



## BANKRUPTCY PRACTICE

BY JOHN J. RAPISARDI

### *Junior Lienholders to Use 'PW' to Protest Proposed Sales?*

**T**he recent decision of the Bankruptcy Appellate Panel of the U.S. Court of Appeals for the Ninth Circuit (the Ninth Circuit BAP) in *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*<sup>1</sup> has caused quite a stir among members of the bankruptcy bar. In a dramatic retrenchment of well-settled bankruptcy practice, the Ninth Circuit BAP has held that a senior secured creditor cannot take title of a debtor's assets free and clear of junior liens if such acquisition is accomplished by a credit bid of the lender's outstanding debt.

Should other bankruptcy courts adopt the rationale of the *PW* decision, interested parties may find that certain bankruptcy sales in the coming cycle will be saddled with inefficiencies and uncertainty.

#### Background

PW LLC (PW), a real estate developer, entered into an agreement with the city of Burbank, Calif. (Burbank) to develop a mixed-use complex of condominiums and retail space. A condition of the agreement was PW's acquisition of 18 contiguous properties by February 2009. DB Burbank LLC (DB), an affiliate of a large public hedge fund, held a first-priority lien on all of PW's assets in the amount of \$40 million. In addition, Clear Channel Outdoor Inc. (Clear Channel) held a junior lien on PW's assets in the amount of \$2.5 million.

When it was evident that PW was unable to satisfy its obligations under the agreement it had with Burbank, DB commenced foreclosure proceedings. Pursuant to DB's request, the state court appointed a receiver to take



over PW's assets. On the eve of a scheduled foreclosure sale, PW filed a voluntary petition under chapter 11 of the Bankruptcy Code.

Following the commencement of PW's chapter 11 case, the bankruptcy court granted DB's motion to appoint a chapter 11 trustee to administer PW's assets. The trustee faced numerous obstacles in PW's case because of the debtor's inability to comply with its agreement with Burbank and the truncated time frames that the Bankruptcy Code imposes upon single asset real estate debtors such as PW. The trustee sought to market PW's properties for sale under Bankruptcy Code §363 free and clear of Clear Channel's lien. Pursuant to the trustee's proposed sale procedures, DB agreed to serve as a "stalking horse" bidder and to forbear from moving to lift the automatic stay to pursue foreclosure in state court. The sale procedures provided that DB's stalking horse bid would be a credit bid in the amount of the debt PW owed to DB and that the trustee would hold an auction in an effort to obtain higher and better bids.

Clear Channel objected to the trustee's proposed sale procedures on the ground that DB's credit bid did not qualify under Bankruptcy Code §363(f)(5), which authorizes debtors in certain circumstances to sell their assets free and clear of any encumbrances. The bankruptcy court permitted the auction to go forward over Clear Channel's objection.

The auction did not attract any bids that were higher and better than DB's. The bankruptcy court then entered an order confirming the sale and declaring DB a good-faith purchaser. In conjunction with the order, the bankruptcy court denied Clear Channel's motion to stay the closing of the sale during the pendency of an appeal of the sale. Soon after the entry of the sale order, DB and the trustee closed the sale of PW's assets. Clear Channel received no payment following the sale because DB's credit bid meant that there were no proceeds to which Clear Channel's junior lien could attach. In bankruptcy parlance, DB's purchase "stripped" Clear Channel of its lien, leaving Clear Channel with a significantly diminished potential recovery despite its secured status. Because of the sale order's adverse impact, Clear Channel appealed the order to the Ninth Circuit BAP.

#### The Decision

The Ninth Circuit BAP reversed the bankruptcy court's orders solely with respect to the stripping of Clear Channel's lien. In other words, the sale to DB was left undisturbed, except that it became retroactively subject to Clear Channel's lien, even though the underlying agreed-upon sale procedures were premised on a sale free and clear of all liens.

The Ninth Circuit BAP's decision centered on its interpretation of Bankruptcy Code §363(f), which permits debtors to sell assets free and clear of any lien on or interest in such property only if any of the following conditions are present:

- (1) applicable nonbankruptcy law permits the sale of the asset free and clear of the relevant lien or interest;
- (2) the holder of the relevant lien or interest consents;
- (3) in the case of an underlying lien, the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
- (4) the lien or interest is in bona fide

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dispute; or

(5) the holder of the lien or interest could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.<sup>2</sup>

Subsections (3) and (5) of Bankruptcy Code §363(f) were the focus of the Ninth Circuit BAP's examination. DB and the trustee argued that subsection (3) permitted the sale free and clear of Clear Channel's lien based on the proposition that the value of the claims secured by the assets could be no more than the value of the underlying assets. The court rejected this argument and found that subsection (3) did not apply because, under DB and the trustee's theory, the purchase price for the assets would only equal—not be “greater than,” as the provision requires—the value of the underlying secured claims.

DB and the trustee also argued that the Ninth Circuit BAP should affirm the bankruptcy court's holding that subsection (5) permitted the sale. The bankruptcy court held that subsection (5) was satisfied because Clear Channel's lien could theoretically be satisfied with money.

The Ninth Circuit BAP rejected this view as an overly expansive and simplistic reading of the provision. The court went on to agree with courts that have narrowly held subsection (5) requires a showing that there exists a mechanism to extinguishing the applicable lien with payment in less than the lien's face amount.

The Ninth Circuit BAP offered examples meeting this test such as a buy-out arrangement among partners providing for a valuation that yields less than the market value of the underlying interest or the enforcement of a liquidated damages provision in favor of a nonbreaching party in a case in which specific performance would have otherwise been granted.

The PW court further held that cramdown provisions of Bankruptcy Code §1129(b), which permits the confirmation of a chapter 11 plan in the face of a nonconsenting lienholder, do not provide for an eligible “legal or equitable proceeding” under subsection 363(f)(5) because the cram-down process cannot serve as a basis to justify a lien-stripping sale absent the application of the remaining substantive and procedural protections provided by §1129(b). Finding no justification under Bankruptcy Code §363(f) for the sale of PW's assets to DB free and clear of Clear Channel's lien, the Ninth Circuit BAP reversed the bankruptcy court's sale order solely

with respect to the lien-stripping component of the sale.

Interestingly, a key gating issue in the PW decision was the Ninth Circuit BAP's holding on mootness. An oft-cited bankruptcy rule, which is embodied in Bankruptcy Code §363(m), is the notion that bankruptcy sales to a good faith purchaser cannot be challenged and unwound absent a stay pending the appeal of the sale.

The reason for this rule is that the finality of sale orders ensures a competitive and reliable process for prospective purchasers of assets in bankruptcy. Although the PW court did hold that the actual sale to DB could not be challenged, it parsed Bankruptcy Code §363(m) to exclude the lien-stripping aspect of the sale from the protection of §363(m) because the provision expressly references sales under §363(b) and (c) only, which subsections focus on non-ordinary course and ordinary course sales, respectively. In response to DB's argument that a fundamental premise underlying its stalking horse bid was its purchase of the property free and clear of Clear Channel's lien, the PW court held that DB was sufficiently sophisticated to understand the risk that the lien-stripping feature of the sale may not work.

### Analysis

The PW decision portends significant inefficiency in the bankruptcy sale process and generally will force senior creditors to be less patient with distressed companies. Specifically, PW may cause senior secured lenders to take the view that they will be better off taking an aggressive approach toward exercising remedies under state law instead of cooperating with troubled companies in an out of court restructuring or in chapter 11.

Debtors may be more likely to precipitously file for bankruptcy in order to put a halt to impending state court foreclosure sales. Such cases will be characterized by secured lenders moving to lift stay very early in a bankruptcy case. Courts that lift stay for such lenders will be permitting the dissipation of significant value early on in a case and outside the purview of the court and creditors, which will essentially force more chapter 11 debtors into liquidation under a liquidating chapter 11 plan or by conversion to a chapter 7 case. On the other hand, courts that prevent secured lenders from exercising their state law rights for a protracted period of time will channel parties into an

inefficient and potentially dysfunctional sale process in which secured creditors will have no incentive to participate by credit bidding their debt.

Furthermore, the PW court's ruling excepting the lien-stripping feature of a sale from the statutory mootness principle of Bankruptcy Code §363(m) is not reflective of considerations undertaken by bankruptcy sale participants and is generally not a pragmatic approach to the issue. This portion of the decision will likely cause senior secured creditors to think twice before offering a credit bid, which will imperil the ability of debtors to dispose of assets that are of lesser marketability.

A prospective move away from the PW decision by other courts will aid in sustaining a healthy chapter 11 sale process that protects the rights of secured creditors, is premised on the maximization of the value of a debtor's assets, and is sufficiently reliable to encourage the participation of potential purchasers.

### Conclusion

The PW decision certainly establishes a rule that runs counter to established norms of bankruptcy practice. It seems certain that the PW decision will be seized by junior lienholders seeking to challenge a proposed sale and will likely chill credit bids. Either way, the decision will certainly add significant inefficiencies to certain asset sales. The question remains whether other courts will adopt or reject the rationale of the PW decision. There will likely be courts that will avoid interpreting §363(f)(5) by holding that §363(m) implicitly protects the lien-stripping feature of a sale and, therefore, any challenge of such a sale would be moot. If a rift develops among the courts, the issue of lien-stripping may sufficiently undermine the bankruptcy sale process to warrant the intervention of the Supreme Court or Congress.

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1. 391 B.R. 25 (9th Cir. B.A.P. 2008).
2. See 11 U.S.C. §363(f)(5).