SALES FREE AND CLEAR – WILL THE EXPANSION CONTINUE?

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Section 363(f) of the Bankruptcy Code provides an extraordinary tool to trustees and debtors in possession - the ability to sell property "free and clear." This unique power, unavailable to a seller outside bankruptcy, not only facilitates the tasks of liquidation or reorganization, but it may even be the critical incentive for entering bankruptcy in the first place. It has now become the principal focus of many Chapter 11 cases.

THE GROWING USE OF SECTION 363 SALES IN CHAPTER 11

Sales of estate assets under 11 U.S.C. § 363 have always been the primary working tool of Chapter 7 trustees, whose straightforward mission is to sell assets and distribute the proceeds. The sale of assets under Section 363 in Chapter 11 cases, however, has taken longer to win widespread acceptance as a standard part of the reorganization process. The alternative to Section 363 sales in Chapter 11 is the sale of assets as part of a Chapter 11 plan, as recognized by 11 U.S.C. §§ 1123(a)(5)(D) (a plan shall "provide adequate means for the plan's implementation, such as … sale of all or any part of the property of the estate, either subject to or free of any lien") and 1141(c) ("after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors").

Because of the more comprehensive resolution of claims and interests allowed by a Chapter 11 plan, a substantial body of case law developed favoring Chapter 11 sales under plans, rather than Section 363. Cases have held that Section 363 sales,

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particularly those early in a case and those involving a large part of the debtor's assets, should be scrutinized carefully lest they amount to a "sub rosa" plan, effectively precluding any other reorganization plan and supplanting the carefully constructed plan confirmation process. *Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935 (5th Cir. 1983). While this approach to Section 363 sales made sense under the Code's statutory structure, the courts have generally moved away from this restrictive view toward a more flexible acceptance of Section 363 sales. *Official Comm. of Unsecured Creditors v. Cajun Electric Power Coop., Inc. (In re Cajun Electric Power Coop., Inc.)*, 119 F.3d 349 (5th Cir. 1997).

The Chapter 11 plan confirmation process, with its elaborate disclosure requirements, lengthy notice and approval periods, and comprehensive resolution of all debt related issues, is simply too burdensome and time-consuming for the many debtors that need to maximize the value of their assets during the limited time they are able to continue functioning in Chapter 11. Therefore, courts have become increasingly tolerant of Section 363 sales in Chapter 11 cases, to the point that in today's environment such sales are a commonly accepted part of the reorganization process. *See Comm. of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2nd Cir. 1983).

The attraction for debtors is not only the ability to convert assets to cash relatively quickly, but the ability to deliver clean title to their purchasers, often without the need for the careful investigation and structuring normally required of transactions in a non-bankruptcy context. Debtors also have the advantage of being able to negotiate the best sale terms they can while still retaining the opportunity to subject the

negotiated sale to competitive bidding, which has become a standard part of the Section 363 sale process.

For purchasers, the ability to acquire clean title under Section 363(f) can make acquisitions from bankruptcy more appealing than they otherwise would be, even compensating for the disadvantage of having a negotiated transaction subjected to competitive bidding. For competing bidders, the debtor's ability to deliver clean title may often make it possible to submit a competitive bid on relatively short notice without the extensive due diligence that otherwise might be required.

While opinions may differ, a strong case can be made that the liberalized use of sales free and clear under Section 363(f) has on the whole enhanced, rather than undermined, the Chapter 11 process. Debtors otherwise unable to complete asset sales before their financial demise may be able to get maximum value for their creditors through asset sales in Chapter 11. The future impact of Section 363 sales on the reorganization world will likely depend to a large extent on how far Section 363(f) is taken. The bounds of how thoroughly assets can be cleansed of the rights of other parties have been pushed and expanded in recent years. It appears that we have not yet reached the limit of how far they can go.

SECTION 363(f)'S BASIC POWERS

Section 363(f) allows sales of property "free and clear of any interest in such property of an entity other than the estate" under any one of five conditions. Subsections 1 through 4, while they have generated some debate, cover most of the clear cases: (1) non-bankruptcy law permits sale of the property free and clear of such interest; (2) the entity holding the interest consents; (3) the interest is a lien and the sale

price exceeds the aggregate value of all liens**;** or (4) the interest is in bona fide dispute. Subsection 5, which allows sale free and clear if the interest holder could be compelled to accept a money satisfaction, is the potential wild card, opening up even more opportunities. Section 363(h) augments this power by permitting sale free of the interests of a co-owner of property if certain different conditions are met.

Although Section 363(f) requires that one of five conditions be satisfied for the court to approve a sale free and clear, the reported opinions often do not identify which one has been satisfied. *See, e.g., Precision Ind., Inc. v. Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp.)*, 327 F.3d 537 (7th Cir. 2003) (holding that Section 363(f) extinguished a lessee's possessory interest, despite Section 365, which generally protects possessory interests upon rejection of a lease, and notwithstanding that neither party identified which of the five conditions had been satisfied).

With respect to the second condition (consent), a number of courts have deemed it satisfied when the holder of the interest receives notice of the sale and fails to object. *FutureSource LLC v. Reuters Ltd*., 312 F.3d 281 (7th Cir. 2002); *Ragosa v. Canzano*, 295 B.R. 166 (1st Cir. BAP 2003) *In re Enron Corp., et. al.,* 2003 WL 21755006 (Bankr. S.D.N.Y. 2003); *cf. In re Roberts,* 249 B.R. 152 (Bankr. W.D. Mich. 2000) (holding that consent may not be implied from a lienholder's failure to object).

When applying the third condition (price exceeding value of liens), courts have reached different conclusions as to the meaning of the term "value" as it is used in Section 363(f)(3). Some courts have held that "value" means actual or economic value and not the face amount of the liens. *In re Collins*, 180 B.R. 447 (Bankr. E.D. Va. 1995); *In re Terrace Gardens Park Partnership,* 96 B.R. 707 (Bankr. W.D.Tex. 1989);

In re Beker Ind. Corp., 63 B.R. 474 (Bankr. S.D.N.Y. 1986). Other courts have held that "value" means the face amount of the liens. *In re Perroncello*, 170 B.R. 189 (Bankr. D. Mass 1994); *Schere v. Federal Nat'l Mortgage Assoc. (In re Terrace Chalet Apartment, Ltd.)*, 159 B.R. 829 (N.D. Ill. 1993); *Richardson v. Pitt County (In re Stroud Wholesale, Inc.)*, 47 B.R. 999 (Bankr. E.D.N.C. 1985). According to the latter line of cases, an interpretation of Section 363(f)(3) that protects only actual or economic value renders Section 363(f)(5) superfluous.

FINDING THE LIMITS

Section 363(f)(5) (allowing sale free and clear if "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest") is the provision that blurs the limits of sales free and clear. As with many Code provisions, statutory language that seems simple in the abstract becomes complex when applied to the practicalities of the real world. The principal difference of opinion on the extent of subsection 5 has been whether it requires only that the interest being affected be capable of being "crammed down" under a Chapter 11 plan. A number of courts have held that this is sufficient. *See, e.g., In re Healthco Int'l., Inc.*, 174 B.R. 174 (Bankr. D. Mass. 1994) (citing cases). Regardless of the outcome of this debate, some limits on the extent of Section 363(f) have been quite clearly established.

While some argument could be made that virtually any right that could be characterized as an "interest" can be removed from property under Section 363(f), the cases have found ways in logic and the law to set limits. For example, easements and restrictive covenants on real property cannot be removed and transferred to proceeds by a Section 363(f) sale. *In re Oyster Bay Cove, Ltd.,* 161 B.R. 338 (Bankr. E.D.N.Y.

1993). Although somewhat less clearly established, there has been acceptance of the principle that a right of first refusal to acquire the property at issue cannot be abrogated by a sale under Section 363(f). *Berg v. Scanlon (In re Alisha Partnership)*, 15 B.R. 802 (Bankr. D. Del. 1981). Whether or not purchase options can be removed from the property, however, may depend as much on an executory contract analysis as on Section 363(f). *In re Fleishman*, 138 B.R. 641 (Bankr. D. Mass. 1992).

THE EXPANDING FRONTIER OF SECTION 363(f)

There is a vast gray area between those interests that clearly can or cannot be removed by a sale under Section 363(f). In considering how far sales free and clear can go, the first inquiry is what constitutes an "interest" under Section 363(f). The next question is whether the holder of the interest, if it is one, can be compelled in a legal or equitable proceeding to accept a money satisfaction. These concepts, although distinct, are intertwined, and have led to inconsistent results in the case law.

One issue at the heart of the analysis is whether "claims" constitute "interests" that can be pushed aside in a Section 363(f) sale. The most recent decision at the Court of Appeals level has held that a sale can be free and clear of claims, as long as the claims are connected to or arise from the property being sold and would under normal circumstances follow the property when sold. *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3rd Cir. 2003). This decision followed the precedent of *In re Leckie Smokeless Coal Co.*, 99 F.3d 573 (4th Cir. 1996), which held that, although not all general rights to payment are within the scope of Section 363(f), property can be sold free of claims amounting to successor liability if they are somehow connected to the

property. *See also, In re Medical Software Solutions*, 286 B.R. 431 (Bankr. D. Utah 2002) (approving the sale of assets free and clear of successor liability claims).

The use of Section 363(f) to free purchasers from successor liability claims has not been uniformly accepted, however, and the proposition remains subject to doubt. *See* Kuney*, Misinterpreting Bankruptcy Code §363(f) and Undermining the Chapter 11 Process,* 6 Am. Bankr. L.J. 235 (Spring 2002). Moreover, the debate continues over whether future claims, such as product liability claims not yet manifested by injury, can be kept from flowing with the property to the purchaser. *In re All American of Ashburn,* 56 B.R. 186 (Bankr. N.D. Ga. 1986), *aff'd.*, 805 F.2d 1515 (11th Cir. 1986); *In re Mooney Aircraft, Inc.*, 730 F.2d 367 (5th Cir. 1984).

Nevertheless, debtors, in their efforts to liquidate assets for the best price, and purchasers, in their understandable desire to buy assets, not liabilities, will continue to push for the expansion of the kinds of "interests" that bankruptcy sales can detach from property. In recent cases, "interest" has been expanded to include: an adverse possession claim in *Ragosa v. Canzano*, 295 B.R. 166 (1st Cir. BAP 2003); a personal injury claim in *Myers v. United States of America, et. al.*, 297 B.R. 774 (S.D. Cal. 2003); a license to use intellectual property in *FutureSource LLC v. Reuters Ltd.*, 312 F.3d 281 (7th Cir. 2002); and a lessee's possessory interest in *Precision Ind., Inc. v. Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp.)*, 327 F.3d 537, 546 (7th Cir. 2003).

It is not uncommon for motions and orders under Section 363(f) to encompass all kinds of rights and interests, including claims and successor liability, in the scope of the free and clear title to be conveyed to the buyer. *In re Enron Corp., et. al.,* 2003 WL

21755006 (Bankr. S.D.N.Y. 2003). In fact, the natural dynamics of Chapter 11, in which the debtor and creditors all want to maximize the value of the assets, and the purchaser wants the broadest order possible, drive the process in this direction. Since the language of the Code itself does not expressly preclude such a broad application, this is a natural trend.

THE FUTURE OF FREE AND CLEAR SALES

While any prediction of the future course of interpretations of bankruptcy law is difficult at best, the trend to date has been toward broader use of Section 363 sales in Chapter 11 and a more and more liberal application of Section 363(f). While ultimate determinations may have to await decisions by the Supreme Court, Section 363(f) is likely to continue growing in popularity, judicial acceptance, and scope. What is seemingly lost in the shuffle is the additional capability given to a debtor under a Chapter 11 plan. Whether or not plans will once again become the preferred method of legitimizing free and clear sales in reorganization cases is unknown, although the developing case law to this point has not turned that way. What is known is that the power to make sales free and clear under Section 363 has become a cornerstone of the bankruptcy process, both in Chapter 7 and Chapter 11 cases. With the economics at work in most cases, the horizons of sales free and clear are likely to continue to expand.