

BANKRUPTCY LAW

Buyers Take Notice: Section 363 Sales May Not Be as Final as You Think

By Scott Cargill and Eric H. Horn

A July 2008 decision issued by the Ninth Circuit Bankruptcy Appellate Panel (the “BAP”), if adopted by other bankruptcy courts, has the potential to substantially alter the way bankruptcy assets are liquidated. In a one-two punch decision, the BAP held that the provision of a sale order authorizing the transfer “free and clear” of interests in the debtor’s property may be reversed on appeal even if the sale itself was final, there was no stay pending appeal, and the bankruptcy court found the buyer was a good-faith purchaser entitled to bankruptcy code Section 363(m) protection.

Facts

PW, LLC (the “Debtor”) entered into an agreement with the city of Burbank, California, to develop a mixed-use complex of luxury condominiums and retail space. The debtor’s agreement was conditioned, however, on the acquisition of 18 parcels of land by February. By the time of the debtor’s November 20, 2006,

Cargill is a partner and Horn is counsel in Lowenstein Sandler’s Bankruptcy, Financial Reorganization & Creditors’ Rights Group in the firm’s Roseland office.

bankruptcy filing, the debtor had acquired 14 of the parcels and entered into a conditional agreement to acquire the remaining four. DB Burbank, LLC (“DB Burbank”), held a first priority lien on all of the debtor’s assets, including the real estate, in the amount of approximately \$40 million. Clear Channel Outdoor, Inc. (“Clear Channel”) held a junior lien on the debtor’s assets in the amount of \$2.5 million.

In July 2006, DB Burbank commenced foreclosure proceedings against the debtor and subsequently obtained the appointment of a state court receiver. After the receiver was appointed, DB Burbank loaned the receiver additional funds to purchase the remaining four parcels and began negotiations relative to a pre-arranged Chapter 11 plan. The parties were unable to reach an agreement relative to a Chapter 11 plan, and on the eve of the foreclosure sale, the Debtor commenced a Chapter 11 case.

Following the commencement of the Chapter 11 case, the bankruptcy court granted DB Burbank’s motion to appoint a bankruptcy trustee. The trustee faced several immediate concerns, including cash issues and the likelihood that DB Burbank would be granted stay relief to foreclose on the debtor’s assets. In an effort to address those concerns, the trustee, working with DB Burbank, proposed to liquidate the debtor’s assets pursuant to a

bankruptcy code Section 363 sale.

Pursuant to the court-approved sale procedures, DB Burbank agreed to serve as the stalking horse bidder for the sale of the debtor’s assets, provide a carve-out for payment of certain administrative expenses, and forebear from moving to lift the automatic stay to foreclosure on the debtor’s assets. Essentially, the sale procedures provided that DB Burbank’s stalking horse bid would be a credit bid in the amount the debtor owed DB Burbank, and such bid would be subject to higher and better offers.

The trustee moved for court approval of the sale, free and clear of liens — including Clear Channel’s lien — pursuant to Bankruptcy Code Section 363(f). Clear Channel objected to the sale on the grounds that Section 363(f) was inapplicable to the facts of the case. The bankruptcy court approved the sale procedures (the “Sale Order”) over Clear Channel’s objection and permitted the sale process to go forward.

During the sale process, the trustee received three offers for the debtor’s assets, all of which were far less than the amount of DB Burbank’s credit bid. As such, the bankruptcy court entered an order confirming (the “Sale Confirmation Order”) the sale of assets to DB Burbank free and clear of liens and finding that DB Burbank was a purchaser in good faith.

Following the denial of Clear Channel's request for a stay of the sale confirmation order pending appeal, the asset sale to DB Burbank closed.

Clear Channel did not receive any payment on account of its subordinate lien because DB Burbank's credit bid meant that there were no proceeds to which Clear Channel's lien could attach. Clear Channel appealed the sale order and sale confirmation order to the BAP.

Opinion

Before delving into the crux of the appeal, the BAP addressed whether the issues on appeal were moot and thus could not be heard. The BAP first focused on constitutional mootness and found that although the asset sale closed, there was still a live case or controversy for which relief could be fashioned. Thus, the BAP found that the appeal was not constitutionally moot.

Next, the BAP focused on whether the appeal was equitably moot. Equitable mootness requires the court to look at "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." The BAP noted that subsequent to the sale, substantive steps were completed, including transferring title of the assets to DB Burbank and assumption of executory contracts and unexpired leases, causing third parties to rely on the finality of the sale. As such, the BAP found a review of the sale to DB Burbank was equitably moot.

Importantly, the BAP did not find the dispute over the "free and clear" portion of the sale and sale confirmation orders (*i.e.*, the stripping of Clear Channel's lien) was equitably moot. Indeed, the BAP noted that "[a]n appeal is not equitably moot as to lien-stripping under Section 363(f) if reversing the lien-stripping raises neither the issue of complexity nor the issue of negative impact on third parties." The BAP found that because DB Burbank did not identify any third party who would be prejudiced, and given the relative ease with which Clear Channel can receive the relief it requests, Clear Channel's appeal relative to the stripping of its lien was not equitably

moot.

Lastly, the BAP considered whether Clear Channel's appeal was moot pursuant to bankruptcy code Section 363(m). Section 363(m) generally insulates a bankruptcy sale to a good-faith purchaser absent a stay pending an appeal of the sale. Parsing the language of Section 363(m), the BAP found Section 363(m) applicable only to sales authorized pursuant to bankruptcy code Sections 363(b) and (c) (nonordinary and ordinary course sales). Thus, because Section 363(f) is not mentioned in Section 363(m), the free and clear portion of a sale is not protected by § 363(m). Stated differently, the BAP found that "stripping a lien is not a sale . . . protected by the language of § 363(m), either directly or indirectly."

The BAP then considered whether the stripping of Clear Channel's lien pursuant to bankruptcy code Section 363(f) was proper. Bankruptcy code Section 363(f) permits a debtor to sell assets free and clear of liens or interests in such property if any of the following conditions are satisfied:

- applicable nonbankruptcy law permits sale of such property free and clear of such interest;
- such entity consents;
- 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;
- such interest is in bona fide dispute; or
- such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

The BAP centered its analysis on subsections (f) (3) and (5). With respect to subsection (f) (3), the trustee asserted that

the "aggregate value of all liens" means the economic value of such liens as opposed to their face value. The BAP rejected the argument, finding that "Section 363(f) does not authorize the sale free and clear of a lienholder's interest if the price of the estate property is equal to or less than the aggregate amount of all claims held by creditors who hold a lien or security interest in the property being sold."

Next, the BAP focused on the language of subsection (f) (5). DB Burbank and the trustee asserted, among other things, that the bankruptcy court correctly found subsection (f)(5) applicable where a claim or interest can be satisfied by the payment of money to the lienholder. The BAP reversed the bankruptcy court's holding and found subsection (f)(5) requires a showing that a legal or equitable proceeding exists in which a claimant's lien may be extinguished without full payment of the face amount of the lien. The BAP suggested that the universe of such proceedings is quite small and specifically rejected the argument that a "cramdown" pursuant to bankruptcy code Section 1129(b), which provides for confirmation of a plan over the objections of nonconsenting lienholders, is not a qualified proceeding. The BAP ultimately remanded the issue back to the bankruptcy court for determination as to whether such a qualified proceeding exists.

Conclusion

The BAP's decision throws the proverbial wrench into the process of how bankruptcy assets are liquidated outside of a plan. While it is too soon to determine the decision's overall impact, its holding certainly adds an additional element of uncertainty to the sale process. For instance, junior creditors now have more ammunition in negotiating Section 363 asset sales where the assets are being sold by credit bid. More importantly, the BAP's finding that bankruptcy code Section 363(m) is inapplicable to lien-stripping is the most novel part of the opinion and has the potential to chill Section 363 sales altogether. This is an important decision to keep an eye on, particularly focusing on how other bankruptcy court's receive and interpret the opinion. ■