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Sand Traps for the Unwary: Golf Course Case Questions the Finality of 'Free and Clear' Sale Orders by Bankruptcy Courts

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When might a bankruptcy court's "free and clear" order not be the last word in a Section 363 sale? *Mid-City Bank v. Skyline Woods Homeowners Association*,[1] a recent case out of the 8th Circuit, highlights the interplay between federal and state court decisions interpreting bankruptcy laws, the "full faith and credit" mandated by 28 U.S.C. § 1738, and bankruptcy sales free and clear of real estate interests created under state law. This intersection of legal principles, addressing the sale of a golf course in bankruptcy, suggests that the answer to this question can be complex and, in some respects, unpredictable.

An "Interest"ing Journey from Bankruptcy Court to State Court

Skyline Woods Country Club, L.L.C. filed for bankruptcy in late 2004 and, in early 2005, sold property that had been operated as a golf course for 40 years free and clear of all "mortgages, liens, pledges . . . encumbrances, easements, options, rights of first refusal, restrictions, judgments, claims, demands . . . interests or liabilities of any kind or nature (whether known or unknown, accrued, absolute, contingent, or otherwise)"[2] through a sale order in the bankruptcy proceeding under 11 U.S.C. § 363 ("Sale Order") to Liberty Building Corporation ("Liberty"). When Liberty stopped operating the property as a golf course a year later, homeowners in the surrounding neighborhood ("Homeowners")[3] brought an action in Nebraska state court to enforce an implied restrictive covenant requiring that the property be used as a golf course. Liberty contended that, because of the prior free and clear sale order issued by the Bankruptcy Court, Liberty was not required to operate the property as a golf course. The state district court held for the Homeowners, and Liberty appealed to the Nebraska Supreme Court.

In its analysis, the Nebraska Supreme Court considered that when the original owner of the golf course developed the Skyline Woods neighborhood surrounding the golf course, he used the proximity and existence of the golf course as an enticement to purchasers of the housing lots, claiming that the golf course was the "center and heart" of the residential development.[4] Because the real estate records were replete with evidence supporting the existence of this common scheme of development and the Homeowners had relied on this scheme, there was an "implied" restrictive

covenant requiring that the property be used only as a golf course, and this covenant ran with the golf course property, despite the covenant itself being unrecorded. This "implied" restrictive covenant was found to exist as a matter of Nebraska state law, even though no "express" restrictive covenant had been set forth in the property deeds themselves.

Once the Nebraska Supreme Court determined that such an implied restrictive covenant existed, it turned to consider whether the bankruptcy sale eliminated the covenant. Pursuant to Section 363(f) of the Bankruptcy Code, a trustee or debtor can sell property of an estate free and clear of *any interest* only if one of five statutory requirements is satisfied: (1) applicable nonbankruptcy law permits the sale of such property free and clear of such interest; (2) the entity holding the interest 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.[5] While "interest" is not defined in the Bankruptcy Code, the Nebraska Supreme Court found that applicable case law had held that "interest" does not encompass implied restrictive covenants such as the one encumbering the golf course.[6] Therefore, the court did not reach an analysis of whether any of the five requirements for selling the property free and clear of an "interest" were satisfied.

In finding that the implied restrictive covenant—evidenced in large part by documents in the real estate records—was not an "interest" in property, the Nebraska Supreme Court provided an interesting contrast to federal court decisions that extend the definition of "interest" to contract claims (and authorize a sale "free and clear" of those interests). For example, in *In re Trans World Airlines, Inc. ("TWA")*, the 3rd Circuit discussed what constitutes an "interest" in determining whether Trans World Airlines could sell its assets free and clear of travel vouchers held by flight attendants. In that case, the court noted that the trend is toward an expansive reading of the term "interests," and held that the debtors could sell free and clear of the vouchers under Section 363(f)(5) since they were subject to monetary valuation.[7] The more recent *In re Chrysler LLC* decision from the Southern District of New York used *TWA*'s broad construction of "interest" to hold that tort claims are "interests" of which the debtor can sell free and clear.[8]

In holding that the restrictive covenant did not constitute an "interest," the Nebraska Supreme Court affirmed the state district court's order that the implied covenant required the property to be used as a golf course.[9] Liberty therefore remained obligated to maintain the course.

"Reopening" the Debate in Bankruptcy Court

After the Nebraska Supreme Court's decision, Liberty defaulted on its secured loan to Mid-City Bank (the "Bank"). When the Bank recorded an election to sell the golf course, the Homeowners commenced a second state court action, seeking to subordinate the Bank's deed of trust to the Homeowners' equitable lien for the costs of maintaining the golf course. At that point, Liberty filed a motion to reopen the bankruptcy case and enforce the Sale Order. The Bankruptcy Court denied the motion. It determined that: (1) the Nebraska Supreme Court had concurrent jurisdiction to interpret

the Sale Order; (2) the dispute the Bank and Liberty sought to adjudicate if the case were reopened —whether the Sale Order eliminated the covenants requiring the operation of a golf course on the property—had been decided by the Nebraska Supreme Court; and (3) the movants had "no right to another bite at the apple in the bankruptcy court."[10]

Appealing to the Federal BAP and Circuit Courts

Liberty appealed the decision to the Bankruptcy Appellate Panel for the 8th Circuit ("8th Circuit BAP"), which affirmed the Bankruptcy Court's decision. The 8th Circuit BAP focused on the fact that the Nebraska Supreme Court had concurrent jurisdiction to interpret the Sale Order, distinguishing between a bankruptcy court's jurisdiction to *enter* a sale order which is original and exclusive, and a bankruptcy court's jurisdiction to *interpret* a sale order that was previously entered, which is concurrent with other federal and state courts.[11]

Still unsatisfied with the result, the Bank and Liberty appealed the 8th Circuit BAP's decision to the U.S. Court of Appeals for the Eighth Circuit ("8th Circuit").

There, the 8th Circuit identified as the critical question the following: whether the Nebraska Supreme Court's judgment was entitled to "full faith and credit" under 28 U.S.C. § 1738. If it was, then a federal court in a reopened bankruptcy case would have to give it the same preclusive effect as it would be given under the state laws of Nebraska.[12] In this case, such a preclusive effect would mean defeat for the Bank and Liberty.

The 8th Circuit initially looked to the United States Supreme Court's decision in *Durfee v. Duke*, in which the Supreme Court had adopted a broad principle of jurisdictional finality: "a judgment is entitled to full faith and credit—even as to questions of jurisdiction—when the second court's inquiry discloses that those questions have been fully and fairly litigated and finally decided in the court which rendered the original judgment."[13] The Bank and Liberty argued that the instant case came within an exception to *Durfee* because the matter was within the exclusive jurisdiction of the federal bankruptcy courts, and thus the original Nebraska state court action was void from its inception. But the 8th Circuit rejected the contention that the Bankruptcy Court had maintained exclusive jurisdiction over the Homeowners' claims at the time of the first state court action. Although a bankruptcy court has exclusive *in rem* jurisdiction over the property of the estate granted by 28 U.S.C. § 1334(e)(1), the 8th Circuit's view is that this exclusive jurisdiction exists only so long as the property is part of the bankruptcy estate, and not after the property is sold. The Bankruptcy Court's jurisdiction over the *post*-sale dispute would more properly fall under 28 U.S.C. § 1334(b), the portion of the federal bankruptcy jurisdiction statute that provides non-exclusive jurisdiction, concurrent with state courts.

The Bank and Liberty also argued that Section 363(m)—which provides that the appeal of a Section 363 sale order does not affect the validity of a sale unless the sale order was stayed pending appeal—prevented the Nebraska state courts from modifying Liberty's "free and clear" title. In

rejecting that argument, the 8th Circuit noted that Section 363(m) applies, by its terms, to *appeals* of sales orders, but took this point no farther, leaving the implication that Section 363(m) applies *only* to direct appeals of bankruptcy court orders to higher federal courts and not to collateral challenges of bankruptcy court orders in state courts. The 8th Circuit conceded that the Sale Order was itself entitled to full faith and credit in the Nebraska state court proceedings.[14] But, the court said, the Nebraska courts *had* given full faith and credit to the Sale Order and Section 363(f)—the state courts had merely interpreted the scope of the Sale Order's free and clear provision—and ruled against Liberty's claim "on the merits."

Notably, the 8th Circuit did not explore the line between permitting an "on the merits" interpretation of a free and clear sale order and prohibiting a challenge to the order under Section 363(m). Based on the broad "free and clear" language in the Skyline Sale Order and the state court's decision, it is difficult to imagine what "on the merits" interpretation of a sale order by a state court would not be permitted under the 8th Circuit's analysis.

It is interesting to consider that the 8th Circuit's approach to this issue reaches a similar result to the decision of the 9th Circuit Bankruptcy Appellate Panel in the much-discussed *Clear Channel* case of several years ago.[15] In *Clear Channel*, the 9th Circuit BAP held that an aggrieved junior lienholder could challenge the effect of the "free and clear" provisions of a sale order, notwithstanding Section 363(m), because a challenge to the "free and clear" provisions was not an attack on the sale order itself. In *Skyline Woods*, the 8th Circuit seems to be saying that a party may obtain a state court judgment that "free and clear" provisions of a sale order are not applicable to it, because such a judgment is not the result of an appeal of the sale order, but rather an interpretation of the sale order. These two decisions arise in different procedural contexts, with the 9th Circuit BAP allowing a challenge to "free and clear" language on appeal because the language is not integral to the sale order, and with the 8th Circuit allowing a challenge to the application of the "free and clear" language because the challenge goes to the "merits" of the sale order. But in each case the "free and clear" language was successfully challenged notwithstanding Section 363(m)'s apparent finality.

The Bottom Line

Purchasers rely on a bankruptcy court's "free and clear" order when purchasing property. Many purchasers may anticipate that, if the sale order is later challenged, they can return to the bankruptcy court and resolve the dispute in a favorable forum. *Mid-City Bank v. Skyline Woods Homeowners Association* illustrates that when purchasers buy free and clear under Section 363 of the Bankruptcy Code, they should consider, among other risks, the risk that a non-bankruptcy court will decide issues of whether the sale was "free and clear," and that its decision will be adverse to and binding on the purchasers. Purchasers may be able to mitigate this risk in part by providing notice of the pending sale and "free and clear" terms to all parties holding potential claims, and by insisting that the sale order address those claims specifically and clearly, reducing the likelihood that a state court will find the need to "interpret" the sale order. However, even after taking these actions, some risk and unpredictability may remain.

[1] *In re Skyline Woods Country Club*, 2011 WL 589912 (8th Cir. 2011).

[2] Order Under 11 U.S.C. §§ 105(a), 363 and 365 and Federal Bankruptcy Rules 2042, 6004 and 6006 Authorizing and Approving (A) the Sale of Substantially all of the Debtor's Assets Free and Clear of Liens, Claims, and Encumbrances, (B) the Assumption and Assignment of Executory Contracts and Unexpired Leases; and (C) Granting Related Relief, *In re Skyline Woods Country Club, L.L.C.*, No. 04-84218 (Bankr. Neb. Feb. 9, 2005) [Docket No. 75].

[3] The Homeowners had not been given notice of the sale. This was noted by the courts in stating the factual background but was not the expressed basis of any court's decision.

[4] *Skyline Woods Homeowners v. Broekemeier*, 758 N.W. 2d 376, 381 (Neb. S. Ct. 2008).

[5] 11 U.S.C. § 363(f)(1)-(5) (2011).

[6] *Skyline Woods Homeowners*, 758 N.W. 2d. at 392 (citing *Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994); *In re WBQ P'ship*, 189 B.R. 97 (Bankr. E.D. Va. 1995); *In re Oyster Bay Cove, Ltd.*, 161 B.R. 338 (Bankr. E.D.N.Y. 1993); and *In re 523 E. Fifth St. Housing Pres. Dev. Fund*, 79 B.R. 568 (Bankr. S.D.N.Y. 1987)). These cases do not hold that restrictive covenants do not constitute "interests" as the Nebraska Supreme Court suggests. Other than *Oyster Bay*, they uniformly agree that the trustee or debtor could not sell free and clear of the "interest" of the beneficiary of a restrictive covenant because the sale did not satisfy any of the provisions in Section 363(f) of the Bankruptcy Code–including Section 363(f)(5). *Gouveia*, 37 F.3d at 299; *In re WBQ*, 189 B.R. at 105-107; and *In re 523 E. Fifth St.*, 79 B.R. at 570-71. *Oyster Bay* did not go through the analysis of Section 363(f)(1)-(5), but held that the language of the sale order at issue in that case did not imply that the land was to be sold free and clear of non-monetary restrictions of record which ran with the land. *Oyster Bay*, 161 B.R. at 343.

[7] *In re Trans World Airlines, Inc.*, 322 F.3d 283, 288-91 (3d Cir. 2003).

[8] *In re Chrysler LLC*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009).

[9] *Skyline Woods Homeowners*, 758 N.W. 2d at 395.

[10] Order regarding Motion by Liberty Building Corporation, Mid-City Bank, David Broekemeier and Robin Broekemeier to Reopen Chapter 7 Case, *In re Skyline Woods Country Club, L.L.C.*, No. 04-84218 (Bankr. Neb. Nov.

13, 2009) [Docket No. 180].

[11] *In re Skyline Woods Country Club*, 431 B.R. 830, 835 (B.A.P. 8th Cir. 2010).

[12] *Mid-City Bank v. Skyline Woods Homeowners Association* (*In re Skyline Woods Country Club*), 2011 WL 589912, *2 (8th Cir. 2011).

[13] 375 US 106, 111 (1963).

[14] The 8th Circuit cited its own decision in *Regions Bank v. J.R. Oil Co., LLC* for this principle. Notably, in *Regions Bank*, the 8th Circuit held that a "free and clear" sale order was binding on a non-party to the bankruptcy proceeding because a bankruptcy sale order "free and clear of all liens, is a judgment that is good as against the world, not merely as against parties to the proceedings." 387 F.3d 721, 732 (8th Cir. 2004).

[15] *Clear Channel Outdoor, Inc. v. Knupfer*, 391 B.R. 25 (B.A.P. 9th Cir. 2008).

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