

# **HOW FAR WILL GOOD FAITH GET YOU IN THE NINTH CIRCUIT AFTER CLEAR CHANNEL?**

**By  
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## INTRODUCTION

This article discusses three situations which can affect sales of assets free and clear of any interest under Section 363(f) of the Bankruptcy Code and the protection provided to a purchaser of assets under Section 363(m) of the Bankruptcy Code. Set forth below are discussions of (1) a recent decision by the Ninth Circuit Bankruptcy Appellate Panel (“BAP”), which creates significant risk for certain purchasers of assets by its interpretation of Section 363(m) mootness doctrine as applied to lien stripping under Section 363(f), (2) court decisions involving challenges with respect to good faith findings under Section 363(f), and (3) court decisions involving successor liability with respect to sales under Section 363.

## DISCUSSION

Section 363(f) provides for the sale of assets “free and clear of any interest in such property”, if certain conditions are met. Specifically, Section 363(f) provides:

(f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if-

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- (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).

Section 363(m) provides that the reversal or modification on appeal of an authorization of the sale or lease of property does not affect the validity of that sale or lease under such authorization to an entity that purchased the property in good faith.

(m) The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

11 U.S.C. § 363(m).

## 1. The Clear Channel Case and Mootness.

A recent decision by the BAP, Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC), 391 B.R. 25 (9th Cir. BAP 2008) (“Clear Channel”), creates significant risk for certain purchasers of assets in Section 363 bankruptcy sales by its interpretation of Section 363(m) mootness doctrine as applied to lien stripping. In Clear Channel, the debtor owed more than \$40 million to a senior secured lender and approximately \$2.5 million to a junior secured lender (Clear Channel). The debtor filed a Chapter 11 bankruptcy petition, and a Chapter 11 trustee was appointed. The Chapter 11 trustee proposed to sell the debtor’s assets free and clear of liens pursuant to Section 363(f)(3) and (f)(5). Ultimately, the Chapter 11 trustee entered into an agreement for the senior lender to serve as a stalking horse bidder and, absent qualified overbidders, for the senior lender to purchase the property for \$41,434,465. Over the objection of the junior lender, the bankruptcy court approved the sale to the senior lender free and clear of the junior lender’s liens, pursuant to Section 363(f)(5). The bankruptcy court further specifically found that the senior lender was a good-faith purchaser under Section 363(m). The junior lender was not successful in obtaining a stay pending appeal from either the bankruptcy court or the appellate court, and the senior lender closed on the sale with no recovery to the junior lender.

The BAP reversed, concluding that while the review of the sale of assets to the senior lender was ultimately moot, the lien stripping issue was neither equitably nor statutorily moot. The BAP then examined statutory mootness under Section 363(m) and held that Section 363(m) does not apply to Section 363(f) lien-stripping for several reasons. First, the plain language of Section 363(m), the court noted, applies only to an “authorization under subsection (b) or (c)” of Section 363, not subsection (f) to sell free of an entity’s lien. Second, Section 363(m) limits the ability to “affect the validity of a sale or lease under such authorization.” The court continued that “Congress intended that § 363(m) address only changes of title or other essential attributes of a sale, together with the changes of authorized possession that occur with leases. The terms of those sales, including the ‘free and clear’ term at issue here, are not protected.” Congress, according to the court, did not broaden the protection of Section 363(m) to include lien-stripping. See Richard J. Corbi, 18 Norton Journal of Bankruptcy Law and Practice Art. 8, Section 363(f) “Free and Clear” Sales May Not Survive Appeal (January 2009).

Finally, the BAP looked to the absence of “words specific to the task” in Section 363(m) in comparison to those present in Section 364(e), another provision of the Bankruptcy Code that renders certain appeals statutorily moot, in concluding that Congress intended to limit the protections of Section 363(m). Essentially, the BAP reasoned that because Congress specified that reversal or modification of an authorization to obtain “credit,” incur “debt,” or grant a “priority” or a “lien” pursuant to Section 364 would not affect the validity of any debt so incurred, or any priority or lien so granted, the absence of “these types of words... from § 363(m) underscores congressional intent not to insulate and immunize lien-stripping actions from appellate review.” See Dennis J. Connolly and Sage M. Sigler, Section 363 Revisited: The Limitations on “Free and Clear” Sales, 2008 No. 11 Norton Bankr. L. Adviser 2 (November 2008).

Turning to the merits, the BAP determined that the bankruptcy court had erred in finding that the junior lender’s liens could be stripped pursuant to Section 363(f)(5). The BAP remanded the case to the bankruptcy court to provide the parties the opportunity to argue whether there is

some other type of proceeding under which the junior lienholder could be compelled to release its liens.

The Clear Channel decision has already been criticized by many commentators. The decision is at odds with what many practitioners take for granted, and if not remedied on remand (or on further appeal), it could potentially elevate the rights of junior lienholders vis-à-vis senior lienholders, not only in credit bid situations, but also in cash-purchase situations. See Joel H. Levitin, 27 Am. Bankr. Inst. J. 1, Ninth Circuit BAP Dresses Down Lienstripping - Could This Be the Last Dance for 363 Sales? (October 2008). The BAP's analysis of the protections of Section 363(m) will likely have the effect of decreasing the number of Section 363 sales conducted in the Ninth Circuit. First, the bankruptcy sale process would cost more money with all the subsequent appeals as opposed to a state court foreclosure suit, therefore defeating the purpose of Section 363 sales in Chapter 11 proceedings. It will also force other alternatives and may scare potential buyers away from a bankruptcy sale. Second, it may chill credit bidding by senior secured creditors. Third, senior secured creditors might be more inclined to file more motions to lift the automatic stay under Section 362 in order to foreclose on their collateral in state court out of fear that a sale might not be a "final" sale in the bankruptcy court. Richard J. Corbi, 18 Norton Journal of Bankruptcy Law and Practice Art. 8, Section 363(f) "Free and Clear" Sales May Not Survive Appeal (January 2009).

Moreover, the BAP's analysis of the protections of Section 363(m) is extremely narrow. There is a good argument that the language of Section 363(m) is broader than the BAP interpreted it. Section 363(m) says that "reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization[.]" While authorization of a sale under Section 363(c) comes directly from the statute, Section 363(b) provides no authorization on its own, but instead allows a court to authorize a sale by court order. The argument then is that Section 363(m) protects the validity of a sale "under the court's order" and that a sale under a court's Section 363(b) order cannot be reversed or modified when Section 363(m) applies. In other words, the "sale" and the "terms of the sale" pursuant to the court's Section 363(b) order cannot be treated separately on appeal because Section 363(m) protects the validity of a sale pursuant to the terms of the court's Section 363(b) order authorizing such sale. See Section 363 Revisited: The Limitations on "Free and Clear" Sales, 2008 No. 11 Norton Bankr. L. Adviser 2 (November 2008).

Numerous courts before Clear Channel, including the Ninth Circuit, have mooted appeals attacking Section 363(f) relief under Section 363(m) without hesitation. See In re Robert L. Helms Const. & Dev. Co., Inc., 110 F.3d 1470, 1475 (9th Cir. 1997), vacated as to one of the consolidated appeals on other grounds; In re Colarusso, 382 F.3d 51, 61-62 (1st Cir. 2004) ("Helms I"). In Helms I, Southmark Corporation ("Southmark") sold a ranch to Double Diamond Ranch Limited Partnership ("Diamond Ranch") subject to Southmark's option to repurchase. Southmark filed for Chapter 11. Southmark, in its Chapter 11 case, confirmed a Chapter 11 plan of reorganization that provided for the rejection of all executory contracts not previously assumed. The option to repurchase the ranch was not expressly assumed. Thereafter, Diamond Ranch filed its own Chapter 11 case and sought to sell the ranch to South Meadows Properties Limited Partnership ("South Meadows"), free of Southmark's option. Southmark objected to the sale. The bankruptcy court determined that Southmark's option was an executory

contract that was rejected under Southmark's Chapter 11 plan. The court granted a motion to amend the sale order to provide that the sale of the ranch was free and clear of Southmark's option pursuant to Section 363(f)(4).

There were two related appeals before the Ninth Circuit panel in Helms I. The first appeal by Southmark was whether its option was an executory contract under Section 365, and the second appeal by South Meadows directly raised the issue of whether the sale order it obtained under Section 363(f)(4) was entitled to the protections of Section 363(m). In connection with the second appeal, South Meadows argued that Section 363(m) protected the validity of its sale as a good-faith purchaser, including delivery of the ranch free and clear of the option pursuant to Section 363(f)(4). See Reply Brief of Appellant, South Meadows Properties Limited Partnership v. Southmark Corp., 1995 WL 17847679 at \*2 (9th Cir. Dec. 26, 1995). The Ninth Circuit in Helms I agreed, ruling that the Section 363(f) portion of the sale order "was not affected by these proceedings, and therefore [the] appeal is moot." 11 U.S.C. § 363(m)." In re Robert L. Helms Const. & Dev. Co., Inc., 110 F.3d at 1475 (citation omitted).

On appeal, the Ninth Circuit vacated the Helms I opinion in an en banc decision based only on the issue of whether the option was executory. With respect to the Section 363(f) appeal, the court noted as follows:

The second [appeal], between South Meadows and Southmark, addressed whether, regardless of the ultimate validity of the option, the sale was free and clear under 11 U.S.C. § 363(f) and could not now be modified due to 11 U.S.C. § 363(m). The panel held the sale was free and clear of the option, and that case is now final. See Unsecured Creditors Comm. v. Southmark (In re Helms Constr. & Dev. Co.), 110 F.3d 1470, 1475 (9th Cir. 1997).

In re Robert L. Helms Const. & Development Co., Inc., 139 F.3d 702, 704 n.2 (9th Cir. 1998) ("Helms II").

Thus, it appears that the Ninth Circuit in Helms I addressed and decided the very issue considered by Clear Channel. The BAP in Clear Channel did not address or cite Helms I or Helms II. See Shirley S. Cho & Bennett L. Spiegel, Clear Channel Muddies the Waters of §363(m) Mootness Protection, 26 No. 2 Bankruptcy Strategist 1 (December 2008)

Other courts have also mooted appeals attacking Section 363(f) relief under Section 363(m) without hesitation. See, e.g., In re Wintz Companies, 230 B.R. 840, 844-45 (B.A.P. 8th Cir. 1999); International Union, et al. v. Morse Tool, Inc., 85 B.R. 666, 668 (D. Mass. 1988); In re Lake Placid Co., 78 B.R. 131, 135 n.1 (W.D. Va. 1987); In re Whatley, 169 B.R. 698, 701 (D. Colo. 1994).

As various commentators have suggested, Section 363(m) encompasses Section 363(f) through Section 363(b). Section 363(f) is a subcategory of sales under Section 363(b) and by its plain terms incorporates subsection (b). At least three courts whose decisions are not referenced in Clear Channel, agree: "Because Section 363(f) simply refers to the trustee's authority under [Section] 363(b), this court holds that Section 363(m) applies to appeals from orders authorized under Section 363(f)." In re Wieboldt Stores, Inc., 92 B.R. 309, 311 n.1 (N.D. Ill. 1988). See

also Morse Tool, Inc., 85 B.R. at 668; In re Lake Placid Co., 78 B.R. at 135 n.1; Shirley S. Cho & Bennett L. Spiegel, Clear Channel Muddies the Waters of §363(m) Mootness Protection, 26 No. 2 Bankruptcy Strategist 1 (December 2008).

## 2. Challenges to Good Faith Findings.

Section 363(m) provides that the reversal or modification on appeal of an authorization of the sale or lease of property does not affect the validity of that sale or lease under such authorization *to an entity that purchased the property in good faith*. The policy behind Section 363(m) is to promote finality in judgments and encourage the obtaining of maximum value of assets notwithstanding the risks associated with bankruptcy sales. In re Sax, 796 F.2d 994, 998 (7th Cir.1986); In re Cable One CATV, 169 B.R. 488, 492 (Bankr. D.N.H. 1994). However, there must be an actual finding of good faith in order for Section 363(m) to apply. A finding of “good faith” is not an essential element for approval of a sale under Section 363(b). Hence, unless and until “good faith” has been determined, the appeal is not moot under Section 363(m). In re Thomas, 287 B.R. 782, 785 (9th Cir. BAP 2002).

If the objecting party fails to obtain a stay pending appeal, the objecting party may still appeal whether the bankruptcy court correctly determined that the purchaser qualified as “an entity that purchased ... in good faith.” See, e.g., In re Thomas, 154 Fed. Appx. 673, 674 (9th Cir. 2005) (“[Debtor] did not obtain a stay pending appeal of the bankruptcy court order authorizing Chapter 7 trustee [] to sell [debtor’s] real property to [purchaser]. Consequently, [debtor’s] only avenue for unwinding the sale under Section 363(m) is to establish that [purchaser] is not a good-faith purchaser.”); In re R.B.B., Inc., 211 F.3d 475, 476 (9th Cir. 2000) (holding purchaser was not a good faith purchaser, hence Section 363(m) does not protect the sale from attack.); In re Schugg, 2006 WL 1455568, \*4 (D.Ariz. 2006) (reversing sale order where district court determined “that the bankruptcy court’s finding that the [purchaser] was a purchaser in good faith is clearly erroneous.”); In re Colarusso, 382 F.3d 51, 62 fn. 10 (1st Cir. 2004) (“We observe that a stay is not required to challenge a sale on the ground that § 363(m) does not apply because the purchaser did not act in good faith.”); In re Sax, 796 F.2d 994, 997 n.4 (7th Cir. 1986) (“As indicated in § 363(m), a stay is not required to challenge a sale on the grounds that an entity did not purchase in good faith”).

However, in order to appeal a good faith determination under Section 363(m), such challenge must have been made at the bankruptcy court level, and cannot be raised for the first time on appeal. In re The Ginther Trusts, 238 F.3d 686, 688-89 (5th Cir.2001) (challenge to whether the purchaser was a “good-faith” purchaser may not be raised for the first time on appeal); In Matter of The Watch Ltd., 257 Fed. Appx. 748, 750 (5th Cir. 2007) (“Although this court has indicated a challenge to whether the purchaser was a “good-faith” purchaser is not made moot by a subsequent sale, it is well established such a challenge may not be raised for the first time on appeal to the district court.”); In re Rare Earth Minerals, 445 F.3d 359, 364-365 (4th Cir. 2006) (Court of Appeals would not disturb bankruptcy court’s determination that purchaser who acquired Chapter 11 debtor’s oil and gas lease did so in good faith, based upon argument that lessor belatedly sought to raise for first time on appeal).

A determination of good faith under Section 363(m) is generally a factual finding and is thus reviewed on appeal for clear error. Hower v. Molding Systems Engineering Corp., 445 F.3d

935, 938 (7th Cir. 2006) (“Good faith is a factual finding and reviewed for clear error.”); In re Thomas, 154 Fed. At 674-675 (“We agree with the BAP that the bankruptcy court’s finding that [purchaser] was a good-faith purchaser is not clearly erroneous.”); In re Thomas, 287 B.R. at 785 (“‘Good faith’ is a factual determination to be reviewed for clear error”). But see In re Made in Detroit, Inc., 414 F.3d 576, 580 (6th Cir. 2005) (“The bankruptcy court’s conclusion that [purchaser] was a good-faith purchaser is a mixed question of law and fact.”)

The proponent of the good faith under Section 363(m) has the burden of proof, and thus it is error to presume good faith solely from a lack of evidence in the record to the contrary. In re M Capital Corp., 290 B.R. 743, 747-748 (9th Cir. BAP 2003).

The appellate court has the discretion to decide the appellate challenge to the Section 363(m) determination in the context of the appellee’s motion to dismiss as moot, rather than a full appellate review. See In re Second Grand Traverse School, 100 Fed. Appx. 430, 433 (6th Cir. 2004) (“Appellants argued that the issue of good faith ‘is a primary issue in this appeal, not yet ripe for determination by the Court without a full review of the record and briefing by the parties.’ \*\*\* It was not error for the district court to consider the issue of good faith in the context of a motion to dismiss under § 363(m): courts routinely consider the issue of good faith when determining whether § 363(m) applies.”); In re Tempo Tech. Corp., 202 B.R. 363, 367 (D. Del. 1996) (“Thus, where the good faith of the purchaser is at issue, the district court is required to review the bankruptcy court’s finding of good faith before dismissing any subsequent appeal as moot under section 363(m).”).

### 3. Successor Liability.

Prior to Clear Channel, Section 363 sales had been gaining such popularity where the bulk of filings seemed to involve all asset sales pursuant to Section 363(f). Along with mootness, another principal reason for Section 363’s recent popularity is the ability of a purchaser to obtain substantially all of the assets of a going concern “free and clear of any interests in such property.” While it is generally the case that a buyer in a Section 363 sale will not be liable to the debtor’s creditors, it is less clear whether the buyer can be held liable to certain creditors under the theory of successor liability pursuant to state law or “federal common law.” The situation is no less murky when the Bankruptcy Court overseeing and approving the sale makes a finding of no successor liability. Accordingly, it is the objective of every Section 363 buyer to do what it can to cut off, to the greatest extent possible, successor liability.

Many jurisdictions, including California, follow essentially the same test for successor liability. The general rule is that a corporation purchasing the principal *assets* of another corporation does *not* assume the seller’s liability *unless* certain conditions are present. As stated by the California Supreme Court in Ray v. Alad Corp., 19 Cal.3d 22 (1977):

As typically formulated the rule states that the purchaser does not assume the seller’s liabilities unless (1) there is an express or implied agreement of assumption, (2) the transaction amounts to a consolidation or merger of the two corporations, (3) the purchasing corporation is a mere continuation of the seller, or (4) the transfer of assets to the purchaser is for the fraudulent purpose of escaping liability for the seller's debts.

Id. at 28 (emphasis added).<sup>1</sup>

To the extent there is such a thing as “Federal common law,” it also adopts the same basic exceptions. U.S. v. Iron Mountain Mines, Inc., 987 F. Supp. 1233, 1238-1239 (E.D.Cal. 1997). See also Atchison, Topeka and Santa Fe Ry. Co. v. Brown & Bryant, Inc., 159 F.3d 358, 362 (9th Cir. 1997) (“the ‘federal common law’ rules for successor liability under CERCLA in this circuit mirror the traditional successor liability rules of most states, including California”).

The Bankruptcy Code does not define “any interest” for the purposes of Section 363(f). Folger Adam Security, Inc. v. DeMatteis/MacGregor, JV, 209 F.3d 252, 258 (3d Cir. 2000); Precision Industries, Inc. v. Qualitech Steel SBO, LLC, 327 F.3d 537, 545 (7th Cir. 2003). There is a split of authority as to whether successor liability claims constitute an “interest in such property” and thus whether Section 363(f) permits a sale of the debtor’s assets free and clear of successor liability claims.

The trend in decisions is that term “any interest in such property” should be broadly interpreted and not limited to “in rem” interest in property. See In re Leckie Smokeless Coal Co., 99 F.3d 573, 582 (4th Cir.1996); In re Trans World Airlines, Inc., 322 F.3d 283, 290 (3d Cir. 2003); In re Beker Indus. Corp., 63 B.R. 474, 478 (Bankr. S.D.N.Y. 1986); In re Manning, 37 B.R. 755, 759 (Bankr.D.Colo.1984), aff’d in part, vacated in part, 831 F.2d 205 (10th Cir.1987); In re WBQ Partnership, 189 B.R. 97, 105 (Bankr. E.D.Va. 1995).

A minority of courts have narrowly interpreted “any interest in such property” to mean *in rem* interests in property, such as liens. Under this view, successor liability claims are not “in rem” interests in property and thus Section 363(f) does not allow sales free and clear of state law successor liability claims. In dicta, the Seventh Circuit stated that Section 363(f) refers only to liens. See Zerand-Bernal, Inc. v. Cox, 23 F.3d 159, 163 (7th Cir.1994); In re Fairchild Aircraft Corp., 184 B.R. 910, 917-918 (Bankr. W.D. Tex. 1995) vacated on other grounds, 220 B.R. 909 (Bankr. W.D. Tex. 1998).

## CONCLUSION

If Clear Channel survives, there now are various situations in the Ninth Circuit in which a sale under Section 363 may not be afforded the protections provided by Section 363(f) and (m). Accordingly, practitioners and other parties should pay close attention to the intricacies provided by case law with respect to the application of Section 363(f) and (m) when property of the estate is being proposed to be sold pursuant Section 363.

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<sup>1</sup> A fifth exception to the general rule of successor nonliability was created by the California Supreme Court in Ray v. Alad, 19 Cal. 3d 22 (1977), and has become known as the “product line successor” rule because, in certain limited situations, a person injured by the predecessor’s product is given a remedy against the successor corporation.