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Ninth Circuit BAP Dresses Down Lienstripping

Could This Be the Last Dance for 363 Sales?

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A recent decision of the Bankruptcy Appellate Panel (BAP) for the U.S. Court of Appeals for the Ninth Circuit (BAP)[2] could have a significant impact on bankruptcy sales. *In Clear Channel Outdoor*, the bankruptcy court had authorized a sale of real estate to a credit-bidding senior lienholder free and clear of claims held by an objecting junior lienholder on the basis that the lienholder's claim could be crammed down under a plan of reorganization. The BAP reversed, holding that the closing of the sale, even in the absence of a stay, did not moot the appeal with respect to the stripping of the junior liens, notwithstanding the good-faith purchaser protections afforded the senior lienholder, suggesting that the property could remain subject to the junior liens. The court remanded the case to the bankruptcy court for further proceedings.


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This decision is at odds with what many practitioners take for granted, and if not remedied on remand (or on further appeal), it could potentially elevate the rights of junior lienholders vis-à-vis senior lienholders, not only in credit bid situations, but also in cash-purchase situations. This article summarizes the decision and addresses certain seemingly questionable aspects of the court's reasoning and the potential ramifications thereof for bankruptcy sales.

The Decision

The debtor owed more than $40 million to a senior lender[3] and approximately $2.5 million to a junior lender, both of which were secured by the debtor's real estate located in Burbank, Calif. The debtor defaulted on payments under its senior loan, and the senior lender commenced foreclosure proceedings. A receiver was appointed, and the senior lender loaned additional funds to enable value-enhancing additional property purchases to be made while the parties attempted to negotiate a consensual resolution. The parties did not come to terms, and on the eve of the foreclosure sale, the debtor filed a chapter 11 bankruptcy petition in the U.S. Bankruptcy Court for the Central District of California.

A chapter 11 trustee was appointed, and she negotiated a deal with the senior lender to facilitate a bankruptcy sale process under Bankruptcy Code §363(b).[4] The senior lender agreed to serve as the stalking-horse bidder with a credit bid under Code §363(k)[5] in the approximate amount of $41.4 million. The senior lender also agreed to cover various administrative and other expenses and claims totaling approximately $2.2 million and not to seek relief from the automatic stay. Only three other bids were received, the highest of which was a contingent bid of approximately $25 million.

Over the objection of the junior lender, the bankruptcy court approved the sale to the senior lender free and clear of the junior lender's liens, pursuant to Code §363(f)(5),[6] on the basis that the junior lender could be compelled to release its liens in a legal proceeding—particularly, a cramdown under a plan of reorganization. The bankruptcy court further specifically found that the senior lender was a good-faith purchaser under Code §363(m).[7]

The junior lender was not successful in obtaining a stay pending appeal from

Feature

1 The views expressed herein do not necessarily reflect those of Cahill Gordon & Reindel LLP or its clients.

2 *Clear Channel Outdoor Inc. v. Knupfer (In re PW LLC),* 391 B.R. 25 (B.A.P. 9th Cir. 2008).

3 There was a party owed $750,000 with an even more senior lien that was paid off by the party referred to herein as the senior lender.

4 Section 363(b) provides, in pertinent part, that "[t]he trustee, after notice and a hearing, may...sell...other than in the ordinary course of business, property of the estate...."

5 Section 363(k) provides that "[a]t a sale under [Bankruptcy Code §363(b)] of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property."

6 Section 363(f) provides that "[t]he trustee may sell property under [Bankruptcy Code §363(b) or (c)] 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 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."

7 Section 363(m) provides that "[t]he reversal or modification of an appeal of an authorization under [Bankruptcy Code §363(b) or (c)] of a sale...of property does not affect the validity of a sale...under such authorization to an entity that purchased...such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale...were stayed pending appeal."

either the bankruptcy court or the appellate court, and the senior lender closed on the sale with no recovery to the junior lender. In accordance with its agreement with the chapter 11 trustee, the senior lender paid out approximately $1.5 million, including payments to professionals, to a more senior lienholder and for real estate taxes.

The junior lender appealed, arguing that the bankruptcy court had erred in allowing the stripping of its liens. The trustee and the senior lender argued that the appeal was moot and should be denied on the merits in any event. The BAP found that the appeal of the sale itself was moot, but that the portion of the sale order pertaining to lienstripping under Code §363(f) was not. Specifically, the court held that it was not equitably moot because a remedy could be fashioned—*i.e.,* the junior liens could be reinstated—and it was not statutorily moot because, using a very literal reading, Code §363(m) references only §363(b) and not §363(f).

Turning to the merits, the BAP determined that the bankruptcy court had erred in finding that the junior lender's liens could be stripped pursuant to Code §363(f)(5) because, in its view, the possibility of a cramdown of the junior lienholder in a hypothetical plan scenario did not constitute the type of legal proceeding referenced in that section for purposes of a free and clear sale. The BAP remanded the case to the bankruptcy court to provide the parties the opportunity to argue whether there is some other type of proceeding under which the junior lienholder could be compelled to release its liens.

Questionable Reasoning and Potential Ramifications

Presumably it is clear that in the context of a foreclosure proceeding, if nothing else, a senior secured creditor can credit bid and eliminate the liens of junior secured creditors. Therefore, it will be quite surprising if the bankruptcy court does not find, on remand, that there is a proceeding that satisfies the lienstripping requirements of §363(f)(5) and reach the same result it did the first time, and if such finding does not hold up on appeal.

If somehow that is not the ultimate resolution, and the junior lien is permanently reinstated, the senior lender is in a most untenable position. Usually it is not possible to "unscramble the egg" and undo a closed sale, and it would be extremely unfair for the senior lender to be in a position where it has given up its liens, paid out significant cash to others, potentially invested additional funds in and improved the purchased assets, and then be stuck with a property subject to the junior lender's liens. On top of everything else, the senior lender could actually be forced to pay cash or other consideration to the junior lender to extinguish its liens and/or to have the junior lender paid out ahead of itself. Such a result would turn the lien priority system on its head. Even worse, the reasoning of the case would not necessarily be limited to senior lender credit bid scenarios and could apply generally even to sales to third parties where the cash purchase price does not fully cover all secured lenders, causing buyers to be deprived of the benefit of their bargains (or to bid less in light of this risk, to the detriment of more senior lenders).

What the BAP seemingly failed to recognize is that sale closure mootness principles, including under §363(m), are specifically designed to avoid these sorts of extremely unfair results. Initially, the BAP read §363(m) too narrowly and ignored the reality that virtually no buyer (especially not a senior credit-bidder that is buying assets as a last resort alternative to receiving a significantly discounted payout) would purchase assets out of bankruptcy, certainly not at the highest price, if junior liens potentially remained on the assets. Section 363(f) contemplates stripping all liens, including those of a senior secured creditor under appropriate circumstances, and is not appropriately applied to "out-of-the-money" junior lienholders. The value of the collateral was effectively established by the auction process, and the remedy for such junior lienholders to protect any value they perceive in their collateral beyond that established by the market is to pay off the senior lender in full and credit-bid their own claims.

Moreover, it is impossible to separate the relief granted under §363(f) from that under §363(b), and obtaining assets free and clear of liens (particularly junior liens) is a critical component of any sale under §363(b). Indeed, §363(f) by its terms applies specifically to sales "under subsection [363](b)."

While it may be that the BAP is trying to drive more bankruptcy cases toward the plan confirmation process, as opposed to a §363 sale process, its decision could have the effect of jeopardizing the successful use of timely and efficient §363 sales and of chapter 11 in general. There are many situations where a prompt §363 sale is the best way to maximize value for all parties-in-interest. A business may be losing money or otherwise rapidly declining in value, for example, and there may not be sufficient time to complete a sale under a plan of reorganization. In addition, buyers may be reluctant to participate in a plan process that may have significant risks and contingencies prior to confirmation. Moreover, completing a plan process is likely to be significantly more expensive than a §363 sale process.

Particularly in today's lending market, more bankruptcy cases involve likely undersecured lenders offering to fund a sale process in the hope of inducing third parties to offer a reasonable price at a going-concern auction sale (and thereby have some chance of generating distributions to additional constituencies), with the lenders reserving the right to credit-bid if they are not satisfied with any third-party offers. In most such cases, lenders would not likely be willing to fund a more protracted and costly plan sale. If the debtor is not able to effectuate a §363 sale with the support of its senior lenders, there may be no legitimate basis for it to remain in chapter 11. In any event, the lenders should be able to obtain relief from the automatic stay to foreclose on their collateral, likely eliminating the possibility of any recovery by any other parties (including junior lienholders) and potentially destroying any ongoing business to the detriment of employees, suppliers and customers, among others.

Conclusion

If the implications of this decision are not remedied on remand or the case is not otherwise overturned, and/or if other courts decide to follow the logic of the BAP in *Clear Channel Outdoor*, sales under Code §363 as we know them could change dramatically. A pre-plan sale where the debtor has multiple tiers of secured claims would not often be a feasible option, and many cases would end in liquidations after all collateral is removed from the estate, which would not benefit any parties other than the most senior secured lenders. ■

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