

# ACRELive! Section 363 Sales June 27, 2024

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# Today's presentation

- ▶ Overview of 363 sales procedures
- ▶ Title insurance issues in 363 sales
- ▶ Practical issues in 363 sales
- ▶ Questions--



# Goals of a 363 Sale

- ▶ Use the bankruptcy code to clear title to the property being sold
- ▶ Sale is free and clear of liens and other interests in the property
- ▶ Liens attach to the proceeds from the sale



# Where to start? 363(f)

- ▶ Sales free and clear permitted when:
  - ▶ Applicable non-bankruptcy law permits the sale
  - ▶ The entity consents
  - ▶ If the sale price exceeds the aggregate value of all liens on the property
  - ▶ If there is a bona fide dispute over the interest in the property
  - ▶ If the entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of the interest



# Where to start?

- ▶ Lender's consent - makes life easier
  - ▶ But the debtor can compel a sale without the lender's consent
- ▶ Title insurance issues—Ken will deal with those later; but knowing what a title insurance company will require to issue a policy is critical in drafting the sale order and the motion to conduct the 363(f) sale
- ▶ Draft the order first. Sample orders are on the ACREL website.



# Challenges - Credit Bid

- ▶ 363(k) - unless the court “for cause” orders otherwise; a secured creditor can credit bid at the 363 sale
  - ▶ Does the right to credit bid really chill sales?
  - ▶ Debtors’ counsel appear to assume that the credit bid chills sales; but where’s the evidence
  - ▶ Can be avoided with the lender’s consent to the sale



# Challenges - Agreements Controlling Sales Price

- ▶ 363(n) - sale can be avoided if the sales price was controlled by an agreement among potential bidders
- ▶ As the debtor - stay away from any activity that could be considered as controlling the sales price
- ▶ Debtor has an obligation to get the best price for the property
- ▶ Watch for offers from entities that have common ownership with the Debtor
  - ▶ If in doubt, remember the 3 D's of bankruptcy. “Disclose, disclose, disclose”



# Rule 6004

- ▶ Notice in the manner required by Rule 2002(a)(2), (c)(1), (i), and (k) and, if applicable, in accordance with §363(b)(2) of the Code
- ▶ Sales free and clear - noticed under Rule 9014
  - ▶ Notice by mail
  - ▶ CMRRR on financial institutions insured by FDIC
- ▶ Objections to sale governed by Rule 9014
- ▶ Sale can be by private or public sale
- ▶ Rule 6004(g) if the Debtor proposes to sell Personally Identifiable Information





# Rule 6004(h) stay of sale

- ▶ 6004(h) requires a 14 day stay unless the court orders otherwise
- ▶ Ask the bankruptcy court to waive the stay so that closing can occur as soon as the order entering the sale is entered
- ▶ The sales agreement should include a closing date tied to the date of bankruptcy court approval
- ▶ Appeals time is 14 days after the order approving the sale is entered under Rule 8002
  - ▶ Party appealing may file a motion to stay the effectiveness of the order either before or after the filing of the notice of appeal under Rule 8007



# Check for Local Rules

- ▶ Nebraska Local Rule 6004-1:
  - ▶ Notice must name the purchaser and the relationship, if any, the purchaser and all members, associates and professional employees may directly or indirectly have with the case or any related case.
    - ▶ VERY BROAD
  - ▶ Tax information: Tax consequences of the sale have to be disclosed; including the tax basis of the property; projected costs of sale; anticipated capital gain or loss and anticipated net taxable income from sale after adjustments.
  - ▶ In a Chapter 11 - if the sale is before confirmation of a plan and the sale includes substantially all of the Debtor's assets, the sales notice has to "conspicuously state that fact."



# More Local Rule 6004-1

- ▶ For sales before confirmation of a plan, the notice must state the extent to which the sales proceeds will be used to benefit each class of creditors; the extent of the Debtor's liabilities; and the estimated net value of any remaining assets not subject to the sale; and the business justification for a sale before a plan is confirmed.
- ▶ IRS is required to be noticed
  - ▶ Remember to serve the US Attorney General and the applicable US Attorney



# Sales procedures motion

- ▶ Depending on the nature of the assets being sold; the Debtor may start the sales process by filing a motion for the approval of a sales procedures order
  - ▶ Can include a break up fee
  - ▶ Could set a base price or starting bid
  - ▶ Can include an “auction” if there are upset bidders
  - ▶ Normally includes a way for bidders to be qualified to bid at the sale



# Break up fee

- ▶ Depends on local procedure
- ▶ If the amount is large; need to explain why a break up fee is appropriate
  - ▶ Could be significant due diligence costs incurred by the “stalking horse” bidder
  - ▶ If there are due diligence costs; then explain what those costs are
    - ▶ Phase I, II audits
    - ▶ Surveys
    - ▶ Other due diligence



# Sales Agreement

- ▶ Contingent on bankruptcy court approval
- ▶ If lender has approved the sales agreement; consider adding a clause that the lender has approved the sale
- ▶ Seller's representations and warranties
  - ▶ Not very valuable—substantially all assets sold; Debtor likely to either dismiss case with no assets or convert to a 7; no source of recovery



# Sale Agreement

- ▶ Due diligence needs to be done up front
- ▶ Protect Debtor with nondisclosure agreement
- ▶ If the Debtor's employees, or certain employees, are proposed to be hired by the buyer, identify the employees
- ▶ What if there's an appeal?
  - ▶ Lease?
  - ▶ Management agreement?



# Bankruptcy Section 363 Sales

## Title Insurance Considerations

### Overview

Bankruptcy Code Section 363(b) allows the trustee or debtor in possession (DIP) to sell or lease real property other than in the ordinary course of business after notice and a hearing. Due to claims against the bankruptcy estate that may be attached to the property in question, a buyer and its title agent usually desire to purchase the property under Section 363 (f), which allows the trustee or DIP to sell the property free and clear of “any interest” in the property of persons other than the bankruptcy estate.





## The title insurance agent should be involved early in the process

- ▶ A sophisticated DIP or trustee seeking to sell real property should order a title insurance commitment first to determine what liens, claims and other encumbrances exist on the property prior to formulating the sale motion.
- ▶ The title agent will need to examine the debtor's schedules to determine if the property was scheduled as an asset of the bankruptcy estate and whether all of the creditors and other parties claiming interest in the property were scheduled creditors. All parties that may have an interest, including all whose interests might be affected, must be provided advance notice of the motion to sell under Section 363(f).
- ▶ The title agent and buyer should also examine the sale/auction procedures order to assess bidder requirements; the agent should provide input/comments to the proposed order approving a completed sale so that it contains the essential elements for the sale to be insurable. The ABI has model orders available.
- ▶ The title agent will need to determine the proposed closing date to occur when it can bind title insurance coverage after the order of sale is entered and the appeal period has run.



# Notice Procedures

Bankruptcy Rule 2002(a): requires minimum 21 day notice to all creditors of the hearing on motion under Section 363(b) (unless court shortens), and local bankruptcy rules should be reviewed in case they change this period.

Bankruptcy Rule 6004(c): requires that a written notice of a motion to sell a property free and clear of liens must be served on every party who has a lien or other interest in the property. The notice must include a date for hearing on the motion and the time within which objections must be filed and served.

Hearings are often dispensed with if no objections are filed.

- ▶ Bankruptcy Rule 6004(f) also provides the basic rules that a sale not in the ordinary course of business may be by private sale or by public auction.
- ▶ Part (h) of Rule 6004 provides that an order authorizing the sale of property is stayed until the expiration of fourteen days after the entry of the order unless the court orders otherwise. This is designed to provide sufficient time to request a stay pending an appeal before the order is implemented, but often in larger cases this period is shortened by specific order.
- ▶ The Bankruptcy Rules are flexible and are often modified in a case by specific court order, so the buyer and title agent should be alert to such modifications that could implicate due process concerns about adequacy of notice. Best practice to provide input and get court approval of the form of notice of the auction procedures and ensure that it is served on all necessary parties.



## Interests and the statutory grounds to remove interests

The statutory text and general case law suggest a panoply of “interests” that may be stripped from the property if the Section 363(f) requirements are satisfied. The interests that may be affected include tax liens, mortgages, leases, easements, purchase options/contracts, covenants and restrictions, successor liability issues and environmental claims.

- ▶ “A bankruptcy court may approve a section 363 sale free and clear of successor liability claims if those claims flow from the debtor’s ownership of the sold assets.” *In re Motors Liquidation Co.*, 829 F.3d 135 (2nd. Cir. 2016).
- ▶ Federal labor law successor business obligations were not extinguished by a free and clear bankruptcy sale since they were continuing obligations for the entity which was found to be a successor of the debtor. *See, e.g., In re Norrenberns Foods, Inc.*, 2022 WL 26557213 (S.D., Ill. 2022) (pension fund withdrawal liability); *In re Braeburn Alloy Steel LLC*, Civ. No. 22-1563 (D. Del Sept. 18, 2023) (collective bargaining unit negotiation obligations).
- ▶ Similarly, continuing environmental liability for latent environmental contamination imposed on an operator is not amenable to being stripped by a Section 363 sale. It may be a “future interest” or not an interest in the property at all.
- ▶ If these are not interests in the real property asset, being in the nature of police powers and regulatory interests, they would be excluded from title insurance coverage by the standard policy jacket exclusions.



## The requirements

The sale made by the DIP or trustee may be made free and clear of an interest “only if” the DIP or trustee can prove to the bankruptcy judge that any one of the five requirements enumerated in Section 363(f)(1) to (5) as to each such interest has been satisfied.

The buyer or title agent should endeavor with the DIP counsel to ensure that the order allowing sale is very specific about what property interests are to be stripped.

If being asked to insure over a record or non-record interest that is not excluded by the title insurance policy generally, the title agent must determine what non-bankruptcy law would permit the sale free of the interest.

If the aggregate value of all liens is less than the sale price to a stalking horse bidder, perhaps the underwriting decision is easier, but only if the interests to be stripped can all be reduced to a monetary amount. Or, what if a claimant objects and asserts a larger claim, for example, yield maintenance on its note?

Should the title agent or buyer accept the risk of a negative outcome if the claim to be stripped is in bona fide dispute?

A title agent should decline from insuring over the interest purported to be stripped if it cannot be shown to satisfy one of the five requirements under 363(f).



Section 363(f)(1): “applicable non-bankruptcy law permits sale of such property free and clear of such interest.”

Requirement (1) is similar in application to requirement (5), since in applying either requirement the title agent must determine whether or not applicable non-bankruptcy law, such as foreclosure by a senior creditor or receivership under state law, would allow the sale free and clear of the interest in question.



## Section 363(f)(2): “such entity consents.”

A split of authority exists as to whether consent can be inferred.

- ▶ cannot be inferred, it must be express.

See, e.g., *In re Arch Hospitality Inc.*, 530 B.R. 588 (Bankr. W.D.N.Y. 2015); *In re Roberts*, 249 B.R. 152 (Bankr. W.D. Mich. 2000); *In re DeCelis*, 349 B.R. 465 (Bankr. E.D. Va. 2006).

- ▶ minority view is that consent can be inferred (by silence), but an astute title insurance underwriter is unlikely to rely on an inferred consent in the absence of other compelling circumstances.



Section 363(f)(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.”

- ▶ This factor may be of limited applicability or practical if the sale actually generates proceeds less than the value of the liens, as is often the case, or if an auction is involved and the sale price is not known until the end.
- ▶ Split of authority exists on the meaning of “value” of the liens; face value, or allowed amount?
- ▶ The issue of determining the allowed amount of a claim may be premature in the bankruptcy case, which is why the liens attach to the proceeds for later determination of distribution and allowance.



## Section 363(f)(4): “Such interest is in bona fide dispute.”

- ▶ This requirement is often applied to strip a mechanic’s lien that was being contested by the debtor before bankruptcy, or a lease that was in default before the bankruptcy case was filed.
- ▶ The DIP should have objected to the claim if a claims bar date has passed; but the 363 sale usually occurs earlier in the bankruptcy case.
- ▶ Although not strictly a requirement, the DIP or Trustee should have commenced an adversary proceeding to contest validity or priority of the mechanics lien to undergird requirement (4).





§363(f)(5): “Such entity could be compelled, in a legal or equitable proceeding to accept a money satisfaction of such interest.”

- ▶ Sale free and clear of a lease is possible where facts/law show that the lease was subordinate to the secured creditor’s interest, without benefit of an SNDA, and likely to be foreclosed by the senior creditor in a state law proceeding. *See In re Spanish Peaks Holdings II LLC*, 872 F.3d 892 (9th Cir. 2017). The spurned lessee later sought adequate protection of its stripped interest which was denied by the bankruptcy court.
- ▶ The Fifth Circuit reached a similar result in a case with a subordinated lease and a senior creditor that could destroy it in foreclosure, therefore affirming that adequate protection under 365(h) was inapplicable and denying it under Section 363 (e). *See In re Royal Alice Properties, LLC*, 26 F.4th 326 (5th Cir. 2022).
- ▶ In a case where the lessee failed to object to the sale terms, it lost its lease and the Seventh Circuit said that this was not a rejection of the lease under 365 triggering adequate protection. *Precision Industries, Inc. v Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003).
- ▶ Other courts refused to strip a lease because adequate protection to a non-debtor lessee usually includes a right of continued possession pursuant to Section 365(h), meaning that the lessee could not be compelled to accept only a money satisfaction. *In re Haskell LP*, 321 B.R. 1 (Bankr. D. Mass 2005); *In re Samaritan Alliance, LLC*, 58 Collier Bankr. Cas. 2d (Bankr E.D. Ky. Nov. 21, 2007); *Dishi & Sons v. Bay Condos, LLC*, 510 B.R. 696 (S.D.N.Y. 2014) (court analyzed 363(f) requirements and found them lacking, did not order section 365(h) adequate protection, but instead granted continued possession as adequate protection under section 363(e)).



§363(f)(5): “Such entity could be compelled, in a legal or equitable proceeding to accept a money satisfaction of such interest.”

- ▶ It is unlikely under most states’ law that an easement or restrictive covenant could be extinguished by a payment of money, although it is a fact specific inquiry. For instance, if the restriction on use contained a liquidated damages provision for a breach, then theoretically the benefitted party could be compelled to take money. On the other hand, if the group of benefitted parties is difficult to determine, and any one of them could enforce their equitable right to the benefits of the easement or covenant, it is probably not feasible to wash it away under Section 363.
- ▶ Courts hold that the cram-down provisions in §1129 of the Bankruptcy Code cannot be the basis of the Section 363(f)(5) finding, as this is circular reasoning and would only apply after plan voting. See, e.g., *Clear Channel Outdoor Inc. v. Kupfer*, 391 B.R. 25 (9th Cir. B.A.P. 2008).
- ▶ Constitutional Takings clause is not implicated since the debtor does not have eminent domain powers (usually).

Bottom line: title agent must do underwriting as if a foreclosure sale is occurring (analyze priority, adequacy of service and notice, due process, choice of state law, etc.)



# Can the bankruptcy court strip an appurtenant easement?

Doubtful.

In *Port of Corpus Christi v. Sherwin Alumina Company, LLC (in re Sherwin Pipeline, Inc.)*, 952 F3d 229 (5<sup>th</sup> Cir. 2020), the Corpus Christi Port Authority lost its right to an appurtenant access easement when a tract of land was sold free and clear of the easement as part of a liquidating plan. Procedurally, the Port did not effectively object to the sale which purported to sell free of the easement, or seek a stay, or perfect an appeal, and later filed an adversary proceeding to collaterally attack the sale. The Fifth Circuit dismissed an appeal of the adversary proceeding on all but due process grounds.

- ▶ Last minute change to terms of a 363 sale embedded in a Chapter 11 plan of reorganization confirmation order
- ▶ Port “attended” a telephonic hearing but did not object, based on assurance from debtor’s counsel to court that no substantive changes were made
- ▶ Bankruptcy court made no finding of any applicable grounds under §363(f) to strip the easement
- ▶ Sale occurred before any stay motion or appeal filed by Port Authority
- ▶ Due process claim left unresolved by Fifth Circuit. Asset buyer was affiliated with Debtor; was it really a BFP?



## Essential elements of the order approving the sale:

- ▶ That all objections and responses have been disposed of in favor of allowing the sale pursuant to Section 363(c) and (f)
- ▶ that notice is fair and in accordance with all applicable Bankruptcy Code Sections and Rules and due process
- ▶ that the DIP or trustee are specifically authorized to sell the property, and including a legal description of the real property being sold, to the buyer identified in the private sale contract or at the conclusion of the auction
- ▶ that the buyer is a good faith purchaser and is entitled to all the protections of 363(m) of the Bankruptcy Code such that a modification, reversal or a vacatur of the order will not affect the validity and enforceability of the sale (no divestment)
- ▶ that the sale is not subject to avoidance for collusive or bid rigging under Section 363(n) or otherwise



## More essential elements of the order approving the sale:

- ▶ That the DIP or trustee may execute all instruments necessary to transfer title
- ▶ Listing each lien or interest which is being released and the specific justification under one of the five grounds under Section 363(f) for selling the property free and clear of that interest or lien
- ▶ that a certified copy of the order itself may be recorded in the state real estate records that will constitute an effective transfer and release of the liens and encumbrances on the property being stripped; ideally the order will list specifically the liens and encumbrances being released.
- ▶ that all of the interests in the property enumerated attach only to the proceeds of the sale
- ▶ that holders of any liens or interests on the acquired asset may not interfere with buyer and are estopped from taking action against the purchaser of the acquired asset



## More about the order approving the sale:

The ideal order would also contain sufficient recitals referring to the bankruptcy docket to indicate that the DIP or trustee are acting pursuant to the order for relief, that the property was scheduled, and that the parties in interest were either scheduled creditors of the debtor or were given specific notice as required by Rule 6004 and Section 363. Or certified copies of these orders should be recorded

The order may also address remaining leases and executory service contracts to be assigned and assumed by the buyer (however, this type of order created an appealable issue in the *Mall of America* case, discussed below).

The title agent should then record a certified copy of the order after the order is entered and prior to the closing.



# Finality and Insurability under Section 363(m)

“The reversal or modification on appeal of an authorization under [Section 363(c)] does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased the property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.”

- ▶ For this reason it is paramount that the order approving the sale find that the buyer is a purchaser in good faith.
- ▶ The ultimate goal of the title agent is to make sure that Section 363(m) protects the bona fide purchaser and the title company insuring the transaction.



## Appeal issues

Most title Insurance underwriters will not approve issuance of the policy insuring title over interests to be stripped in a Section 363(f) sale unless the time for appeal has expired. Underwriting counsel will examine procedural posture and the possibility of appeals between entry date and closing until appeal period has expired.

- ▶ Bankruptcy Rule 8002: appeal must be filed within fourteen days after the entry of the order being appealed. Since longer than 8 days, Bankruptcy Rule 9001(a) includes Saturdays, Sundays and legal holidays in the time computation.
- ▶ Bankruptcy Rule 8007: provides that a motion to stay pending appeal must be filed in the bankruptcy court, either before or after the notice of appeal.
- ▶ To get the protection of Section 363(m), the title agent will need to determine who are all of the interested parties, that all were notified of the hearing, that all have either waived their right to an appeal or consented to the order approving the sale, and do some due diligence on the buyer, or else risk an adverse appeal reversing any finding that the buyer was acting in good faith (for instance, evidence of collusive bidding or undisclosed knowledge about a title defect).





## Appeals and BFP Status

Section 363(m) only protects the validity of the sale to a bona fide purchaser, but does not necessarily preclude all appealable issues.

See *MOAC Mall Holdings Corp. v. Transform Holdco LLC*, 598 U.S. \_\_\_\_ (2023) (“*Mall of America*”). The Supreme Court resolved a Circuit split of whether section 363(m) is jurisdictional and barred an appeal of an order integral to a lease transfer under section 363(b) which was not stayed pending appeal.

By finding that Section 363(m) is not jurisdictional, the Court interprets Section 363(m) to limit what issues can be raised on appeal and, unless the BFP status of the buyer was timely challenged, Section 363(m) continues to protect the bona fide purchaser as to the validity of the sale only, while permitting appeal on other issues, including Section 363(f) objections to stripping, adequate protection, etc.



## Appeals and BFP Status

The Supreme Court said that the language of Section 363(m) is a “caveated constraint on the effect of a reversal or modification” and has the effect of “cloaking certain good-faith purchasers or lessees with a targeted protection of their newly acquired property interest, applicable even when an appellate court properly exercises jurisdiction.”

*Mall of America* adds some uncertainty when insuring a Section 363 sale. An appeal could reverse a decision to strip an interest that would not necessarily invalidate the sale. For this reason, it is even more important that the title underwriter and buyer try to wait until the appeal period has run without a stay, or scrutinize any appeal to assess whether the interest being purchased and insured is in jeopardy.

