

INTERNATIONAL

# Restructuring NewsWire

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## Special Treatment for Broker-Dealer Customers in the United States

*By David M. LeMay and Christy Rivera*

The collapse of Lehman Brothers has illustrated the special treatment provided to customers, as opposed to “mere” creditors, of a broker-dealer debtor in bankruptcy. The US bankruptcy system has protections built into it which allow customers to get back most, if not all, of their assets, assuming the broker-dealer has complied with specified regulations. In addition, this recovery, for certain customers, will happen in relatively quick fashion, allowing them to extricate themselves from the bankruptcy proceedings. General creditors will look on with envy as they continue to participate in the bankruptcy case until its conclusion to see any recovery on their claims.

Customers of Lehman Brothers Inc. (“LBI”), the US broker-dealer being liquidated in New York, saw their trading accounts transferred to Barclays within the first few weeks of the LBI insolvency proceeding and now, in most instances, have access to all of their assets in their new accounts at Barclays. For creditors and other entities which are not clearly “customers” or which have trading accounts which were not purchased by Barclays, however, the amount and timing of recovery of their claims remains uncertain.

Set forth below is a short overview of the protections which create this “special” treatment provided to customers in the US.

### US Liquidation of Broker-Dealers

The US has developed a particular framework for dealing with broker-dealer liquidations. Securities Exchange Act Rule 15c3-3 (the so-called Customer Protection Rule or “CPR”)

imposes requirements intended to protect customers in the event of their broker’s failure. The CPR requires a broker at all times to have physical possession or control of all of its customers’ fully paid and “excess margin” securities (securities whose market value plus the cash in an account exceeds 140% of a customer’s margin loan balance). The CPR also requires each broker to maintain a special reserve bank account for the exclusive benefit of its customers in an amount equal to the net amount of funds it owes its customers (as determined in accordance with a formula). In addition, the CPR limits a broker’s ability to pledge its customer’s fully paid securities or to use them in the broker’s proprietary businesses, and also limits the amount of a cus- / continued page 2

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## Special Treatment

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customer's securities that a broker can pledge to a third party to collateralize the customer's margin loans owed to the broker.

The CPR should provide a significant measure of protection to the customers of a failed broker. Nevertheless, the fact that the CPR obligates brokers to maintain possession only of "excess" margin securities means that they need not possess securities comprising 40% of margin loan amounts, which gives rise to possible shortfalls. Shortfalls also may result from the insolvent broker's failure to comply with the CPR. Thus, it probably is inevitable that the CPR alone will not fully protect the customers of a failed broker.

In addition, customers must also understand that even to the extent their assets are protected under the CPR, such protection does not ensure that customers will be able to retrieve these assets from a failed broker-dealer immediately. Under either Chapter 7 or a Securities Investor Protection Act ("SIPA") liquidation (as discussed below), there will be some delay during which those assets will be unavailable to customers (and

SIPC Trustee was able to obtain the needed court approvals and to transfer substantially all of LBI's non-prime brokerage customer accounts to Barclays shortly after his appointment, so that customers could resume normal access and trading after a short delay. He was able to accomplish this result because LBI had been in compliance with the Customer Protection Rule, making an immediate bulk transfer of most non-prime brokerage customer accounts and positions possible. The SIPC Trustee is now in the process of reconciling and releasing LBI's US prime brokerage account assets.

A failed broker may be liquidated either pursuant to Chapter 7 (Chapter 11 is unavailable) under the US Bankruptcy Code or a procedure administered by SIPC under SIPA. The primary difference is that under the Chapter 7 approach, all account assets are sold and the customers receive cash, whereas under the SIPC approach the trustee distributes securities to the maximum extent possible.

There are three classes of property to be dealt with under each procedure: (1) customer securities that are held by the broker and are in the name of the customer; (2) customer secu-

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against which customers may be unable to hedge their market exposure). Customer name securities and other customer accounts could be transferred to another healthy broker-dealer quickly, giving customers quick access to these assets at the new broker-dealer, and the Securities Investor Protection Corporation ("SIPC") always makes such transfers its first priority in any failure, including by using its regulatory weight to arrange the immediate transfer of a failed broker's accounts to a healthy one. However, for those accounts not transferred, customers will have to wait while a court-appointed trustee liquidates and distributes the assets' proceeds.

As an example of this process, in the recent failure of LBI, the

rities that are held in street name and cash held in customer accounts; and (3) all other property of the broker. These are subject to the following treatment:

- Under both Chapter 7 and SIPC, type (1) assets are distributable to the customer, subject to prior satisfaction of any amounts owed by the customer to the broker;
- In a Chapter 7, type (2) assets are sold and the proceeds are distributed to the customers pro rata in accordance with their respective net account balances. Customers are treated as general creditors of the estate with respect to any shortfall.

- ⊙ In a SIPC procedure, type (2) assets are divided among the customers in accordance with their respective entitlements thereto. SIPC will satisfy any shortfalls, subject to a maximum of \$500,000 per customer (including a maximum of \$100,000 in cash held in the customer's account). Customers are treated as general creditors with respect to any remaining shortfall. SIPC insurance does not protect against market price fluctuations during the period before the customer receives its distribution.

to non-debtor counterparties. While the Bankruptcy Code applies to several types of derivative contracts, for simplicity, the focus here is on swap agreements.

### Review of Safe Harbor Provisions

Swap agreements typically allow for termination of the agreement if certain events of default occur. A bankruptcy filing by one of the counterparties is usually such an event of default. When a party files for bankruptcy protection, the bankruptcy

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- ⊙ Under both Chapter 7 and SIPC, type (3) assets are used to satisfy any remaining unsecured claims (including remaining customer claims).

While these protections do not guarantee customers a full recovery on an immediate basis, they still place broker-dealer customers in a far better position than general creditors. ⊙

## Counterparties' Rights Under Derivative Contracts with a Debtor

By Ted Zink and Bonnie Dye

The Lehman Brothers bankruptcy cases have highlighted relatively new provisions in the Bankruptcy Code granting parties to derivative contracts (such as swap agreements) certain protections upon the bankruptcy filing of their counterparty. As disruptions in the financial markets continue, it is useful to review the Bankruptcy Code protections and options available

filing gives rise to an automatic stay, prohibiting most counterparties from enforcing their rights under a contract entered into with the debtor prior to the bankruptcy filing.

Counterparties to swap agreements, however, are granted certain reprieves from the automatic stay. These exceptions, referred to as the "safe harbor provisions" in the Bankruptcy Code, facilitate risk management, movement of capital, and market certainty.

Section 560 of the Bankruptcy Code allows counterparties to exercise certain contractual rights in connection with a swap agreement without violating the automatic stay. Specifically, non-debtor counterparties may liquidate, terminate, or accelerate the swap agreement according to the contract's terms, so long as such action is triggered by the bankruptcy filing of the debtor counterparty. These contract clauses providing for contract termination upon a bankruptcy filing are referred to as *ipso facto* clauses and are generally unenforceable. The safe harbor provisions for derivative contracts, however, allow the termination, liquidation and acceleration of the contracts triggered upon the occurrence of the events set forth in such *ipso facto* clauses. Accordingly, if a swap agreement specifically states that the bankruptcy of a swap counterparty or swap guarantor is / continued page 4

## Counterparties' Rights

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an event of default that allows the non-debtor party to terminate, then section 560 allows the swap participant to terminate the agreement and “offset or net out any termination values or payment amounts arising under or in connection with termination” of a swap agreement.

While a swap counterparty's ability to terminate the swap is protected upon a bankruptcy filing, a swap participant should consider whether or not it makes business sense to terminate the swap agreement. Consideration should be given as to whether the termination will result in a termination fee payable to the debtor, i.e., whether the counterparty is “out of the money.” The choice to terminate may also be driven by the counterparty's belief as to where prices that affect the swap agreement will stand in the future. The swap participants should consider if it is “in the money” or not and how the swap participants expect the future to unfold.

order for the non-debtor counterparty to suspend payments otherwise owed to the debtor. This is so because the suspension of payments is not a termination, modification, or alteration of the swap agreement and the safe harbor provisions of the Bankruptcy Code would not shelter the non-debtor counterparty's election to suspend payments.

### Issues to Consider

Several issues may arise from the counterparty's decision to suspend payments owed under a swap, rather than terminating the agreement upon bankruptcy. Significantly, there is no binding case law involving suspension of payments upon a counterparty's bankruptcy and this approach may invite litigation. Another issue may arise if a counterparty who suspended payments later decides to terminate in order to avoid exposure to further market movement. The decision to suspend should be considered carefully as counterparty may be barred from terminating the swap later in the bankruptcy case if the market turns in its favor. In at least one case, a

**Section 560 of the Bankruptcy Code allows counterparties to exercise certain contractual rights in connection with a swap agreement without violating the automatic stay.**

### Suspending Payments In Lieu of Terminating

If the counterparty elects not to terminate the swap, it may seek to suspend payments owed to the debtor under the swap. In such instance, the counterparty may rely on a “flawed asset provision” or similar clause to forego making payments to the debtor. Swap agreements usually contain a flawed asset provision, which provides that each party's obligation to make payments under the swap agreement is conditioned upon the fact that no event of default has occurred. If an event of default occurs and is not cured, then the nondefaulting party is may refuse to continue making payments. For this purpose, however, the non-debtor counterparty cannot rely on ipso facto events of default. Rather, another default must occur in

debtor has argued that a counterparty's delay in seeking to terminate the swap should be deemed a waiver of such counterparty's right to terminate and that the counterparty's basis for termination was not truly due to the bankruptcy filing. Indeed, the legislative intent for the safe harbor provisions is to allow for the *expeditious* termination or netting of certain financial transactions. There is no specified time limit as to when the counterparty will be barred from terminating the swap agreement, but the longer the counterparty waits, the more likely the debtor could successfully argue that the counterparty terminated for other reasons arising outside of the debtor's bankruptcy filing. If the court finds that the counterparty terminated for such alternative reasons, the safe harbor

provision would not protect the counterparty and it could be held in violation of the automatic stay.

In light of the disruptions in the financial markets, many counterparties may have a knee-jerk reaction to automatically terminate derivative contracts upon a bankruptcy filing. For example, Lehman Brothers asserts that more than 733,000 of

### Ipsa Facto Clauses in Executory Contracts

It is well established that the “mere happenstance of bankruptcy” does not give the debtor greater rights and powers under a prepetition contract than it had outside of bankruptcy. It is also statutorily mandated, however, that contractual provisions that would terminate or modify a contract to which a

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its approximately 930,000 derivative contracts have been terminated. However, counterparties should first fully consider their options regarding swap agreements with debtor counterparties. There are both benefits and risks in delaying termination and instead suspending payments on a swap agreement, and considering each may lead to a preferred outcome for the counterparty. ©

## Notso Fasto: *Ipsa Facto* Clauses and the Automatic Stay

*By Gilbert Bradshaw*

Given current economic conditions, contracting parties may be concerned about the ramifications should their counterparties file for bankruptcy. This article briefly examines termination-on-bankruptcy provisions, which generally run afoul of the Bankruptcy Code, and contract termination provisions that may be enforceable notwithstanding a counterparty’s bankruptcy.

debtor is a party premised solely on the bankruptcy filing or the debtor’s financial condition (so called “*ipso facto*” clauses) are not enforceable

Section 365(e)(1) provides in relevant part that

an executory contract or unexpired lease of the debtor may not be terminated or modified... at any time after the commencement of the [bankruptcy] case solely because of a provision in such contract or lease that is conditioned on (A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under this title; or (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

Bankruptcy courts have generally strictly interpreted section 365(e)(1) and have held that it does not apply to contractual provisions that are not conditioned on any of the three circumstances listed in 365(e)(1). Accordingly, a provision that provides for the automatic termination or modification of a contract upon the occurrence of some other event may be enforceable.

### “Failure to Pay” Provisions

Courts have generally held that language in a contract providing for the automatic termination or mod- / *continued page 6*

## ***Ipsa Facto* Clauses**

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ification of the contract upon a party's failure to pay in accordance with the contract's terms is not an unenforceable *ipso facto* provision. In the seminal case of *In re Trigg*, 630 F.2d 1370 (10th Cir. 1980), the debtors leased oil and drilling rights from the Bureau of Land Management ("BLM") and the state of Wyoming. The leases provided that the lease would automatically terminate upon the debtors' failure to make certain timely payments. After filing for bankruptcy, the debtors

table and would violate the strong policy favoring the sanctity of contracts.

Subsequent cases have followed the *Trigg* rationale. For example, in *In re C.A.F. Bindery*, 199 B.R. 828 (Bankr. S.D.N.Y. 1996), the debtor was contractually entitled to a three-month rent concession if the debtor remained current on rent payments up through May 1996. In October 1995, the debtor filed for bankruptcy relief. The debtor failed to make the full rent payment through May 1996. Starting in June 1996, the debtor paid the reduced rent, as if the concession had been triggered.

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ceased making the lease payments. The lessors subsequently argued that the leases terminated automatically in accordance with their terms upon the debtors' default in payment and sought enforcement of the automatic termination provisions. The debtors argued that they should retain their rights under the leases because the termination clause was an unenforceable *ipso facto* provision under section 365(e) of the Bankruptcy Code.

The bankruptcy court in the *Trigg* case sided with the lessors and held that the leases automatically terminated when the debtors failed to timely make the payments due under the leases. Subsequently, the United States District Court for the District of New Mexico and the Court of Appeals for the Tenth Circuit affirmed the bankruptcy court's decision. The Tenth Circuit noted that "[t]he general equitable powers of the bankruptcy court cannot create for the debtors a right to property they have lost through an incurable default." In this instance, the debtors lost their rights under the leases because of their failure to pay in accordance with the terms of the leases. The Tenth Circuit further observed that to deprive the lessors of their rights and permit the debtors to retain the lease simply because the debtors filed for bankruptcy would not be equi-

The lessor filed a motion for an order compelling the debtor to pay the higher rent because the debtor did not make the timely payments and therefore was not entitled to the rent reduction. The debtor argued that the contract provision requiring him to pay the higher rent if he was not in default was an unenforceable *ipso facto* provision.

The court granted the property owner's motion and held that the broad construction of *ipso facto* clauses in section 365(e)(1) "does not relieve a debtor of every contract or lease default." Thus, because the debtor defaulted under the terms of the contract and the default was not based upon any of the conditions enumerated in section 365(e)(1), then the rent could automatically increase. A bankruptcy filing is not, with limited exceptions, a basis to vitiate valid contractual remedies that were negotiated between parties.

More recently, in *In re Margulis*, 323 B.R. 130 (Bankr. S.D.N.Y. 2005), the debtor was a party to a prepetition settlement agreement. Pursuant to the agreement, the debtor agreed to pay \$140,000 by May 25, 2004 to avoid paying \$790,000, which reflected the full amount of the disputed claim. The agreement further provided that if the debtor failed to make payment by the deadline, he would be responsible for the

immediate payment of \$790,000. Seven days before the payment was due, the debtor filed for bankruptcy relief. The non-debtor party to the agreement filed a proof of claim for the \$790,000 with the bankruptcy court. The debtor filed an objection to the proof of claim and asserted that that claim should be reduced to \$140,000.

According to the debtor, the provision that resulted in an automatic increase in the amount of the payment upon the debtor's failure to timely pay was an unenforceable *ipso facto* clause. The court disagreed and noted that the modification of the payment was not as a result of any of the circumstances enumerated in section 365(e)(1). The court further noted that while the bankruptcy may have made the higher claim more difficult to pay, it did not trigger the increase in the amount. Accordingly, the failure to pay provision was not an unenforceable *ipso facto* clause and the court allowed the non-debtor party's claim at the higher amount.

### Automatic Stay

Non-debtor parties need to be mindful of the automatic stay, however, where the contract is merely terminable, but not

debtor's postpetition contract breach constitutes sufficient cause to lift the automatic stay to enable the non-debtor party to enforce contractual rights, including the right to terminate the contract. Some courts have noted that a termination or modification may occur without need for relief from the automatic stay where the termination or modification was automatic, and did not require any affirmative actions or the exercise of discretion on the part of the non-debtor party. *In re J.E. Adams Indus.*, 269 B.R. 808, 814 (Bankr. D. Iowa 2001) ("The automatic stay applies to prevent the creditor from taking affirmative steps to forfeit or foreclose an interest or to collect a debt, but it does not normally impair the terms of contracts concerning expiration ... and thus it does not prevent automatic termination of the contract.").

### Conclusion

The expected wave of new bankruptcy cases will cause contracting parties to review contract provisions that enable them to sever the relationship upon the financial hardship of their counterparties. While parties may try to mitigate the risk of their counterparty's bankruptcy, they should be

**Non-debtor parties need to be mindful of the automatic stay, however, where the contract is merely terminable, but not automatically terminated, upon the debtor's non-payment of amounts due under the contract.**

automatically terminated, upon the debtor's non-payment of amounts due under the contract. In general, the automatic stay enjoins creditors from enforcing remedies against a debtor or its assets. Relief from the stay may be granted upon a showing of "cause." Although the Bankruptcy Code does not define "cause," courts have consistently held that the determination of whether "cause" exists to vacate the stay must be determined on a case-by-case basis. In the context of contracts, bankruptcy courts have generally concluded that a

aware that so-called *ipso facto* clauses providing for contract termination or modification upon the counterparty's deteriorating financial condition or bankruptcy will not be enforced in that party's bankruptcy case. Other provisions, however, including clauses providing for the automatic contract modification or termination upon a party's failure to pay, should be enforceable. Prudence suggests reviewing all such provisions with counsel before taking steps that might violate the automatic stay. ☺

# A Refresher on Substantive Consolidation

By Andrew Rosenblatt

Although there have not been any recent cases of note, the economic downturn and increase in bankruptcy filings have once again brought substantive consolidation issues to the forefront. Given the significant impact that substantive consolidation can have on a creditor's rights, it is worthwhile to review the basics of substantive consolidation and discuss ways for lenders and other creditors to mitigate substantive consolidation risk.

## The Nuts and Bolts of Substantive Consolidation

Substantive consolidation is the doctrine of federal bankruptcy law under which bankruptcy courts may, in the exercise of their general equitable powers under section 105(a) of the Bankruptcy Code, consolidate the assets and liabilities of separate and distinct (but related) legal entities and treat them as one for purposes of a bankruptcy proceeding.

Under substantive consolidation, however, a bankruptcy court may use its equitable powers to consolidate the assets of a debtor's affiliates with the debtor's bankruptcy estate and compel creditors of the consolidated entities to seek satisfaction from the consolidated pool of assets.

In the event that affiliated entities are substantively consolidated in bankruptcy, intercompany claims are usually eliminated, the assets of the entities to be consolidated are pooled and treated as common assets, and the claims of creditors against any of the entities are treated as claims against the common pool of assets. Substantive consolidation is intended to further the general bankruptcy objective of equitable treatment of all creditors. However, consolidation does not necessarily benefit all creditors because different debtors are likely to have different asset/liability ratios. Therefore, creditors holding claims against a financially stronger debtor will be prejudiced by the dilutive effect resulting from substantive consolidation. Moreover, the pooling of assets has the consequence of eradicating affiliate guarantees. Based on the potentially adverse impact on innocent creditors, courts generally view substantive consolidation as an extreme remedy to be granted in extraordinary circumstances.

**As a general legal principle, only the property of a debtor is administered in a case under the Bankruptcy Code, and mere corporate affiliation will not support a bankruptcy court's jurisdiction over the property of an affiliate of the debtor.**

Notwithstanding the requirement of the filing of a voluntary or involuntary petition for relief under sections 301 or 303 of the Bankruptcy Code, a non-debtor entity may become subject to the bankruptcy court's jurisdiction and have its assets and liabilities administered in a bankruptcy case of its affiliate pursuant to the doctrine of substantive consolidation. As a general legal principle, only the property of a debtor is administered in a case under the Bankruptcy Code, and mere corporate affiliation will not support a bankruptcy court's jurisdiction over the property of an affiliate of the debtor.

There is no direct statutory authority or prescribed standard for substantive consolidation. Instead, judicially developed standards control whether substantive consolidation should be granted in any given case. One of the more prominent cases setting forth the standards for substantive consolidation is *Augie/Restivo*, which was decided by the United States Court of Appeals for the Second Circuit. In that case, the Second Circuit set forth the following alternative tests to determine whether substantive consolidation is warranted: (i) whether creditors dealt with the entities as a single economic unit and

did not rely on their separate identities in extending credit or (ii) whether the entities' affairs are so entangled and confused that substantive consolidation will benefit all creditors. The presence of either factor is sufficient for a court to order substantive consolidation. The Third Circuit and the Ninth Circuit have adopted the *Augie/Restivo* tests.

The first factor is premised on the notion that creditors should receive the benefit of their bargain and, therefore, to the extent a creditor made a loan on the basis of the financial status or credit risk of a particular entity, they should

expensive or impossible, courts are more willing to grant substantive consolidation.

While substantive consolidation can have an adverse impact on creditors, it is important to note that substantive consolidation should not impair validly perfected security interests. Some courts have held that if substantive consolidation would have the effect of eliminating a secured creditor's lien (*i.e.*, a pledge of an equity interest in a subsidiary), then substantive consolidation may not be appropriate and should not be ordered unless some alternative protection may be imple-

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expect to be able to look to the assets of that entity for satisfaction of the loan. In expanding on the "corporate separateness" prong of the *Augie/Restivo* test, the Third Circuit in *Owens Corning* has held that a *prima facie* case for substantive consolidation exists when, based on the parties' prepetition dealings, it can be shown that there was "corporate disregard" creating expectations that the creditor was dealing with debtors as one indistinguishable entity. An opponent of consolidation can defeat this *prima facie* showing by proving it is adversely affected and actually relied on the debtor's separate existence.

The second *Augie/Restivo* factor can best be described as a strict administrative convenience test that takes into account the best interest of creditors. Under this test, substantive consolidation should only be ordered in those situations where "untangling" is either impossible or so costly as to consume the assets. Poor or nonexistent record keeping of separate assets (particularly cash and other liquid assets) and liabilities and interaffiliate transactions is one of the more common reasons for imposing substantive consolidation. When the combination of affiliates' assets, liabilities and business affairs is so "hopelessly entangled" that segregation is either prohibitively

mented. On a related note, although substantive consolidation has the effect of eradicating affiliate guarantees, the mere existence of a guarantee may militate against substantive consolidation. In 2005, the Third Circuit, in *Owens Corning*, held that the existence of an affiliate guarantee is evidence of a lender's reliance on the separateness of the affiliates, which is a ground for denying substantive consolidation.

### Mitigating Substantive Consolidation Risk

Substantive consolidation analysis is extremely fact sensitive. Therefore, it is difficult to generalize what steps should be taken to mitigate risk in all circumstances. Nevertheless, based on *Augie/Restivo* and its progeny, there are several recommended steps that lenders and creditors should take to mitigate substantive consolidation risk. With respect to the "hopeless entanglement" prong of *Augie/Restivo*, lenders should require, through covenants or similar contractual promises, that their debtor maintain separate books and records and file independent financial statements. Moreover, although it may be typical in parent-subsidiary relationships for the parent to pay overhead expenses, lenders should nevertheless require that intercompany claims be care- / continued page 10

## Substantive Consolidation

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fully booked and recorded and balances be tried up. If possible, lenders should also require that the debtor's assets (which may also constitute collateral) be segregated and not commingled with the assets of its affiliates. This can be accomplished through the imposition of account control agreements, the appointment of a collateral agent, and/or the right of lenders (or the lenders' agent) to periodically inspect the debtor's assets.

The "corporate separateness" prong of *Augie/Restivo* is even more fact sensitive than the "hopeless entanglement" prong. In order to show that a lender relied on the credit worthiness of a particular debtor (as opposed to the debtor's affiliates), it is recommended that lenders, when conducting due diligence, request financial information for their particular debtor. If possible, defaults in loan documents and other contracts should be tied directly to the borrower and its financial condition or performance, and not to the financial condition or performance of the debtor's affiliates.

### Conclusion

With the economic downturn and increase in the number of bankruptcy filings, lenders and other creditors need to be aware of substantive consolidation issues. This article has only touched on a few of the myriad issues in a substantive consolidation analysis. Nevertheless, understanding what substantive consolidation is and the factors that bankruptcy courts consider in a substantive consolidation analysis can help lenders and other creditors identify and hopefully mitigate that risk. ☺

## Are Section 363 Sales Really "Free and Clear"?

*By Douglas Deutsch*

The Bankruptcy Appellate Panel for the U.S. Court of Appeals for the Ninth Circuit ("BAP") recently issued a decision in *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25, that addressed fundamental Section 363 bankruptcy sale issues. Stating that the case turned on the "simple issue" of whether a senior lender can eliminate an out-of-the-money junior

lender's interest by "purchasing" (via a credit bid) the underlying estate property in a court-sanctioned Section 363 sale, the 22-page BAP decision provided a conclusion that most bankruptcy lawyers and commentators find very surprising: it does not. Given the importance of Section 363 sales to buyers and bankruptcy estates, especially in many of the cases filed more recently, the effect of the decision could be significant.

### Case Background

The facts in this case are rather straightforward. PW, LLC (the "Debtor") owned prime real estate in Burbank, California. DB Burbank, LLC (the "Senior Secured Lender") held a claim of more than \$40 million against the Debtor that was secured by a senior lien in the real estate. Clear Channel Outdoor, Inc. (the "Junior Secured Lender") was owed \$2.5 million by the Debtor. The Junior Secured Lender's interest was secured by a junior lien in the Debtor's real estate. Ultimately, problems plagued the Debtor's development plan, resulting in the Debtor's bankruptcy filing and the appointment of a Chapter 11 Trustee.

During the bankruptcy case, the Senior Secured Lender worked with the Chapter 11 Trustee to consolidate all of the Debtor's property and development rights so that they could be sold. The Senior Secured Lender agreed to serve as the "stalking horse" bidder for the proposed sale. As permitted by Section 363(k) of the Bankruptcy Code, the court-approved sale procedures provided that the Senior Secured Lender's bid would be a credit bid and that the Chapter 11 Trustee would hold an auction to obtain higher and better bids.

At the sale, the Senior Secured Lender was the highest bidder, paying its consideration by credit-bidding the entire amount of its debt. Relying on Section 363(f)(5) of the Bankruptcy Code, the bankruptcy court confirmed the sale to the Senior Secured Lender free and clear of the Junior Lender's lien. The bankruptcy court then denied the Junior Lender's stay of the sale pending appeal. Accordingly, the Senior Secured Lender closed on the sale.

The matter was then appealed to the BAP, an intermediate appellate court made up of a panel of three bankruptcy judges. Two issues were addressed on appeal: (a) whether the appeal was moot; and (b) whether lien stripping — that is, removing the lien held by the Junior Secured Lender — was authorized by Section 363(f). While the appeal was pending (and without a stay in effect), the Senior Secured Lender paid out approximately \$1.5 million in post-closing obligations,

including payments for taxes, professionals and for the benefit of a more senior lienholder.

### The Ninth Circuit BAP Decision

As a threshold issue, the Ninth Circuit BAP had to first determine whether it could review the issue on appeal. This was important because the hallmark of free and clear sales under the Bankruptcy Code are the protections afforded by Section 363(m), also known as statutory mootness. Section 363(m) provides that the “reversal or modification on appeal of an

lien could be “stripped” of its rights. Section 363(f) permits a debtor to sell bankruptcy estate assets “free and clear” of other interests in certain circumstances including where a sale “could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.” Thus, to “strip” junior claimant rights another legal mechanism (that is, “a legal or equitable proceeding”) must exist that would permit the court to extinguish the lien.

The Debtor asserted that the plan of reorganization “cram-down” rights — found in another provision of the Bankruptcy

## The BAP found that using cramdown as the mechanism created a “circular” reasoning because it sanctioned the effect of a cramdown without the substantive and procedural protections provided by Section 1129(b).

authorization” to sell or lease property “does not affect the validity of a sale” if the purchaser has acted in good faith and there is no stay of the order approving the sale pending appeal. Mechanically, Section 363(m) applies only to sales made pursuant to Section 363(b) or (c).

In this case, no questions existed with respect to the good faith of the purchaser nor was the court required to deal with a stay pending appeal. The Ninth Circuit BAP, accordingly, turned to the core “mootness” issues where it applied a very literal reading of the statute. It concluded that the sale/transfer at issue was made pursuant to Section 363(f) and not pursuant to Section 363(b) — even though the language in Section 363(b) seems to expressly incorporate sales made pursuant to Section 363(b). The BAP also found that transfer of the property was neither a “sale or lease” but the “use” of the property and thus did not fall within the Section 363(m) parameters. Based on these foregoing observations, the BAP concluded that the 363(m) requirements were not satisfied and, therefore, the appeal was not statutorily moot. This finding allowed the BAP to address the more substantive legal issue.

The BAP then asked whether the Junior Secured Lender’s

Code (Section 1129) — provided the bankruptcy court with the legal mechanism to strip the junior claimant rights. While the BAP acknowledged the power of Section 1129 cramdown rights, it disagreed that they could satisfy the obligations set forth in Section 363(f). The BAP found that using cramdown as the mechanism created a “circular” reasoning because it sanctioned the effect of a cramdown without the substantive and procedural protections provided by Section 1129(b). According to the BAP, a separate and distinct mechanism would have to be found.

Based on the foregoing, the BAP reversed the bankruptcy court’s order that concluded that the sale was free and clear of the Junior Lender’s claim. (Procedurally, the BAP concluded that the transfer was effective to the Senior Secured Lender but that the properties remained subject to the Junior Secured Lender’s claim.) Somewhat inconsistently, however, the BAP left open the possibility that another legal mechanism to satisfy Section 363(f)(5) could be found and remanded that issue to the bankruptcy court for further consideration.

### The Affect of the BAP Opinion

After consideration of the remanded case / *continued page 12*

## Section 363 Sales

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by the bankruptcy court, it seems likely that the Senior Secured Lender will ultimately prevail in this case for the simple reason that finding another 363(f) mechanism (again, a “qualifying proceeding under nonbankruptcy law”) would appear to be a simple task: a mortgage foreclosure proceeding would seem to satisfy the requirement. If this is true, the BAP’s Section 363 reasoning will probably never be tested by the applicable appellate court. As such, and although the BAP’s decision is of questionable and limited precedential authority (that is, bankruptcy courts outside of the Ninth Circuit, such as those in the important jurisdictions of New York and Delaware, certainly need not follow its analysis), an unfavorable, and we believe incorrect analysis will remain on the books for other courts to consider. This could create some uncertainty on Section 363 issues for buyers and debtors.

Buyers at bankruptcy sales universally require the protections of 363(m) in the sale orders. In return for these protections, bankruptcy estates are provided the opportunity to obtain the maximum value for their assets. If the finality of a bankruptcy court’s Section 363 sale order is questioned, however, buyers may be buying assets subject to lawsuits or claims of third parties, thus

resulting in reduced offer prices and/or delaying the closing of sales to ensure that any objector’s appeal rights are exhausted.

With respect to junior and senior creditor relationships, the decision may make it more difficult for junior and senior secured creditors to reach compromises. Why should senior secured lenders ever permit junior liens knowing that underwater junior lienholders can delay a sale (thus reducing a senior lender’s ultimate recovery) should the borrower ever file for bankruptcy? Inevitably, junior lienholders will view the *Clear Channel* decision as a tool that can be employed to extract a more favorable settlement. The decision will also discourage any party — whether senior, junior, or other — from credit bidding.

### Conclusion

Buyers and debtors will have to determine whether to treat the Ninth Circuit BAP’s decision in *Clear Channel* as good law that will be followed elsewhere or as an unsound decision that is likely to be followed, at most, only in part or all of the Ninth Circuit. In all instances, and prior to other courts providing additional analysis of the issues raised, a buyer and debtor participating in a Section 363 sale should proceed carefully and determine how best to structure their sale to minimize unwarranted risks in light of the *Clear Channel* decision. ©

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