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## Free And Clear Asset Sales Through Section 363

Law360, New York (October 14, 2008) -- A sale pursuant to section 363 of the Bankruptcy Code generally is the preferred approach for acquiring assets out of bankruptcy because the process is less expensive than sales under Chapter 11 plans or state law foreclosure remedies, presents less execution risk and provides buyers with certainty that the assets they acquire are purchased free and clear of all interests. These advantages have helped create a robust, value-maximizing market for acquiring distressed assets out of bankruptcy.

A recent decision of the Bankruptcy Appellate Panel of the Ninth Circuit in *Clear Channel Outdoor Inc. v. Knupfer (In re PW, LLC)* ("Clear Channel"),<sup>[1]</sup> however, calls into question whether 363 sale advantages can be realized in situations where the aggregate claims of a company's secured creditors exceed the value of the collateral securing their claims.

The Clear Channel decision has ignited a debate about whether an order approving a sale free and clear of interests pursuant to section 363(f) of the Bankruptcy Code can be reversed on appeal notwithstanding the section 363(m) safe harbor for good-faith purchasers and non-statutory mootness doctrines.

It also raises doubts about the ability of a senior lienholder or cash buyer to obtain an order authorizing a sale "free and clear" of junior liens under section 363(f) of the Bankruptcy Code where a junior lienholder does not consent and the bid does not provide for payment in full in cash of all liens.

### *Background*

The debtor in *Clear Channel PW LLC* ("PW"), owned prime real estate in southern California. The property was encumbered by a senior secured claim exceeding \$40 million held by DB Burbank ("DB") and a junior lien of approximately \$2.5 million held by *Clear Channel Outdoor Inc.* ("CCO").

Problems with the development of the property ultimately led to bankruptcy and the appointment of a Chapter 11 trustee. DB and the Trustee devised a process to consolidate and sell substantially all of PW's assets pursuant to a stalking horse bid submitted by DB.

Under the stalking horse bid, DB agreed to credit bid the full amount of its claim plus cash for purposes of covering certain administrative expenses. The Trustee did not receive any "qualified bids" and, therefore, sought court authority to sell the assets to DB free and clear of liens pursuant to sections 363(f)(3) and (f)(5) of the Bankruptcy Code.

The bankruptcy court overruled CCO's objection to approval of the sale free and clear of CCO's junior lien and approved the sale. The bankruptcy court also made a finding that DB was a "good faith purchaser" entitled to the protections of section 363(m) of the Bankruptcy Code.

Though CCO appealed entry of the sale order, it did not seek a stay, and DB consummated the transaction shortly thereafter and made approximately \$1.5 million of sale-related payments to third parties.

#### *Mootness Issues*

On appeal, the first issue addressed by the BAP was whether the sale order was reviewable in light of the section 363(m) safe harbor and applicable mootness doctrines.

The BAP concluded that the approval of the sale itself was not reviewable, finding that the doctrine of equitable mootness precluded appellate review.

Noting that title to the properties had transferred and that numerous third parties had relied upon the sale order in entering into various closing transactions with DB, the BAP concluded that review of the sale was equitably moot.

The BAP next addressed whether it had the power to review the "free and clear" aspects of the sale order that gave DB title to the properties free and clear of CCO's lien. The Trustee and DB argued that the equitable mootness doctrine and section 363(m) of the Bankruptcy Code precluded appellate review, but the BAP disagreed.

The BAP concluded that the equitable mootness doctrine did not apply because reattachment of the CCO lien was neither theoretically nor practically difficult and because DB failed to demonstrate any prejudice to third parties that would result from reinstatement of the CCO junior lien.

Furthermore, the BAP noted that DB was a sophisticated purchaser who was "aware of the risks of going forward with the sale" in the face of the appeal.

The BAP also dismissed DB's argument that section 363(m) of the Bankruptcy Code precluded appellate review of the "free and clear" provisions in the sale order.

Applying principles of statutory construction, the BAP concluded that section 363(m) by its terms only applied to court authorizations to sell, use or lease property under subsections 363(b) and (c) of the Bankruptcy Code, and did not extend to "free and clear" relief granted under section 363(f) of the Bankruptcy Code.

In so ruling, the BAP rejected DB's argument that the consummation of the sale rendered the free and clear aspects of the sale order immune from appellate review.

Amazingly, the BAP decided that a fundamental precept of the transaction - the free and clear nature of the sale - could be set aside without any consideration and without any notion that a material foundation to the entire deal was extinguished.

In the real world, it is questionable at best that the parties would have done the deal had the free and clear aspect been taken away or if they had thought that the Bankruptcy Court could rewrite their agreement instead of simply disapproving it.

#### *Application Of 363(f) To "Underwater" Asset Sales*

The BAP next turned to the issue of whether the assets could be sold free and clear of CCO's junior lien pursuant to sections 363(f)(3) or 363(f)(5) of the Bankruptcy Code.

With respect to subsection 363(f)(3), the BAP joined other courts which have held that section 363(f)(3) 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.

Consequently, the BAP concluded that 363(f)(3) did not apply because the value of DB's credit bid did not exceed the aggregate value of all liens on the assets being sold.

Turning to section 363(f)(5), which permits a sale free and clear of liens if there is a legal or equitable proceeding wherein the junior secured creditor could be compelled to accept less than a full money satisfaction of its interest, the BAP remanded the proceedings to the bankruptcy court for determination of whether such a proceeding is, in fact, available.

The BAP also rejected the Trustee's assertion that the Bankruptcy Code "cramdown" provisions qualified as a legal or equitable proceeding within the meaning of section 363(f)(5).

#### *Implications Of Clear Channel*

While Clear Channel is not binding precedent outside of the Ninth Circuit (and may not be binding upon lower courts in the Ninth Circuit), junior lienholders likely will force

bankruptcy courts and appellate courts to address the BAP's legal conclusions and reasoning for years to come.[2]

With the explosion of second lien and other multi-tranche secured financings working their way through restructuring pipelines, the Clear Channel decision and the attendant risks arising therefrom will become part of the cost-benefit calculus undertaken by stakeholders when evaluating recovery options.

While these issues work their way through the courts, the uncertainties left in the wake of the Clear Channel decision will reverberate through the market for distressed assets.

The prospect of appellate review and reattachment of junior liens supported by Clear Channel undermines the rationale for acquiring assets under section 363: cost savings and limited execution risk.

Prospective asset purchasers may be reluctant to step forward and even do diligence on 363 transactions if the possibility exists that junior liens of nonconsenting lienholders can be reattached to the acquired property after appellate review. Acquisition financing costs in connection with 363 sales may increase, thus taking value off the table for creditors. Cash buyers in 363 sales may require protections such as purchase price holdbacks to address uncertainties posed by appellate review of free and clear orders.

These types of protections will delay distributions of sale proceeds to secured creditors and provide junior lienholders with bargaining power that does not exist outside of bankruptcy. The inevitable result will be more liquidations and a loss of businesses and jobs that otherwise might have been saved.

In other circumstances, drafting may not solve the problem because of the economic consequences of Clear Channel. The costs imposed by the BAP to acquire assets out of bankruptcy free and clear of liens may lead secured creditors to seek relief from the automatic stay to pursue collateral recovery remedies under state law such as foreclosure proceedings, which automatically extinguish out of the money junior liens.

For example, a senior lienholder following Clear Channel would be required to credit bid the entire amount of its secured claim, plus cash necessary to satisfy all junior liens, plus 1 cent to come within section 363(f)(3).

If the same creditor obtained relief from the automatic stay and foreclosed on its collateral under applicable state law, the creditor would extinguish all out of the money liens at no cost and it would retain any deficiency claim.

The BAP also intimated that its decision did not impact the ability of parties to acquire assets free and clear under a Chapter 11 plan.

While a Chapter 11 plan remains available as a means to acquire assets free and clear, buying assets pursuant to a Chapter 11 plan imposes additional costs on the buyer

because of the need to satisfy all administrative expenses and also increases execution risk because approval of the sale may be delayed or never approved due to confirmation issues entirely unrelated to the sale.

The Clear Channel decision likely will require secured lenders, cash buyers and their advisers to reassess whether a section 363 sale is a prudent approach to acquiring assets out of a bankruptcy proceeding.

While it remains to be seen whether the decision is embraced by other bankruptcy courts, the debate ignited by the Clear Channel decision is sure to continue in law offices and boardrooms for some time to come.

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[1] 391 B.R. 25 (9th Cir. BAP 2008).

[2] The parties in Clear Channel have settled the appeal; however, the Clear Channel decision was not vacated under the settlement.