.P.’s reasoning is that

Congress intended merely to draw a distinction between rights that can be satisfied through payment of money and those that cannot. Thus, if an interest can [be] satisfied through payment of money under state law, the property to which such interest attaches can be sold free and clear of such interest; if the interest cannot be satisfied through payment, the interest will remain attached to the property.⁶³

With respect to Clear Channel's requirement that the bankruptcy court identify a qualifying legal or equitable proceeding, the court held that a cramdown under § 1129(b)(2) is not sufficient.⁶⁴ The court reasoned that using cramdown to justify stripping off interests under subsection (f)(5) “sanctions the effect of cramdown without requiring any of the § 1129(b)’s substantive and procedural protections.”⁶⁵ The opinion acknowledged some dispute among courts on this point.⁶⁶ However, several commentators have suggested more palatable alternatives. Most notably, they identify foreclosure in cases of real estate sales (at least in states

⁶¹ Id. at 44.

⁶² Id.

⁶³ Oswald and Winchell, supra note 34.

⁶⁴ 391 B.R. at 46.

⁶⁵ Id. (citing 3 Collier on Bankruptcy ¶ 363.06[6]).

that require judicial foreclosure).⁶⁷ As to personal property, the lender may try to rely on Article 9 of the Uniform Commercial Code, which “specifically authorizes the holder of a foreclosing senior security interest to sell property free and clear of junior security interests under Section 9-617(a)(3) and pay junior interests only proceeds exceeding its own secured claim.”⁶⁸ One commentator even offers eminent domain as a possibility since it is “used not just when the government wants to take property for its own use but when it seeks to redevelop a blighted area by taking the property, compensating the former owner, and then selling or giving the property to a private developer for a specific purpose.”⁶⁹ The court in Clear Channel itself suggested either a proceeding to enforce buy-out provisions in a partnership agreement or a proceeding to enforce a contractual liquidated damages clause in lieu of specific performance.⁷⁰

FINAL THOUGHTS

Clear Channel has altered the established understandings about the process and finality of § 363 sales made free and clear of liens. Although the decision may never be widely adopted—and may not even survive in the Ninth Circuit—it provides a good opportunity for secured creditors to re-examine all their options and attendant risks in the face of a debtor’s bankruptcy filing.⁷¹

66 Id.

67 Mayer, supra note 16, at 11; Russak, supra note 14, at 13; Oswald and Winchell, supra note 34.

68 Mayer, supra note 16, at 11 (citing U.C.C. § 9-617(a)(3), 9-608(a)(1)(C), 9-615(a)(3); see also Oswald and Winchell, supra note 34. If the sale does not required a judicial proceeding, it could still be a valid means to strip of liens under § 363(f)(1).

69 Kuney, supra note 48, at 255.

70 391 B.R. at 43-44.

71 See Martin Zohn and Joshua Thompson, A Wakeup Call for Secured Creditors and Distressed Investors, 240 N.Y.L.J. 12 (Nov. 24, 2008).

In their article on the topic, Martin Zohn and Joshua Thompson offer a comprehensive list of these options, including the following: First, The lender may opt to pursue stay relief so it can sell its collateral under nonbankruptcy law. The ease of obtaining stay relief may increase as the economy worsens and property values decline, depriving the debtor of equity and the ability to provide adequate protection. Second, the lender can simply sell its interest in the property. Third, the lender can aim for a consensual reorganization via a Chapter 11 plan. Fourth, the lender can advocate for a § 363 sale, taking steps to ensure its viability in light of Clear Channel.⁷² Such steps may include reviewing “intercreditor agreements to see if they adequately deal with (or should be revised to deal with) some method of allowing junior lien stripping in appropriate circumstances that are fair and balanced enough to be palatable to junior creditors and enforceable by courts.”⁷³

⁷² Id.

⁷³ Id.