New York Law Journal
A NEW YORK LAW JOURNAL SPECIAL SECTION
An ALM Publication
Corporate Restructuring And Bankruptcy
WWW.NYLJ.COM
MONDAY, DECEMBER 2, 2013

'Free and Clear' Has Broad Reach in Bankruptcy Sales

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One of the most significant tools of federal bankruptcy law is the authority of a trustee or debtor-in-possession to conduct a "free and clear" sale of a bankruptcy estate's assets. Many may think of such sales in terms of being able to sell (or acquire) assets free and clear of the traditional "liens, claims and encumbrances" that may attach to an asset. The Bankruptcy Code provision providing for free and clear sales, however, is more expansive than that, providing that an asset may also be sold free and clear of "interests." Courts have disagreed on the exact breadth of this term—which the Bankruptcy Code does not define. Most courts, however, have construed the term broadly, holding that it encompasses more than just "in rem" interests in property. Two recent bankruptcy court decisions from courts located within the Second Circuit, *In re Tougher Indus.*, No. 06-12960, 2013 WL 1276501 (Bankr. N.D.N.Y. March 27, 2013) (*Tougher*) and *In re USA United Fleet*, 496 B.R. 79 (Bankr. E.D.N.Y. 2013) (*USA United*)—each holding that a debtor's assets may be sold free and clear of the New York Department of Labor's statutory right to transfer a company's unemployment experience rating to a purchaser of the company's assets—illustrate the reach and vibrancy of the "free and clear" bankruptcy tool.

Bankruptcy Free and Clear Sales

Whether a business that has filed for bankruptcy is seeking to reorganize or liquidate, the ability to sell assets for maximum value is often critical. Section 363(b) of the Bankruptcy Code permits a trustee (or debtor in possession) to sell assets outside the ordinary course of business after notice and an opportunity for a hearing.[1] Section 363(f) provides that such a sale may be "free and clear of any interest in such property of an entity other than the estate" if one of the five conditions set forth in the statute is satisfied:

(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

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> greater than the aggregate value of all liens on such property;
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> (4) such interest is in bona fide dispute; or
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> (5) such entity could be compelled, in a legal or equitable proceeding to accept a money satisfaction of such interest.[2]

The statute does not leave those who hold interests in the debtor's property without recourse. Section 363(e) provides that an entity holding an interest in property may request that the court prohibit or condition a sale of property "as is necessary to provide adequate protection of such interest." Often, adequate protection is in the form of having the interest attach to the proceeds of the sale. Assuming adequate notice, a holder of an interest affected by a bankruptcy sale should therefore have adequate opportunity to assert and protect its interest. Requiring the holder—who likely is in the best position to be aware of the interest and the effect of the proposed sale on the interest—to come forward and seek protection before the sale seems to strike a fair balance between maximizing the value of the assets of the debtor (by reducing the risk that potential buyers will face unanticipated liabilities) and protecting the interest holder.

Without the ability to offer clearly defined "free and clear" protection to purchasers, it is unlikely that debtors could recognize maximum value for the assets they convey. Bankruptcy sales often take place under expedited schedules, without the opportunity for the thorough due diligence that prospective purchasers might otherwise conduct. In addition, a seller in bankruptcy may not be able to offer the protections against liability that a purchaser might typically seek (e.g., holdbacks and indemnifications). Free and clear asset sales are thus a staple in business bankruptcies and are attractive to both buyers and sellers. Indeed, purchasers of assets from a company in financial distress often demand that the seller seek Chapter 11 relief so that the purchaser can obtain the "free and clear" protection in connection with an acquisition.

While §363 free and clear sales are common, questions remain as to the type of "interests" that fall within the meaning of the statute. A small number of courts have taken a narrow view of what constitutes an "interest" under §363(f). In *In re Wolverine Radio*, the Sixth Circuit addressed whether §363(f) permitted a debtor to sell its business free and clear of the historical employment experience of the seller (which experience rating dictated the amount of unemployment taxes due from the company). Narrowly construing the phrase "interest," the Sixth Circuit concluded that the concept of interest was limited to those rights that "[attached] to property ownership so as to cloud title."[3] Applying that narrow view, the Sixth Circuit held that a §363 free and clear sale did not permit the purchaser to acquire a debtor's business "free and clear" of the debtor's historical unemployment experience rating. The purchaser could therefore be tagged with higher prospective unemployment taxes by virtue of its acquisition of the debtor's business.

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Most courts to have considered the issue, however, have taken a broader view of this term, rejecting the notion that the term "interest" is limited to in rem interests.[4] In the *General Motors* and *Chrysler* bankruptcy cases, the courts addressed whether successor liability tort claims are "interests" subject to §363(f)'s free and clear provisions, and held that they were.[5] In so holding, the courts refused to limit "interests in property" as used in §363(f) to "in rem" interests:

> It is the transfer of Old Chrysler's tangible and intellectual property to New Chrysler that could lead to successor liability (where applicable under state law) in the absence of the Sale Order's liability provisions. Because appellants' claims arose from Old Chrysler's property, §363(f) permitted the bankruptcy court to authorize the Sale free and clear of appellants' interest in the property.[6]

Relying on the precedent from the Second, Third, Fourth and Seventh circuits, the First Circuit Bankruptcy Appellate Panel (BAP) recently held that §363(f)'s free and clear provisions barred the Massachusetts state unemployment agency from transferring the unemployment experience of a debtor to the purchaser of the debtor's assets. See *Mass. Dept. of Unemployment Assistance v. OPK Biotech (In re PBBPC)*, 484 B.R. 860 (B.A.P. 1st Cir. 2013). This decision is directly at odds with the Sixth Circuit decision in *Wolverine*.

'Tougher Industries' and 'USA United'

It is against this backdrop that the U.S. Bankruptcy Courts for the Northern and Eastern Districts of New York, in the *Tougher* and *USA United* cases, recently considered whether §363(f) of the Bankruptcy Code permitted a debtor to sell assets free and clear of the debtor's unemployment experience rating. New York Labor Law provides for an employer's unemployment taxes to be calculated using an experience rating that is based on the employer's prior employment and unemployment experience. New York Labor Law §581.4(a) provides that when an employer "transfers his or its organization, trade or business in whole or in part, the transferee shall take over and continue the employer's account, including its balance and all other aspects of its experience under the article."[7]

In the *Tougher* and *USA United* cases, the New York Department of Labor (DOL) sought to increase the unemployment taxes owed by companies that had purchased assets in bankruptcy free and clear sales based on the unemployment experience of the respective debtors. In *Tougher*, the debtors, who were in the industrial heating, ventilation, and air conditioning systems business, commenced Chapter 11 bankruptcy cases. A trustee was appointed and, approximately a year after the bankruptcy case was commenced, the trustee sought approval to sell substantially all of the debtors' assets pursuant to §§363(b) and (f) of the Bankruptcy Code. The sale order specifically provided that the assets

> will vest the Purchaser with all right, title, and interest of the Debtors in the

> Assets free and clear of all liens, claims, encumbrances and interests, including, but not limited to: …(ii) those relating to taxes arising under or out of, in connection with, or in any way relating to the operation of the Assets prior to the Closing… .[8]

The sale process in *USA United*, although expedited, was similar. Prior to commencing their Chapter 11 cases, the *USA United* debtors provided school bus transportation services under contracts with New York City's Department of Education. The first of the debtors' bankruptcy cases were filed on July 11, 2011, those cases were converted to Chapter 7 cases on July 29, 2011, and the remaining debtors filed Chapter 7 cases on August 10, all just weeks before the start of the school year. On Aug. 10, 2011, the trustee filed a motion for approval of the sale of the debtors' buses and the Department of Education contracts, seeking an expedited hearing on the motion on the grounds that the contracts would become worthless if the sale was not approved in time to assure performance under the contracts for the start of the school year. The bankruptcy court held a hearing and approved the sale just five days later. The asset purchase agreement expressly contemplated that the purchaser would be released from liability for "unemployment compensation" and other successor tax liability, and the sale order specifically provided that the assets being sold would vest in the buyer "without any successor, transferee or similar liability."[9]

After these sales had closed, the DOL notified the respective purchasers that the debtors' prior unemployment experience rating had been transferred to the purchasers, thereby substantially increasing the debtors' unemployment compensation obligations to the DOL. In response, the debtors each sought determinations that the sale orders in their respective cases prohibited this action. The DOL opposed the debtors' motions, arguing, based on *Wolverine*, that an unemployment insurance experience rating account is not an "interest in property" within the meaning of §363(f).

Both the *Tougher* and the *USA United* courts rejected the narrow interpretation of "interest" adopted by the Sixth Circuit in *Wolverine* as "inconsistent with prevailing jurisprudence" and as having been rejected by courts in the Second Circuit.[10] In *Tougher*, the court agreed with the First Circuit BAP's conclusion in *In re PBBPC* that "§363(f) should be read broadly and encompasses all obligations that may flow from ownership of the property" and held that the decision was "in line with the expansive reading of the term 'any interest' in 363(f) adopted by the Second Circuit."[11]

The *USA United* court also explicitly addressed the DOL's argument that the debtor's unemployment experience rating did not constitute an interest in property because it created no prepetition right of payment against the debtor. The court noted that the DOL had a contingent right to apply the debtors' experience rating if the property was transferred, a right that ran with the property. That this interest was contingent did not matter, the court concluded, because nothing in §363(f) exempts a contingent interest from being within §363(f)'s reach.[12]

After concluding that the free and clear provision of §363(f) was broad enough to encompass the DOL's rights with respect to the transfer of unemployment experience, both the *Tougher* and *USA United* courts noted that this conclusion was consistent with the purpose of §363. In *Tougher*, the court stated:

> This holding is also consistent with the purpose of bankruptcy sales, which is to maximize the value of the asset and, thus, the dividend to creditors… . The possibility of transferring assets free and clear of successor liability was a crucial inducement to TIE and TME entering into the Asset Purchase Agreement with the Trustee and, ultimately, purchasing the Debtors' assets. If the sale had not been free and clear, TIE and TME would presumably have paid less for the assets.[13]

The *USA United* court agreed with the *Tougher* court that the purpose of bankruptcy sales was to maximize the value of assets and concluded:

> Unquestionably, that purpose was achieved in this case. The sale had to be completed within days to preserve the value of the Department of Education contracts. In addition, the sale ensured that pupil transportation services were available at the start of the school year, and protected the jobs of hundreds of employees.[14]

Conclusion

The *Tougher* and *USA United* decisions reflect that, at least in the Second Circuit, "interests" that are subject to §363(f)'s free and clear provisions are construed broadly. The reasoning of the two decisions suggests that any rights of taxing or regulatory authorities to impose liability that in effect treat a purchaser as the successor to a debtor based on the purchase of the debtor's assets could be subject to a "free and clear" sale order. More broadly, the decisions also reflect the general recognition of bankruptcy courts that the free and clear sale provisions of §363(f) are a critical tool in maximizing value in bankruptcy cases and the courts' willingness to permit and protect the use of that tool to the full extent that the Bankruptcy Code permits.

1. 11 U.S.C. §363(b)
2. 11 U.S.C. §363(f).
3. *Mich. Emp't Sec. Comm'n v. Wolverine Radio (In re Wolverine Radio)*, 930 F.2d 1132, 1147 (6th Cir. 1991).
4. See, e.g., *In re Trans World Airlines*, 322 F.3d 283, 288-90 (3d Cir. 2003) (employment discrimination claims constituted "interests in property" under §363(f)); *United Mine Workers of Am. 1992 Benefit Plan v. Leckie Smokeless Coal (In re Leckie Smokeless Coal)*, 99 F.3d 573, 582 (4th Cir. 1996) (holding that rights of pension fund and benefit plan to collect premium payments from debtor constitute interests in the debtor's assets as there was relationship between right to demand payments and use of assets); *Precision Indus. v. Qualitech Steel SBQ*, 327 F.3d 537 (7th Cir. 2003) (right of possession under lease interest in property under §363(f)).
5. See *In re Chrysler*, 405 B.R. 84, 111 (Bankr. S.D.N.Y. 2009), aff'd sub nom. *Ind. State Police Pension Trust v. Chrysler (In re Chrysler)*, 576 F.3d 108 (2d Cir. 2009), vacated as moot, 130 S. Ct. 1015 (2009); *In re General Motors*, 407 B.R. 463, 503-04 (Bankr. S.D.N.Y. 2009) (reaching same result, citing to *Chrysler*).
6. *In re Chrysler*, 576 F.3d at 126.
7. N.Y. Lab. Law §581.4(a).
8. 2013 WL 1276501, at *2.
9. *USA United*, 496 B.R. at 82, 89.
10. Id. at 87.
11. *Tougher*, 2013 WL 1276501, at *8.
12. *USA United*, 496 B.R. at 88.
13. *Tougher*, 2013 WL 1276501 at *8 (internal citations omitted).
14. *USA United*, 496 B.R. at 88-89.