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"The Swamp Hasn't Been Cleaned Up: Recent Developments in Sales and Disposition of Estate Assets"

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Spanish Peaks and the Lessee Who Speaks: The Effect of Free and Clear Sales on Unexpired Leases

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I. Introduction

The Bankruptcy Code provides a mechanism for a trustee or debtor-in-possession to sell property of the Bankruptcy Estate "free and clear of any interest in such property of an entity other than the estate." 11 U.S.C. §363(f); *see also* 11 U.S.C. § 1107(a)(generally stating that in a chapter 11 case, a debtor in possession has all of the rights and powers of a trustee). Although Section 363(f) is seemingly straightforward, controversy exists with respect to its application. More specifically, Bankruptcy Courts disagree regarding Section 363(f)'s application to unexpired leases. While Section 363(f) authorizes the sale of property, free and clear of *any interest*, section 365(h) seems to carve out the rights of tenants under unexpired leases. Accordingly, when read together, "each provision seems to provide an exclusive right that when invoked would override the interest of the other." *In re Churchill Properties III, Ltd. P'ship*, 197 B.R. 283, 286 (Bankr. N.D. Ill. 1996).

II. Conflict in the Code: Sections 363(f) vs. 3635(h)

Which section of the Code prevails: Section 363(f) or Section 365(h)? In this regard, the Code is silent. Some Courts have speculated that "[p]ossibly, this inherent inconsistency was something not contemplated by the drafters. *Id*. at 287. Because of the Code's silence on this issue, Bankruptcy Courts have struggled to reach a consensus regarding which Code provision trumps the other. But before examining the various judicial rulings, a brief analysis of the pertinent Code provisions is necessary.

A. Section 365(h)

Section 365 of the Bankruptcy Code addresses executory contracts and unexpired leases. With respect to unexpired leases, Section 365(h) states:

> if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.

11 U.S.C.A. § 365(h)(1)(A)(ii). In analyzing the legislative history of this section of the Code, courts have noted that "Congress sought to protect both the rights of the lessor and the lessee so as to preserve expectations in real estate transactions." *In re Churchill Properties*, 197 B.R. at 288 (citing *In re Lee Rd. Partners, Ltd.*, 155 B.R. 55, 60 (Bankr. E.D.N.Y. 1993)). Therefore, the "rejection of a lease does not divest the lessee of its interest in the lease." *Id.*

B. Section 363(f)

Section 363 governs the use, sale or lease of estate property. With respect to property sales, Section 363(f) authorizes the sale of estate property, free and clear of any interest, as long as one of five conditions at met. A free and clear sale is authorized if: "(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 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." 11 U.S.C. § 363(f)(1)-(5). Nothing in Section 363(f) excludes its application to leasehold interests.

In other words, pursuant to the language in Section 363(f), a sale of estate property free and clear appears to extinguish the leasehold interests of a rejected-lease-tenant under Section 365(h).

III. The Majority vs. Minority Approaches

In an effort to resolve the conflict in the Code, the majority bankruptcy courts have held that Section 365 trumps Section 363. *See, e.g., In re Zota Petroleums, LLC,* 482 B.R. 154, 163 (Bankr. E.D. Va. 2012)(holding that "[t]he rights of the tenant may not be extinguished by a § 363 sale; to hold to the contrary would give open license to debtors to dispossess tenants by utilizing the § 363 sale mechanism"); *In re Taylor*, 198 B.R. 142, 166 (Bankr. D.S.C. 1996)(noting that "[t]o allow a sale free and clear of a leasehold interest pursuant to § 363 even if the lessee received the value of its interest from the proceeds would effectively provide a debtor-lessor with means of dispossessing the lessee, a result which would appear to be in contravention of Congressional intent"); *In re Haskell L.P.,* 321 B.R. 1, 9 (Bankr. D. Mass. 2005)(stating that a lessee "cannot be compelled to accept money for its rejected lease under § 363(f)(5) in view of the provisions of § 365(h)"). Other Courts, however, have taken the opposite view.

The Seventh and Ninth Circuits have adopted what is referred to as the "minority approach." Utilizing the minority approach, both the Seventh and Ninth Circuits have determined that Section 363(f) allows for the sale of estate property, free and clear of a lessee's interest, provided that the lessee, *upon request*, is granted adequate protection.

A. Precision Industries – The 7th Circuit's Approach

In *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003), the Debtors owned and operated a steel mill in Indiana. Prior to filing for bankruptcy, the Debtors entered into a land lease. After the Petition Date (but before the expiration of the lease at issue), the Debtor sold substantially of its of assets through a bankruptcy auction under Section 363(f).

The lessee of the land lease did not object to the sale, nor did it ask for adequate protection. After some post-sale disputes, however, an issue arose as to whether the lessee's lease survived the sale, and the matter was brought back before the Bankruptcy Court. After a series of lower-court rulings, the case was appealed to the Seventh Circuit.

In conducting its analysis, the Seventh Circuit first turned to the plain language of Section 363(f). The statute allows a trustee to sell property free and clear of *any interest* in such property if certain conditions are met. The Court concluded that the term "any interest" was sufficiently broad to include a lessee's possessory interest as lessee. *Precision Indus., Inc.*, 327 F.3d at 545 (concluding "that the term 'any interest' as used in section 363(f) is sufficiently broad to include Precision's possessory interest as a lessee"). Accordingly, because a lessee's interest in property as a lessee qualifies as an "interest" for the purposes of Section 363(f), the Court determined that Section 363(f) clearly authorized the sale of the Debtor's property, free and clear of any such interest. *Id*. at 546 (stating that "[b]ecause Precision's right to possess the property as a lessee qualifies as an interest for purposes of section 363(f), the statute on its face authorized the sale of Qualitech's property free and clear of that interest").

This, of course, does not leave a lessee without recourse; a lessee can always request adequate protection under Section 363(e). *See* 11 U.S.C. § 363(e)(stating that "[n]otwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest"). In that vein, *Precision* Court concluded that "[w]here estate property under lease is to be sold, section 363 permits the sale to occur free and clear of a lessee's possessory interest—***provided that the lessee (upon request) is granted***

adequate protection for its interest." *Id.* at 548 (emphasis added). On the other hand, "[w]here the property is not sold, and the debtor remains in possession thereof but chooses to reject the lease, section 365(h) comes into play and the lessee retains the right to possess the property." *Id.*

B. Spanish Peaks – The 9th Circuit's Approach

More recently, Ninth Circuit Court of Appeals addressed the same issue in *Matter of Spanish Peaks Holdings II, LLC,* 872 F.3d 892 (9th Cir. 2017). In *Spanish Peaks,* the Debtor was a resort in Big Sky, Montana. Among the Debtor's obligations were unexpired leases for a restaurant space and separate, commercial real estate. Facing a dwindling real estate market and growing operational losses, the Debtor filed for Chapter 7 bankruptcy prior to the expiration of the leases. After the Petition Date, the Trustee proposed to sell substantially all of the Debtor's real and personal property through an auction. The Trustee represented that the proposed sale would be free and clear of all liens, claims and encumbrances, other than those specifically mentioned in the sale motion. The leases for the restaurant and commercial space were *not* mentioned as those encumbrances that would survive the sale. Therefore, the lessees objected to the sale, stating that the Trustee could not sell the property free and clear of their leasehold interests. The lessees did not, however, request adequate protection under Section 363(e). The sale was ultimately approved by the Bankruptcy Court and affirmed by the District Court.

On appeal to the Ninth Circuit, the Court adopted the Seventh Circuit's "minority approach" which broadly defines the term "interest" to include "any interest" as referenced in 363(f). The 9th Circuit also "agree[d] with the Seventh Circuit that sections 363 and 365 do not conflict." *Matter of Spanish Peaks Holdings II, LLC*, 872 F.3d 892, 899 (9th Cir. 2017). Moreover, "section 363 governs the sale of estate property, while section 365 governs the formal rejection of a lease. Where there is a sale, but no rejection (or a rejection, but no sale), there is no conflict." *Id.*

Additionally, while "[a] sale of property free and clear of a lease may be an effective rejection of the lease in some everyday sense, but it is not the same thing as the 'rejection' contemplated by section 365." *Id*.

The *Spanish Peaks* Court also took its analysis further by likening the sale to a foreclosure sale under Montana law (which would have governed the *Spanish Peaks* property in a state court foreclosure action). Under Section 363(f)(1), a Trustee may sell estate property free and clear of any interest in such property if "applicable nonbankruptcy law permits sale of such property free and clear of such interest." *Id*. at 900 (citing 11 U.S.C. § 363(f)(1)). Applying Montana law, "a foreclosure sale to satisfy a mortgage terminates a subsequent lease on the mortgaged property." *Id*. citing *Ruby Valley Nat'l Bank v. Wells Fargo Delaware Trust Co.*, 373 Mont. 374, 317 P.3d 174, 178 (2014). The *Spanish Peaks* Court noted that "had [the Debtor] not declared bankruptcy, we can confidently say that there would have been an actual foreclosure sale. Such a sale would have terminated the [] leases. Section 363(f)(1) does not require an actual or anticipated foreclosure sale. It is satisfied if such a sale would be legally permissible." *Id*.

Therefore, the Court ruled that Section 363(f)(1) authorized the sale of the Debtor's property, free and clear of the leases. And because the trustee did not formally reject the leases, section 365 was not implicated.

As an aside, the *Spanish Peaks* Court also made an interesting observation about the legislative intent behind Section 365. The Court stated that its analysis:

> …highlights a limitation inherent in the "majority" approach. We agree that section 365 embodies a congressional intent to protect lessees. But that intent is not absolute; it exists alongside other purposes and sometimes conflicts with them. To some extent, protecting lessees reduces the value of the estate—property presumably fetches a lower price if it is subject to a lease—and is therefore contrary to the goal of maximizing creditor recovery, another core purpose of the Code. The statutory text is the best

> assurance we have that we are balancing competing purposes in the way Congress intended.

Id. at 900–01 (internal citation omitted).

IV. <u>Conclusion</u>

Lessees should err on the side of caution when presented with a Section 363(f) sale. Given the varying judicial opinions, it is unwise to assume that a bankruptcy court will either preserve or extinguish a lease in a free and clear sale. Rather than remaining silent, lessee's in 363(f) sale situations need to speak up. Moreover, lessees facing a free and clear sale should always request adequate protection to ensure they are compensated for their leasehold rights.

Standards of Appellate Review and Structured Dismissals:
U.S. Bank Nat'l Assoc. v. Village at Lakeridge* and *Czyzewski v. Jevic Holding Corp.

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During the 2017-2018 term, the Supreme Court decided *U.S. Bank Nat'l Assoc. v. Village at Lakeridge*, 583 U.S. ___, 138 S. Ct. 960 (2018), addressing appellate standards of review. During the 2016-2017 term, the Supreme Court decided *Czyzewski v. Jevic Holding Corp.*, 580 U.S. ___, 137 S. Ct. 973 (2017), addressing structured dismissals in Chapter 11 cases. This paper examines these two decisions.

A. Village at Lakeridge and Appellate Standards of Review

In a chapter 11 cram-down case, if a class of claims is impaired, at least one impaired class must vote in favor of the plan in order for the plan to be confirmed, excluding insider votes. 11 U.S.C. § 1129(a)(10). The Code defines insiders to include various persons (known as statutory insiders), but the list is not exhaustive. Others who are sufficiently close to the debtor may also be deemed to be insiders (known as non-statutory insiders). The issue the Supreme Court took for consideration is *not* the resolution of any dispute over the correct test for determining whether a creditor is a non-statutory insider, but rather the standard of review that an appellate court should use in reviewing the decision of a bankruptcy court applying the relevant criteria (whatever they are) to the facts of the case to determine whether the creditor is a non-statutory insider. Ordinarily, courts of appeals review questions of law *de novo*, and questions of fact under the clearly erroneous standard. When it comes to applying the law to the facts, however, some courts have characteristically reviewed the bankruptcy judge's *application* of the law to the facts (assuming the bankruptcy judge has stated the legal test correctly) under the clearly erroneous standard, while others have reviewed it *de novo*.

The facts of the case are colorful. MBP Equity Partners is the equity owner of the Village at Lakeridge, the debtor. U.S. Bank holds an approximately $10 million claim against Lakeridge secured by a mortgage lien. MBP holds an unsecured claims against Lakeridge in the amount of approximately $2.76 million. Lakeridge proposed to confirm a cram down plan that impaired the rights of U.S. Bank and needed at least one impaired class to vote in favor of the plan, but the claim it held was obviously the claim of an insider. So MBP, acting through one of its board members (Ms. Bartlett), sold its claim to an investor (Dr. Rabkin) for $5,000. Ms. Bartlett and Dr. Rabkin were romantically involved.

The bankruptcy court determined that Dr. Rabkin was not a non-statutory insider. The bankruptcy appellate panel reversed, and the Ninth Circuit reversed the bankruptcy appellate panel. The Ninth Circuit reasoned that it reviewed the bankruptcy court's determinations of fact under the clearly erroneous standard, and its conclusions of law *de novo*. Classifying the bankruptcy court's application of the law to the facts as falling within the scope of its clearly erroneous review, a majority of the three-judge panel concluded that the decision was not clearly erroneous (the bankruptcy court having more or less stated the correct legal standard).

In the Supreme Court, U.S. Bank argued that the bankruptcy judge's application of the law to the facts should be reviewed *de novo*, just like questions of law generally. U.S. Bank contended that, among other things, doing so offers important law-clarifying benefits. Lakeridge argued that the bankruptcy judge's application of the law to the facts should be reviewed under the clearly erroneous standard, just like pure questions of fact. Lakeridge argued that the application of the legal standard to the facts is essentially like determinations of fact that the bankruptcy judge is in the best position to assess. The United States filed an amicus brief siding with Lakeridge.

At oral argument, the Justices asked a number of far-ranging questions about method, the capacity of appellate judges to conduct appellate review, and the practical implications of one standard over the other. In rendering its decision, the Court decided for the debtor (and the United States), concluding that a clear error standard applied.

In conducting its analysis of the legal issue of what standard of review properly applies, the court first differentiated three distinct kinds of inquiry: those that are purely legal (*i.e.*, what is the relevant legal rule or test), those that are purely factual (*i.e.*, what happened in the case of relevance to that test), and those that that are a combination of the two (*i.e.*, how is the law to be applied to the particular facts). On the first question, the Court noted (without deciding its merits) that the Ninth Circuit applies a two-part test for non-statutory insider status: whether the person's relationship with the debtor was similar to those listed as statutory insiders, and whether the relevant transaction had been conducted at less than arm's length. The Court took this standard as the given test in deciding the case. Ordinarily such questions are reviewed *de novo*, but the Court did not grant certiorari on this purely legal question. Accordingly, the Court did not decide its merits (although several justices stated in concurrence that they doubted the Ninth Circuit's test was correct).

On the second question, the Court observed that the bankruptcy court made numerous "basic" or "historic" findings of facts regarding what actually happened in the case. The Court noted that the set of relevant facts in any particular instance will turn on the legal test used. In this case, the relevant factual determinations included those surrounding Rabkin's relationship with Bartlett, such as whether they lived together or paid each other's living expenses, and Rabkin's motives for purchasing the claim against the debtor. The Court observed that such determinations are ordinarily reviewed on appeal under the clearly erroneous standard, which gives great deference to the trial court's findings.

On the third question, which was the real bone of contention, the Court characterized the inquiry as involving so-called "mixed questions" of law and fact. Essentially, the third question involves considering whether the facts satisfy the legal test chosen for the resolution of the matter. As noted, the bankruptcy court had determined that the facts did not show the kind of transaction necessary to confer insider status. The question the Court was called up to answer was whether this determination should be reviewed *de novo* or for clear error.

The Court observed that, in general, there is no clear-cut answer to this question because mixed questions of law and fact are not all alike. Sometimes they require a court to expound on the law, such as when they require the elaboration of a legal standard. In such instances, the Court reasoned that appellate courts should review the trial court's determination *de novo*. In other instances, however, the determination is much more intensely factual. In such instances, the Court determined that appellate courts should review the trial court's determination under the highly deferential clearly erroneous rule.

In this case, the Court held that the determination of Rabkin's insider status under the relevant legal test was about as fact-bound as it gets. The nature of the inquiry was such that the bankruptcy court was required to take a raft of case-specific facts and make a determination of whether, on balance, they showed that the parties were acting more like strangers or more like insiders. Conversely, the Court reasoned that, in making its determination, the bankruptcy court was required to do relatively little legal work (other than selecting the correct legal standard). Rather, the bankruptcy court's work essentially involved characterizing the totality of the facts.

The Court's decision thus leaves it up to the lower appellate courts to figure out in each case what is more predominant in the application of the law to the fact—the law or the facts. In some instances, this is likely to be relatively straightforward. In others, it is likely to be more complex. For example, if the law is relatively unsettled, and the application of the law to the facts requires significant illustration of the kinds of things the law is intended to encompass, one would imagine the appellate court opting for *de novo* review. In more run-of-the mill cases in which factual analysis predominates, however, the appellate court is likely to opt for the clear error standard.

B. *Jevic* and Structured Dismissals

The Bankruptcy Code authorizes the dismissal of Chapter 11 bankruptcy cases and generally provides that, unless the court for cause orders otherwise, dismissal has the effect of returning the parties to the status quo immediately prior to the commencement of the case. *See* 11 U.S.C. §§ 349, 1112. Rather than return the parties to the status quo, however, some courts have approved "structured dismissals" that effectively distribute the value of the debtor's assets in various ways, approve the release of various parties, and/or settle various claims. These structured dismissals may or may not comply with the Code's priority rules. The question presented in *Jevic* was whether a structured dismissal that did not comply with absolute priority is something a bankruptcy court is authorized to approve and, if so, under what circumstances.

Jevic Transportation was in the trucking business. Prior to filing for bankruptcy, Jevic engaged in a leverage buyout transaction in which Sun Capital Partners acquired the company. Various lenders led by CIT financed the buyout and provided Jevic with an $85 million revolving line of credit. After Jevic's finances continued to deteriorate, the company decided to file for bankruptcy. It ceased operations, notified its employees of their impending termination, and commenced a

Chapter 11 proceeding in Delaware. At the time, Jevic owed its lenders and Sun approximately $53 million secured by liens on the company's assets. It owed an additional $20 million to taxing authorities and general unsecured creditors. An official committee of unsecured creditors was appointed.

After the commencement of the bankruptcy case, a group of Jevic's terminated truck drivers filed a class action against Jevic and Sun, alleging violations of federal and state WARN acts, under which Jevic was supposed to provide 60 days' written notice before laying them off. In addition, the creditors' committee brought a fraudulent transfer action against CIT and Sun, alleging that Sun, with CIT's help, took over Jevic with essentially none of its own money in an ill-conceived transaction that placed Jevic in an unreasonably precarious financial position.

Several years later, the bankruptcy court granted in part and denied in part CIT's motion to dismiss the litigation. Thereafter, representatives of the committee, Sun, CIT, Jevic, and the drivers convened to negotiate a settlement. Previously, all of Jevic's assets had been liquidated to pay the lender group led by CIT. By the time of the settlement discussions, all that was left of Jevic was about $1.7 million in cash, which was subject to Sun's lien, and the fraudulent transfer action against CIT and Sun.

Eventually the committee, Jevic, CIT, and Sun reached a settlement agreement with four essential features. First, the parties would release each other, and the fraudulent transfer litigation would be dismissed. Second, CIT would pay $2 million to fund the payment of administrative expenses. Third, Sun would assign its lien on the $1.7 million in cash to pay tax and administrative creditors first, and then to distribute something to general unsecured creditors. Fourth, the bankruptcy case would be dismissed. In this way, the settlement contemplated a structured dismissal that provided for the distribution of Jevic's remaining assets. It left out, however, the drivers, who had asserted approximately $8.3 million in wage claims entitled to priority under section 507(a)(4) of the Code. Apparently the drivers had been unable to reach a settlement against Sun on their WARN act claims, and Sun was unwilling to agree to any distribution to the drivers so long as their litigation against Sun remained pending.

The drivers and the U.S. Trustee objected to the proposed settlement and structured dismissal. In particular, they claimed that the dismissal violated the Code's priority scheme by authorizing a distribution to general unsecured creditors while the drivers' priority wage claims received nothing. Rejecting these arguments, the bankruptcy court approved the settlement and the structured dismissal. The court reasoned that other courts has granted similar relief in other cases. The court also observed that dire circumstances existed and that, absent the settlement, there was no meaningful prospect of any distribution to anyone other than the secured creditors because completing a Chapter 11 bankruptcy was impractical, as was conversion to a Chapter 7 case. In essence, there was no cash available to fund any further bankruptcy proceedings because all of the available cash was encumbered by Sun's lien.

Although the bankruptcy court observed that Chapter 11 plans cannot violate absolute priority over the objection of creditors, it concluded that there was no similar restriction for settlements. The court found that the drivers' claims against Jevic were essentially worthless because there was no unencumbered cash that could be distributed to them. On appeal, the district court affirmed, as did the Third Circuit, which held that, in rare instances such as the present case, courts could approve structured dismissals. The Third Circuit believed that, in this case, there was no real alternative and observed that, although structured dismissals might not be used simply to evade the Code's procedural protections and safeguards, there was in this matter no prospect of either a confirmable plan or a viable Chapter 7 case. In addition, the court determined that, although skipping a priority class in favor of distributions to a junior class raises justifiable concerns, it could be done where there are specific and credible grounds that justify the deviation. In this matter, although the drivers were left out in the cold, the bankruptcy court concluded correctly, the court believed, that the settlement best served the interests of the estate and its creditors because further litigation would merely deplete the assets of the estate with little prospect of assisting anyone.

In the Supreme Court, the drivers argued that the absolute priority standard applied equally to settlements as well as plans of reorganization. The drivers reasoned that this was essential to effectuate Congress's policy choice in elevating certain creditors over others. Unlike financial creditors, employees are poor loss spreaders, hence their priority treatment, which should be respected.

In addition, the drivers noted, if they could be skipped over in this case, doing so would serve to open the door to further violations of absolute priority in the future. Settling parties, they noted, should not be permitted to get away with deviations from absolute priority simply because they claim they would not settle unless another creditor group is cut out. The drivers warned that, if approved, exceptional deviations from absolute priority would likely become commonplace. This, they contended, would have dire effects for the negotiation of Chapter 11 plans because it would effectively provide a green light for collusion and undermine the kind of predictability that adherence to absolute priority fosters. This, the drivers warned, would effectively marginalize creditors like the drivers in this case, who generally lack the clout of financial creditors.

In contrast, the several respondents argued that the concept of absolute priority does not superintend the approval of settlements. By the Code's terms, they argued, absolute priority has become codified in the confirmation provisions, but not the rules that govern settlements.

Moreover, although a plan must comply with the Code's priority regime set forth in section 507, nothing in the Code mandates the same for settlement agreements.

Respondents also focused on the impossibility of alternative relief. Absent a settlement, there was likely to be nothing to distribute to anyone, other than the secured creditors. Simply put, the settlement was the best vehicle to maximize distributions to creditors. Further, as the bankruptcy court determined, the drivers' claims were essentially worthless because there was essentially no cash available to distribute to them. The distribution to the unsecured creditors simply took funds out of the secured creditors' pockets, so there was no harm to the drivers in any event.

Countering the drivers' policy concerns, respondents argued that siding with the drivers would grant recalcitrant priority creditors too much leverage by encouraging them to demand payment even when doing so would destroy any hope of maximizing value through the settlement process. Although the drivers might have that leverage in the plan process, respondents argued that they do not have it in the settlement context.

Ruling for the drivers, the Supreme Court held that a distribution scheme ordered in the context of a structured dismissal cannot, without the consent of the affected parties, deviate from the ordinary priority rules applicable to distributions under the Bankruptcy Code. The Court noted that the Bankruptcy Code's priority scheme "constitutes a basic underpinning of business bankruptcy law." The Court reasoned that, because of the centrality of this scheme, if Congress had intended to depart from the existing priority rules in the context of the approval of dismissals under section 349, one would expect some affirmative indication of this intent, observing "Congress … does not … hide elephants in mouseholes."

Based on its review of the Code, the Court found nothing demonstrating such intent. Nor did the Court believe that precedent supported Respondents' position. The Court distinguished situations in which lower courts have approved *interim* distributions that violate absolute priority where these distributions have served Code-related objectives, including various first-day orders. The Court observed that those kinds of distributions are commonly justified as enabling a successful reorganization. In contrast, a structured dismissal involves a final disposition that does not serve the same goal. In particular, it does not preserve the debtor as a going concern, offer the prospect of making disfavored creditors better off, promote the possibility of a confirmable plan, restore the status quo, or protect the reliance interests of creditors who have obtained interests during the course of the bankruptcy case.

Finally, the Supreme Court flatly rejected a "rare case" exception based on "sufficient reasons" in particular cases. The Court was blunt in holding that "it is difficult to give precise content to the concept [of] 'sufficient reasons,'" and expressed the concern that a rare case exception could turn into a more general rule. Specifically, the Court stated that "Congress did not authorize a 'rare case' exception …. [and w]e cannot 'alter the balance struck by the statute'… not even in "rare cases."[1]

[1] Justice Thomas authored a dissent, joined by Justice Alito. The dissent noted that the Court had granted certiorari on a particular question, but the Petitioners had argued (and the Court decided) another question. Given the switch, the dissent would have dismissed the writ of certiorari as improvidently granted.

<u>SETTLEMENTS IN BANKRUPTCY – DO SALE PROCEDURES APPLY?</u>

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A bankruptcy trustee or debtor in possession has the authority to manage the assets of a bankruptcy estate. This authority includes the ability to sell or use estate assets in accordance with the requirements set forth in the Bankruptcy Code, in particular 11 U.S.C. § 363. A trustee's authority to manage assets also gives him or her the right to settle causes of action against third parties. In those circumstances, a trustee must satisfy Bankruptcy Rule 9019 to obtain bankruptcy court approval of the settlement by establishing that the following factors favor the settlement: (a) the probability of success in the litigation, (b) the difficulties of collection; (c) the complexity, expense, and delay of the litigation; and (d) the paramount interest of the creditors. Some circuits, however, also require the trustee to show that the proposed settlement satisfies the Bankruptcy Code's sales provisions.

The Third Circuit treats settlements of causes of action as sales under Section 363. *In re Martin,* 91 F.3d 389, 394-95 (3d Cir 1996). In *Martin*, the Third Circuit reviewed a trustee's decision not to argue in support of her motion to approve a previously filed stipulation settling a cause of action against a third party. After filing the stipulation, the trustee learned that a trial of the cause of action could result in a significantly higher recovery to the estate than the proposed settlement amount. This conclusion convinced the trustee that the settlement was no longer in the best interests of the estate. The bankruptcy court agreed and rejected the settlement, thereby upholding the trustee's decision not to pursue the settlement.

Certain parties appealed the decision, arguing that the trustee should have argued in favor of the settlement. The Third Circuit disagreed, finding that the trustee properly discharged her statutory duty to maximize the value of estate assets by not pursuing the settlement. *Id.* at 395. While not explicitly stating that Section 363 is implicated into the analysis of whether to approve a settlement, the court certainly implied it. "The instant agreement compromised an asset of the debtors' estate. And clearly, this act ventured beyond the domain of transactions that [the debtors] encountered in the ordinary course of business prior to the fling of bankruptcy, thereby implicating Section 363. [citation omitted]. The import of Section 363 is that a trustee is prohibited from acting unilaterally." *Id.*. From the Third Circuit's perspective, Section 363's language concerning the use or sale of an estate asset, in this case a cause of action, required attention to that Code section's provisions when considering the trustee's actions when if feel outside the debtor's ordinary course of business.

In *Northview Motors Inc. v. Chrysler Motor Corp*, the Third Circuit reiterated the position announced in *Martin.* 186 F.3d 346 (3d. 1999). There, the Third Circuit observed that a court must determine if a proposed settlement agreement involves the use or sale of estate property outside the ordinary course of business, in which case Section 363 would be implicated. *Id.* at 350. Such a determination, the court observed, would "afford due process protections to parties in interest in the disposition of the estate but who did not themselves enter into the settlement agreement." *Id* at 351.

Other circuits do not draw such a bright line as the Third Circuit and apply Section 363 to settlement proceedings only in certain circumstances. The Ninth Circuit, for example, gives bankruptcy court's the discretion to determine whether to treat a settlement as a sale. In *Mickey Thompson Entertainment Group, Inc.,* the Ninth Circuit BAP held that "a bankruptcy court is obligated to consider, as part of the `fair and equitable' analysis, whether any property of the estate that would be disposed of in connection with the settlement might draw a higher price through a competitive process and be the proper subject of a section 363 sale." 292 BR 415, 421-22 (BAP 9th Cir 2003). There, a Ch. 7 Trustee sought to approve the compromise of a fraudulent transfer claim against third parties for $40,000.00. A creditor opposed the compromise and a third party offered to purchase the claims for $45,000.00, an amount higher than the settlement offer, and even provided the Trustee a cashier's check in that amount. Nevertheless, the trustee sought approval of the $40,000.00 settlement amount "because at the time he entered the [settlement], he believed it was in the estate's best interest" *Id.* at 419. The bankruptcy court approved the settlement. An appeal ensued.

The BAP reversed the bankruptcy court's decision, finding that the bankruptcy court should have considered Section 363 procedures designed to maximize value to the estate when evaluating whether to approve the settlement motion. "Although the bankruptcy court has 'great latitude' in authorizing a compromise, it may only approve a proposal that is 'fair and equitable' to the creditors. The settlement should be in the best interest of the estate . . . and reasonable, given the particular circumstances of the case." *Id.* at 420 (internal citations omitted). The BAP went on to say that, in this particular case, the "settlement is in reality a purchase by the [s]ettling [p]arties of a chose in action of the estate and for which another entity has offered a higher price in circumstances that invite a competitive auction that could yield a considerably higher price." *Id.* at 421. Then referencing the Third Circuit's *Martin* decision, the court said: "the disposition by way of 'compromise' of a claim that is an asset of the estate is the equivalent of a sale of the intangible property represented by the claim, which transaction simultaneously implicates the 'sale' provisions under section 363 as implicated by Rule 6004 and the 'compromise' procedure of Rule 9019(a)." *Id.*. Consequently, the settlement implicated the "sale" provisions under section 363 as well as the "compromise" procedures of Bankruptcy Rule 9019.

The Ninth Circuit in *In re Berkeley Delaware Court, LLC* recently agreed with the BAP's *Mickey Thompson* decision, holding that "a bankruptcy court has the discretion to apply the § 363 procedures to a sale of claims pursuant to a settlement approved under Rule 9019." 834 F.3d 1036 (9th Cir. 2016). The compromising of an estate's claim is "in essence the sale of that claim to the defendant." *Id*. "We see no good reason why a trustee and the bankruptcy court cannot utilize the procedures of § 363 in *certain* settlements in order to ensure maximum value for the estate." *Id*. (emphasis added). Further, the Ninth Circuit BAP recently stated that a court may *require an auction* when a 9019 settlement is viewed "solely as a settlement of a claim." *In re Esterlina Vineyards & Winery, LLC*, 2018 WL 1254331, at *4 (B.A.P. 9th Cir. Mar. 13, 2018).

At the opposite end of the spectrum is the First Circuit, which does not treat settlements as sales. In *In re Healthco International, Inc.,* 136 F.3d 45, 49 (1st Cir 1998), the trustee proposed to settle fraudulent transfer and tort claims whereby the estate would release its claims against a third party in exchange for a cash payment and mutual release. The bankruptcy court approved the settlement, reviewing only Bankruptcy Rule 9019. Certain parties appealed the bankruptcy court's conclusion that the settlement was negotiated in "good faith." The district court found the "good faith" test immaterial under Bankruptcy Rule 9019. An appeal to the First Circuit ensued.

The trustee argued that the appeal should be mooted by § 363(m) since the settlement was the "functional equivalent" of a sale of estate property. *Id.* at 49. The First Circuit disagreed, characterizing the trustee's contention as "fraught with problems." "By its very nature a settlement resolves adversarial claims *prior* to their definitive determination by the court. In contrast, a 'sale' effects a [t]ransfer of ['the title …'] [to] property for [a] consideration." *Id*. In the

First Circuit's view, a settlement was a fundamentally different transaction from a sale of an asset. As a result of these differences, the court refused to apply Section 363 to the settlement approval process and instead will approve a compromise as long as it falls within a "range of reasonableness." *Id*. at 51.

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LIMITATIONS ON CREDIT BIDDING

A sale of estate property in bankruptcy is governed by 11 USC Section 363. A secured lender's rights to credit bid is generally preserved therein. Under 363(k), a lien holder "may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase of such property." Thus, a secured creditor has the right to credit bid at a sale of its collateral up to the value of its secured claim.

These credit bid rights were once called into question by the court in *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3rd Cir. 2010). There, the court looked at the interplay between the right to credit bid and plan confirmation. A bankruptcy court may confirm a plan under 1129(a) if all the classes of creditors accept the plan. If a creditor class rejects the plan, however, a bankruptcy court can still "cramdown" the plan pursuant to the provisions of 1129(b). In particular, a rejecting class can be crammed down if the court determines, among other things, that the treatment offered to the rejecting class is "fair and equitable." Section 1129(b)(2)(A) provides that a plan is fair and equitable to a secured creditor if: (i) the creditor retains its lien and receives deferred payments on their claim, with interest, equal to the value of the claim; (ii) in a sale, the secured creditor's interest attaches to the sale proceeds; or (iii) the lien holder realizes the "indubitable equivalent" of their claim, which the Third Circuit described as "the unquestionable value of a lender's secured interest in the collateral". *Philadelphia Newspapers* at 310. While a secured creditor's right to credit bid are expressly preserved for any sale under 1129(b)(2)(A)(ii), it is not expressly preserved under 1129(b)(2)(A)(iii).

The Court in *Philadelphia Newspapers* approved the debtor's request to cramdown a plan wherein the debtor sought to sell a secured creditor's collateral without allowing the secured creditor to credit bid. 599 F.3d at 301. The debtor argued that stripping the creditor bidder's right to credit bidding would allow the property to be sold for its true market value, and the proceeds would be the indubitable equivalent of the secured claim under 1129(b)(2)(A)(iii). *See Id*. at 301-302. The Court reasoned that the 1129(b)(2)(A)(1) prongs are not mutually exclusive, meaning the Debtor could choose which prong it wished to satisfy. *Id*. at 305, 308. The court reasoned that while prong (ii) may reflect a "special congressional concern" about the free and clear transfer of collateral that secures a loan, prong (iii) provides a flexible, alternative path for debtors to "craft an appropriate treatment of a secured creditor's claim" without the rigid requirements of prong (ii). *Id*. at 308, 310. Because the plain language of 1129(b)(2)(A)(iii) does not preserve the right to credit bid, a sale under that provision did not preserve a secured creditor's right to credit bid. *Id*. at 311. The decision sent shock waves around the lending community.

Two years later, the Supreme Court mollified those lender concerns in *RadLAX Gateway Hotel*, a case in which the debtor tried to cram down the secured creditor in a manner similar to *Philadelphia Newspaper*. 566 U.S. 639 (2012). The Court reasoned that prong (ii) specifically details the requirements for a cramdown sale and that those specific requirements govern over the more general language found in prong (iii). *Id.* at 646-647. Accordingly, the *RadLax* decision again made clear that a secured creditor's right to credit bid are preserved irrespective of what cramdown provisions the debtor sought to enforce.

While the *RadLAX* decision did put an end to the notion that a secured creditor does not have the right to credit bid during the confirmation process, the decision did not stop efforts by parties in interest to attempt to curtail those secured creditor rights in certain circumstances. Indeed, a secured creditor's right to credit bid is not absolute. *In re The Free Lance-Star Publishing Co. of Fredericksburg, VA,* 512 B.R. 798, 805 (Bankr. E.D. Vir. 2014). Under 363(k), a secured creditor's right to credit bid is preserved "unless the court for cause orders otherwise." Soon the debate over the right to credit bid moved to the definition of "cause." Courts have great discretion to determine what constitutes cause. *In re RML Development, Inc.*, 528 B.R. 150, 155 (Bankr. W.D. Tenn. 2014). A uniform standard over the definition, however, remains elusive.

The validity of the secured creditor's claim could impact the decision of whether cause exists. *In re CS Mining, LLC*, 574 B.R. 259, 283 (Bankr. D. Utah 2017). Per the express terms of 363(k), the right to credit bid is only provided for *allowed* claims. Thus, credit bid rights are not automatic when there is a bona fide dispute with regards to a secured creditor's lien. *Id.* at 283. Depending on the nature of the dispute concerning the secured claim, a court has several options: it could allow the right to credit bid in full, deny the right to credit bid outright, reduce the amount of the credit bid, or estimate the allowed claim for purposes of the credit bid. *See RML Development*, 528 B.R. at 156. When the credit bid is estimated, the secured creditor could ultimately be reimbursed for any amount it bids beyond its credit bid rights if the allowed secured claim is later determined to be greater than the estimate. *Id.* at 157.

Courts may also consider equitable factors in determining whether to limit a secured creditor's right to credit bid. For example, a credit bid could be limited if there is a perceived "closeness" between the creditor and the debtor. A Utah court, for example, stated that "cause" may exist if allowing a lien holder to credit bid at a sale would benefit an insider, impede or delay a successful reorganization strategy, chill the bidding process, and reduce the overall benefits to the estate. *CS Mining*, 574 B.R. at 285. In that case, the creditors seeking the right to credit bid would stand to gain personally from any sale and had close ties to the debtor beyond that of a secured creditor. The potential insider bids would have likely resulted in several objections which would have ultimately delayed the sales process and hampered the reorganization efforts of the debtor. *Id*. Denying the creditor's right to credit bid, reasoned the court, was in the best interests of the estate. *Id*.

Other courts have looked at whether the party seeking to credit bid has complied with the court's sale procedures. *In re Aeropostale, Inc.*, 555 B.R. 369, 415 (Bankr. S.D.N.Y. 2016) (citing *Greenblatt v. Steinberg*, 339 B.R. 458, 463 (N.D. Ill. 2006) (party not allowed to credit bid because it failed to meet a condition of the sales procedure order)); *see also CS Mining*, 574 B.R. at 284 (approving bid procedures without right to credit bid).

The potential chilling effect of a credit bid may also be a factor in determining cause, particularly when an overly zealous creditor's conduct dampens an open and robust sales process. In *In re Fisker Automotive Holdings, Inc.*, 510 B.R. 55, 57 (Bankr. D. Del. 2014), the debtor owed a $168 million secured claim to the Department of Energy. A rival entity purchased the secured claim for $25 million. The bankruptcy court limited the credit bid to the $25 million purchase amount, reasoning that allowing the full credit bid would ensure that nobody else bid on the property. *Id*. at 59-60. The sale process would be "frozen," not just "chilled." *Id*. at 60. Other equitable factors beyond the chill on bidding persuaded the court to limit the amount of the credit bid. The case and sale were rushed at the creditor's behest. *Id*. at 60-61. The case was filed Thanksgiving week with a sale set for January 3, an unnecessarily tight schedule since the debtor was not operating. *Id*. at 60. This rushed process and timing clearly affected the bidding process and were inconsistent with "the notions of fairness in the bankruptcy process." *Id*. at 60-61. Further, capping the creditor's credit bid rights was appropriate because, while it was clear that the creditor had a secured claim, it was unclear to what extent their claim was truly secured. *Id*. at 61.

In *Free Lance-Star Publishing,* a creditor acquired a debt prior to the petition in a loan-to-own strategy. 512 B.R. at 806. When the creditor realized its lien did not attach to all of the debtor's assets, it knowingly sought to perfect its lien on assets not previously encumbered. *Id*. at 802. The creditor then asserted these lien rights during cash collateral hearings despite knowledge that said rights were not as extensive as argued. *Id*. at 806. The creditor also sought to frustrate the bidding process by forcing the debtor to shorten the time to market the property and required publication of its credit bid rights on sale advertisements. *Id*. at 803. The creditor's conduct led the court to conclude that the actions were designed to chill the sales process and lead to one result - allowing creditor to obtain the collateral with a low credit bid. *Id*. at 806. The court found that such egregious, inequitable conduct justified a finding of cause to limit, but not eliminate, the creditor's credit bid amount. *Id*. at 808.

<u>Other Recent Credit Bid Cases</u>

- *In re Tempnology, LLC,* 542 B.R. 50 (Bankr. D. N.H. 2015)
  - No cause. No evidence of inequitable conduct and did not think lender's claim was subject to a bona fide dispute. 3rd party could also not make showing that debt should be treated like equity instead of debt.

- *SEC v. Capital Cove Bancorp LLC,* 2015 WL 9701154 (C.D. Cal. Oct. 13, 2015)
  - Cause found. SEC had a prima facie case of security fraud and there was evidence of a Ponzi scheme. Allowing creditor to credit bid would harm many of the unsecured and junior creditors who awaited recovery, and there was a bona fide dispute to extent of creditor's liens.

- *In re RML Development,* 528 B.R. 150 (Bankr. W.D. Tenn, 2014)

- Creditor's claim was objected to and therefore not deemed allowed. Since the objection did not seek full allowance of claim, court estimated claim for credit bidding purposes / modified bidding rights down under 363(k).

- *In re Charles Street African Methodist Episcopal Church of Boston*, 510 B.R. 453 (Bankr. D. Mass 2014)
  - The existence of counterclaims against lender were not cause to deny or modify credit bid rights because there was no bona fide dispute to the underlying claims of lender.