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Third Circuit Holds That Debtor's Assets Can Be Sold in Bankruptcy Cases "Free and Clear" of a Broad Range of Interests, Including Certain Successor Liability Claims

What is the best way to buy assets from a distressed company? There is no simple answer to this question, as it requires the consideration of many factors and methods. There are, however, two virtually unavoidable legal considerations: (1) are the assets subject to adverse liens, claims, or encumbrances, and (2) can the assets be acquired free of them? When it comes to acquiring assets free of adverse interests, a sale conducted under section 363 of the U.S. Bankruptcy Code (the Bankruptcy Code) is generally considered the best method. The reason, in large part, is because the purchaser acquires the assets pursuant to a court order that provides for the sale of assets "free and clear" of any interest in the property.

How free is "free and clear"? Section 363(f) of the Bankruptcy Code permits only sales of property free and clear of "interests." While the Bankruptcy Code does not define what constitutes an "interest," some courts narrowly construe the term to mean only *in rem* interests, such as liens. The trend, however, is toward a more expansive interpretation of "interests." In the recent case of *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003), the Third Circuit Court of Appeals continued this trend, finding that assets sold by Trans World Airlines (TWA) to American Airlines (American) pursuant to section 363(f) of the Bankruptcy Code were sold free and clear of successor liability claims of TWA's employees. The case highlights the power of section 363.

Background

In the TWA case, a class of employees and the Equal Employment Opportunity Commission (EEOC) challenged the bankruptcy court's power to sell TWA's assets free and clear of two categories of claims: (1) twenty-nine employment discrimination claims that were pending before the EEOC and various state and local commissions, and (2) the claims of approximately 2,053 current and former employees of TWA holding travel vouchers that were received in settlement of two sex discrimination lawsuits against TWA.

The employees and the EEOC claimed that the phrase "interests in property" as the phrase is used in section 363(f) of the Bankruptcy Code does not encompass successor liability claims and is limited to *in rem*-type interests such as "liens, mortgages, money judgments, writs of garnishment and attachment, and the like." TWA and the buyer, American, asserted that the phrase "interests in property" should be read broadly to authorize the bankruptcy court to sell free of any interest that could potentially travel with the property being sold.

Third Circuit holds that assets sold pursuant to section 363(f) of the Bankruptcy Code can be sold free and clear of employee successor liability claims.

The employees and the EEOC also argued that even if their claims are "interests in property," the court could not sell free of such claims because the requirements of section 363(f) of the Bankruptcy Code were not satisfied. Section 363(f) permits the sale of assets free and clear of a third party's interests in property if one of five requirements are met: (1) applicable non-bankruptcy law permits such sale free and clear, (2) such third party consents, (3) such interest is a lien and the property is sold for more than the aggregate of all liens on the property, (4) such interest is in bona fide dispute, or (5) such entity could be compelled in a proceeding to accept monetary satisfaction of such interest. Both sides apparently acknowledged that none of the first four requirements could be satisfied. They each focused on whether the claimants could, under the fifth requirement, be compelled to accept monetary satisfaction of their claims.

The court held that the claims against TWA were "interests in property" within the meaning of section 363. In doing so, the court rejected the proposition that the phrase "interests in property" was limited to *in rem* interests. Instead, relying on dicta from its decision in *In re Folger Adam Sec., Inc. v. DeMatteis/MacGregor*, JV, 209 F.3d 252, 259 (3d Cir. 2000), and analogizing to the Fourth Circuit's decision in *In re Leckie Smokeless Coal Co*, 99 F.3d 573 (4th Cir. 1996) (holding that a sale under section 363(f) could extinguish successor liability claims arising under the Coal Act), the court held that the phrase "interests in property" refers to all obligations that are connected to, or arise from, the property being sold. According to the court, the claims of the EEOC and the employees were inextricably linked to TWA's employment of employees who would not have been employed but for TWA's decision to invest in the airline assets sold to American and therefore were interests in property.

The court also rejected the appellants' argument that their claims could not be reduced to monetary satisfaction under section 363(f)(5). The court held that both classes of claimants could be compelled to accept monetary satisfaction in a legal proceeding even though some of the relief sought was injunctive in nature. The court further justified its decision by reference to the Bankruptcy Code's established priority scheme. The court noted that allowing the claimants to recover in full from a successor entity, while other creditors with the same or higher priority recover a fraction of their claims from the bankrupt estate, would subvert the Bankruptcy Code. According to the court, its holding would also promote the policy of providing the most consideration to a bankrupt estate in a section 363 sale. Perhaps most revealing of the court's ultimate rationale for the decision, the court acknowledged that if the sale to American did not occur, the assets of TWA would likely have been liquidated, and that approval of the sale to American free of successor liability claims was necessary in order to preserve some 20,000 jobs (including those of certain of the claimants) and also to provide funding for other employee-related liabilities, including retirement benefits.

Summary

The holding by the court continues the trend to expand the meaning of "interests in property," making a sale pursuant to section 363 of the Bankruptcy Code an even more attractive option to any purchaser of assets from a distressed company.

– Dennis L. Jenkins

– Jamie N. Class

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Cybergenics II Reversed

In Hale and Dorr's December 2002 *Commercial Advisor*, we reported that the Third Circuit's holding in *In re Cybergenics Corporation*

(Cybergenics II), that only a trustee may assert a fraudulent transfer action under section 544 of the Bankruptcy Code (and that a creditor or creditors' committee cannot bring such an avoidance action derivatively), had been vacated pending a rehearing by the Third Circuit *en banc*. On May 29, 2003, the Third Circuit reversed the district court's decision in *Cybergenics II*, holding that "bankruptcy courts can authorize creditors' committees to sue derivatively to avoid fraudulent transfers for the benefit of the estate." *Official Committee of Unsecured Creditors of Cybergenics Corporation v. Chinery*, 330 F.3d 548, 580 (3d Cir. 2003).

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