LEGAL ISSUES PRESENTED BY THE CHANGING DEBT MARKETS AND THEIR IMPACT ON A COMPANY'S ABILITY TO REORGANIZE

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Our panel will discuss how the financial and debt markets have changed, the different variety of debt instruments, and how these instruments may affect a reorganization or sale of a debtor's business in and out of bankruptcy. In this paper, we examine a few legal issues from both the perspective of the debtor and creditor that may arise in a restructuring or sale involving multiple layers of secured debt. These issues include: (1) a trustee's ability to sell free and clear of junior liens; (2) the enforceability of intercreditor agreements in bankruptcy; (3) successor liability; and (4) a claim purchaser's exposure to equitable subordination.

1. <u>Selling Free And Clear Of Junior Liens</u>

When bankruptcy trustees (or debtors in possession) seek to sell property encumbered by multiple liens free and clear of those liens, section 363(f) of the Bankruptcy Code may present issues. Section 363(f) states:

> 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;
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> (2) such entity consents;
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> (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;
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> (4) such interest is in bona fide dispute; or
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> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.[1]

[1] 11 U.S.C. § 363(f).

If the collateral has value sufficient to pay off all the liens, the trustee may sell free and clear with no problem; the trustee has clear authority to do so under 363(f)(3). However, when the collateral is under water, the trustee's authority to make such a sale is far from clear. This lack of clarity stems from ambiguities in the language of 363(f)(3) and (f)(5), which has caused much confusion in the courts. This paper examines how courts have construed these clauses in working through the ambiguities.

a. Section 363(f)(3)

Under section 363(f)(3), the trustee may sell property free and clear of any interest if the interest is a lien and the price of the property is "greater than the aggregate value of all liens on such property." The confusion caused by this language stems from the ambiguity of the term "value": it is unclear whether "value" measures the face amount of debt secured by the liens or the actual economic value of the liens (i.e., the portion of the liens secured by value of the collateral). For example, suppose that collateral worth $100,000 secures a senior loan for $75,000 and junior loan for $75,000, the junior loan being $50,000 undersecured. The aggregate value of the liens would either be $150,000 or $100,000 depending on the interpretation of (f)(3). The effect of the different interpretations is that, if a court reads value to mean the amount of debt, collateral that is under water could never be sold free and clear of liens under (f)(3). If a court reads value to mean actual economic value, then courts generally allow the collateral to be sold.

Courts are split in their interpretations of 363(f)(3). The leading case interpreting value to mean the amount of debt is *In re Stroud Wholesale, Inc*.[2] The *Stroud* court based its interpretation on the fact that the 1984 amendment to this section replaced the former language "such interests" with the current language "all liens on such property."[3] This change, the court said, shows that Congress intended value to mean the amount of debt, but the court did not explain why.

The court in *In re Terrace Chalet* [4] agreed with *Stroud* and clarified its reasoning. The *Terrace Chalet* court explained that the 1984 Amendment revealed Congress's intent because when Congress intends to express actual economic value in the Bankruptcy Code, it consistently uses the term "interest." For example, section 506(a) uses the phrase "value of such creditor's interest" to denote economic value, and section 1129(a)(7)(B) uses the phrase "value of such holder's interest" to denote economic value. Thus, the court reasoned, the use of the term "lien" in (f)(3) shows that Congress intended not to express economic value, but rather amount of debt. Further, the court stated that the legislative history supports its interpretation. The court cited language in the House and Senate reports stating that, "[t]he trustee may sell free and clear if… the sale price of the property is greater than the *amount secured by the lien*."[5] Although this statement itself is arguably ambiguous, the court reasoned that the statement gave additional support to its interpretation.

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[2] 47 B.R. 999 (E.D.N.C. 1985).
[3] Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub.L. No. 98-353, 98 Stat. 372.
[4] 159 B.R. 821 (N.D. Ill. 1993).
[5] H.R.Rep. Mo. 95-595, 95th Cong., 1st Sess. 345 (1977) (emphasis added).; S.Rep. Mo. 95-989, 95th Cong., 2d Sess. 56 (1978) (emphasis added).

The *Terrace Chalet* court also reasoned that to interpret value to mean economic value would make clause (f)(5) superfluous. Clause (f)(5), discussed below, allows for the sale of property free of interests if the interest holder could be compelled to accept money in satisfaction of its interest. Some courts, the *Terrace Chalet* court included, have interpreted this section to mean that, if the interest could be "crammed down" under chapter 11, then the interest holder could be compelled to accept a money satisfaction. One of the three elements to cram down is that the interest holder must receive actual economic value. If the "cram down" interpretation of subsection (f)(5) were correct, then no party would needlessly prove the other two elements when satisfaction of that one element would allow for sale free of interests under (f)(3). Other courts, however, have interpreted subsection (f)(5) differently in a manner that could be consistent with value meaning economic value. (See discussion on (f)(5), *infra*.)

Within the First Circuit, the courts in *In re Perroncello*[6], *In re Healthco International, Inc.*[7], and *In re WPRV-TV, Inc.*,[8] followed the *Terrace Chalet* interpretation that value means the amount of debt. The *WPRV-TV* court considered the interpretation that value means economic value to be "a highly criticized and unduly strict interpretation of the Bankruptcy Code."[9]

Finally, the court in *In re Canonigo*[10] made a compelling argument that value means amount of debt based on the use of the term "greater" in (f)(3). The court stated,

> Although the word "value" is ambiguous, as used in section 363(f)(3), the word "greater" is not. Assuming the sale price determines the value of the property to be sold, the sale price can never be *greater* than the aggregate economic value of the liens on the property.[11]

In other words, the sale price could never be greater than the economic value of the liens because the sale price would always *equal* the economic value of the liens. Thus, the court concluded that Congress intended value to mean the amount of debt.

For the interpretation that "value" means economic value, the leading case is *In re Beker Industries Corp*.[12] *Beker* and its progeny base their interpretations primarily on the concept of lien value under section 506(a). The *Beker* court reasoned that, in statutory construction, terms of a particular meaning should be interpreted consistently throughout the statute. In section 506(a), "value" is used to mean economic value, as opposed to amount of debt. Therefore, the court concluded that value should be used the same way in (f)(3). Further, the court in *In re Terrace Gardens*[13] stated that such an interpretation would also be consistent with the concept of "adequate protection" under the Code, where the protection needs to be given only to the economic value of the lien, not the amount of debt.

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[6] 170 B.R. 189 (Bankr. D. Mass. 1994) (Hillman, J.).
[7] 174 B.R. 174 (Bankr. D. Mass. 1994) (Queenan, J.).
[8] 143 B.R. 315 (D.P.R. 1991).
[9] 143 B.R. at 319; *See also Perroncello*, 170 B.R. at 191.
[10] 276 B.R. 257 (Bankr. N.D. Cal. 2002).
[11] Id. at 262. (Emphasis supplied.)
[12] 63 B.R. 474 (Bankr. S.D.N.Y. 1986).
[13] 96 B.R. 707 (Bankr. W.D. Tex. 1989).

The *Terrace Gardens* and *WPRV-TV* courts also gave a policy consideration supporting the *Beker* court's holding. Whereas *Stroud* noted the "well-established rule" that property should not be sold free and clear of liens unless it produces some equity for the estate, *Terrace Gardens* and *WPRV-TV* stated that there are situations when a sale of collateral for less than the amount of debt can produce benefit to the estate, such as when a sale free and clear of liens facilitates a greater sale price.

b. Section 363(f)(5)

As noted above, section (f)(5) states that the trustee may sell property free and clear of any interest if the entity holding the interest "could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest." Congress, however, presumably did not intend the literal meaning of this language because any lienholder can be compelled to accept a money satisfaction. Thus, under the literal meaning, property could be sold free of any lien under (f)(5), and the value requirements of (f)(3) would be rendered meaningless. Courts have accordingly developed various interpretations as to what Congress intended (f)(5) to mean.

Perhaps the most straightforward interpretation of this clause was made by the court in *In re Feinstein Family Partnership*[14]. The *Feinstein* court simply read "money satisfaction" to mean *full* money satisfaction; in other words, the interest holder must receive the full amount of debt.

A more popular interpretation reads (f)(5) to be broader than as interpreted in *Feinstein*. Under this interpretation, (f)(5) requires payment of the full amount of debt, but could require less if the interest holder could be "crammed down" in a chapter 11 proceeding. Courts following this view reason that a chapter 11 case constitutes such an "equitable proceeding" and that, when crammed down, interest holders are "compelled" to accept a money satisfaction, despite that they receive less than the full amount of debt. The cases purveying this interpretation include *Terrace Chalet*, *Perroncello*, and *Healthco*.

Additionally, the *Stroud* court stated that interest holders could be compelled under (f)(5) to accept less than the full amount of debt in a rehabilitation case (presumably meaning a chapter 11 reorganization) but not in a liquidation case. Other courts have held that (f)(5) could be used to approve a sale for less than the amount of debt in either type of case, but only when there are "compelling equitable considerations."[15]

The *Beker* and *Canonigo* courts had a wholly different interpretation of this clause; they held that (f)(5) was not meant to apply to liens at all. In *Beker*, the court stated that, because (f)(3) was written specifically for liens, Congress intended for only that subsection to apply to liens, not (f)(5).[16] The *Canonigo* court added that, "[i]f section 363(f)(5) is read to apply to liens, read literally, it is puzzling why that section does not require that the sale price be sufficient to provide a money satisfaction of the secured claim."[17] The court reasoned that, although its

[14] 247 B.R. 502 (Bankr. M.D. Fla. 2000).
[15] *See, e.g., In re Heine*, 141 B.R. 185, 189-90 (Bankr. D.S.D. 1992).
[16] 63 B.R. at 478.
[17] 276 B.R. at 265.

interpretation requires a narrower reading of "interest" in (f)(5) than in (f)(3), this "judicial gloss" is less dramatic than the other interpretations.[18]

c. Section 363(f) Debate May Impact Sales of Assets

The split in authority regarding the interpretation of sections 363(f)(3) and (5) could potentially affect the outcome of a sale of assets under section 363(b) of the Bankruptcy Code. In cases where there exist multiple secured creditors, the split in authority could give the junior lienholder leverage to hold up a sale. In those courts that follow the "amount of debt" interpretation of section 363(f)(3) and do not allow for an equitable exception under subsection (f)(5), the court may not approve a sale free and clear of the junior liens unless the sale price is sufficient to pay both the junior and the senior liens in full.

Solutions will vary depending on the circumstances. One solution may be that the senior lienholder negotiate a sharing arrangement with the junior lienholder (and possibly with general unsecured creditors if their support is necessary) to obtain the junior creditor's consent to a sale. Another possible solution is to include in an intercreditor or subordination agreement a provision prohibiting the junior lienholder from opposing a sale by the borrower of substantially all of its assets if such sale is supported by the senior lienholder. Alternatively, in those cases where the senior lienholder may have an opportunity to provide input as to venue for a filing, how a court would interpret section 363(f) of the Bankruptcy Code should be a consideration.

2. <u>The Enforceability Of Intercreditor Agreements In Bankruptcy</u>

Second lien financing is an increasingly common means through which borrowers meet their financing needs. It can provide many advantages over unsecured mezzanine financing for both borrowers and lenders, such advantages including lower interest rates for borrowers and greater security for lenders. A distinct disadvantage for senior lenders, however, is that the intercreditor agreements that typically accompany these financings may sometimes be unenforceable.

Second lien financing generally works as follows: the senior lender holds a first lien on the borrower's assets and has the right to prevent the borrower from further encumbering these assets. If the borrower needs additional financing, and the primary lender does not wish to extend further credit, the primary lender may be persuaded to allow a new lender to extend credit secured by a second lien on the borrower's assets. In exchange for allowing the junior lender to obtain a second lien, the primary lender will require that the junior lender agree to subordinate or waive many of its rights to the primary lender if the borrower defaults or files for bankruptcy. Thus, such second liens are called "silent second liens" because the lienholder agrees to become silent if the borrower seeks bankruptcy protection or defaults.

The following is a list of the most common rights that a second lienholder will waive in such agreements:[19]

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[18] *Id*.
[19] *See* Howard Seife, *Silent Second Liens*, 121 Banking L.J. 771, 773 (2004).

- that the second lienholder will not object to the validity and enforceability of the first lienholder's security interest;
- that the first lienholder will be entitled to proceeds of the collateral until payment in full of its claim before the second lienholder receives any proceeds, even if the senior lien is invalidated;
- to limit its ability to vote on a reorganization plan (e.g., that it will not vote in favor of any plan opposed by the first lienholder, or will assign its right to vote on the plan to the senior secured creditor); and
- to abide by the senior lienholder's positions with respect to adequate protection and use or sale of collateral.

a. Enforceability

The enforceability in bankruptcy of subordination provisions that limit a creditor's right under the Bankruptcy Code is unclear. The issue of enforceability pits the power of private parties to contract amongst themselves against the fundamental rights provided to creditors under the Bankruptcy Code. The extent to which private parties can contract away these statutorily afforded rights remaions unclear.

The analysis of which provisions may be enforceable in bankruptcy generally begins with section 510(a) of the Bankruptcy Code. That section states, "[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law." Some courts interpret "subordination agreements" to include only agreements regarding priority of payment, not the waiver procedural rights as mentioned, and hold that the waiver of such rights are beyond the scope of 510(a).[20] In these cases such clauses may be invalidated as being contrary to the policies of the bankruptcy system.

Little case law exists on this issue because the issue usually arises in the early days of a bankruptcy case, such as in connection with debtor in possession financing, when a court is less likely to write an opinion. Also, the unclear state of the law encourages parties to settle the issue out of court.[21] Of the courts that have written opinions on this issue, a slight majority come down in favor of enforcing intercreditor agreements, though certain procedural issues in these cases have made unclear the extent to which the agreements were upheld. The following is a survey of the most significant cases in this unsettled area of the law.

b. Cases Upholding Intercreditor Agreements

In *In re Inter Urban Broadcasting of Cincinnati, Inc.,*[22] an intercreditor agreement was upheld that entitled the senior lender to vote the junior lender's claim. In that case, the court

[20] *See, e.g., In re Hart Ski Mfg. Co.*, 5 B.R. 734 (Bankr. D. Min. 1980).
[21] *See* Jo Ann Brighton and Mark N. Berman, "Second-Lien Financings: Enforcement of Intercreditor Agreements in Bankruptcy (Part I: More Questions Than Answers)," *ABI Journal*, February 2006 at 38.
[22] 1994 WL 646176 (E.D. La.).

approved the senior lender's plan of reorganization over the debtors' proposed plan. In accordance with the intercreditor agreement, the senior lender voted the junior lender's claim for its plan, even though the junior lender received nothing under the plan. The debtors objected to the approval of the senior lender's plan on the grounds that the junior lender's claim should have been deemed to have rejected the plan under section 1126(g) because, under that section, a class is deemed to have rejected a plan if the class members receive nothing under the plan.

The court upheld the senior lender's right to vote the junior lender's shares because the court determined that, under section 510(a), "[a] subordination agreement is enforceable in a bankruptcy case to the same extent that such agreement is enforceable under applicable non-bankruptcy law…. [The debtors] have neither attacked the agreement nor suggested that it is not enforceable under non-bankruptcy law."[23] Thus, it appears that the court considered the waiver of the right to vote a part of the subordination agreement that is enforceable under section 510(a). In doing so, the court avoided the question of whether such a waiver of rights contravenes the policies of the Bankruptcy Code.

The court in *In re Davis Broadcasting, Inc.*[24] upheld an intercreditor agreement where the junior lender subordinated substantial rights, including voting rights, to the senior lender if the borrower filed for bankruptcy. In *Davis Broadcasting*, the debtor/borrower's reorganization plan was confirmed by the court after the senior lender voted its claim and the junior lender's claim in support of the plan. After substantial consummation of the plan, the junior lender took exception to certain plan provisions and moved to correct the plan. The court denied this motion. The court held that the junior lender was bound by the terms of the plan because it neither objected to nor appealed the confirmation of the plan and, in fact, voted for the plan per the subordination agreement. Thus, the court endorsed the intercreditor agreement. However, this endorsement may be considered non-binding dicta because the holding may have been based on a failure to object rather than enforcement of the intercreditor agreement. The opinion is unclear in this regard.

Perhaps the strongest endorsement of an intercreditor agreement to date was made by the court in *In re Curtis Center Limited Partnership*.[25] The intercreditor agreement in *Curtis Center* gave the senior lender the right to vote the junior lender's claim. The issue of the agreement's validity arose in the context of the debtor's defense against the senior lender's assertion that the debtor could not cramdown a reorganization plan because the debtor could not receive an assenting vote from any impaired class. The debtor attempted to separately classify the junior lender's claim in the debtor's proposed plan and argued that the junior lender would assent to the plan. The court rejected the debtor's argument. Without considering whether the debtor had any grounds for the separate classification, the court held that the senior lender controlled the junior lender's voter per the intercreditor agreement. The court stated that "[t]he language of the subordination agreement is plain and unambiguous. The terms of this prepetition agreement are fully enforceable in the Bankruptcy case pursuant to 11 U.S.C. § 510(a)."[26] Thus, like the *Inter*

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[23] *Id.* at 2.
[24] 169 B.R. 229 (Bankr. M.D. Ga. 1994).
[25] 192 B.R. 648 (Bankr. E.D. Pa. 1996).
[26] *Id.* at 660.

Urban Broadcasting court, the court held that a waiver of rights is included within the scope of a subordination agreement allowed under 510(a).

c. Cases Invalidating Intercreditor Agreements

Two opinions have invalidated provisions of intercreditor agreements that cause a subordinated lender to relinquish rights in bankruptcy: *In re Hart Ski Mfg. Co.*[27] and *In re 203 North LaSalle Street Partnership*.[28] The *Hart Ski* court confronted this issue upon motion of the junior lender seeking adequate protection or to lift the automatic stay. The senior lender objected to this motion on grounds that the junior lender had agreed in its subordination agreement that it would not seek to enforce such rights. The court denied the motion and held that such agreements contravene the Bankruptcy Code. The court stated that the endorsement by Congress of subordination agreements in section 510(a) relates only to agreements dealing with priority of distribution, not general bankruptcy rights. The court went on to explain:

> "The Bankruptcy Code guarantees each secured creditor certain rights, regardless of subordination…. [Rights] not related to contract priority of distribution pursuant to Section 510(a) cannot be affected by the actions of the parties prior to the commencement of a bankruptcy case when such rights did not even exist. To hold that, as a result of a subordination agreement, the "subordinor" gives up all its rights to the "subordinee" would be totally inequitable"[29]

The *203 North LaSalle* court followed *Hart Ski* and provided further reasons why such intercreditor agreement provisions should not be upheld in bankruptcy. In *203 North LaSalle*, the court invalidated an agreement that the senior lender could vote the junior lender's claim in a chapter 11 bankruptcy case. The court provided several reasons for its holding. First, the court cited to case law stating that private parties cannot contract away the policies of the Bankruptcy Code. Second, the court determined that the common meaning of "subordination" relates to the ranking of claims, not the relinquishment of rights. Third, the court reasoned that Fed.R. Bankr.P. 3001(c) prohibits a senior creditor from voting a junior creditor's claim. That rule states that acceptance or rejection of a Chapter 11 plan must be signed by "the creditor… or an authorized agent." In this case, the senior creditor was not an "agent" because it acted in its own interest, not the junior creditor's interest. Finally, the *203 North LaSalle* court reasoned that subordinated creditors may still receive payments in bankruptcy, and thus general bankruptcy policy requires that they should play a role in the negotiation of the bankruptcy plan. Accordingly, the court invalidated the intercreditor agreement at issue.

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[27] 5 B.R. 734.
[28] 246 B.R. 325 (Bankr. N.D. Ill. 2000).
[29] 5 B.R. at 736.

3. Successor Liability For Assets Purchased From Distressed Businesses

When acquiring the assets of a distressed business, the purchaser needs to be aware of possible liabilities that may be deemed assumed under the doctrine of successor liability. The risk of successor liability varies depending on whether the assets are acquired through a UCC foreclosure sale, a section 363 sale in bankruptcy, or a confirmed chapter 11 plan. This paper examines the current state of the law on these issues.

a. Successor Liability

The doctrine of successor liability is an exception to the general rule that an entity that buys all or some of the assets of another entity does not also acquire the liabilities or debts of that entity. The general rule does not apply if: (1) there is an express or implied agreement by the successor to assume the liabilities; (2) the transaction amounts to a consolidation or merger; (3) the successor entity is a mere continuation or reincarnation of the predecessor entity; or (4) the transaction was fraudulent, not made in good faith, or made without sufficient consideration. If one of these four exceptions apply, the buying entity may be vulnerable to successor liability.

b. Liability in UCC Foreclosure Sales

Successor liability is more likely to arise when the buying entity buys assets directly from the selling entity. Intuitively, one would think that a buyer should be shielded from successor liability when buying through a foreclosure sale. The courts that have confronted this issue, however, have uniformly held that a foreclosure sale does not shield the buyer.

The leading case on the issue is *Continental Insurance Company v. Schneider, Inc.*[30] In *Continental*, the borrowers fell into financial distress and cooperated with their secured lenders to have their assets liquidated in a foreclosure sale. These assets were purchased by an entity allegedly owned and operated by the same individuals that owned the borrowers. Continental Insurance, an unsecured creditor of the borrowers, brought a successor liability suit against the buyer, who argued that to impose successor liability after a foreclosure sale would be inconsistent with the UCC policy of protecting secured creditors over unsecured creditors and would essentially "undo" an otherwise valid foreclosure sale.

The court rejected the buyer's argument. The court stated,

> neither the UCC itself nor the policy underlying it demands the imposition of an absolute bar to an unsecured creditor's assertion of a successor liability claim against an entity that has purchased the debtor's assets in a [§9-610] foreclosure sale. Rather, we conclude that such claims may proceed, and if the unsecured creditors can establish that one of the exceptions to the general rule against successor liability applies, it may collect the predecessor's debt from the successor.[31]

[30] 582 Pa. 591 (2005).
[31] *Id*. at 604.

Additionally, the court noted that section 1-103 of the UCC states that "principles of law and equity… shall supplement" the UCC's provisions "unless displaced" by particular provisions. Accordingly, the case was remanded for a factual determination of whether the buyer was a "mere continuation" of the borrowers to impose liability.

c. Liability in Chapter 11 Plans

When a chapter 11 plan of reorganization is confirmed, the liabilities and debts that arose before the confirmation are discharged, provided that the claimholders had been given adequate notice of the bankruptcy. Debts that are discharged under a plan cannot be transferred to a new entity. Thus, a purchaser of assets under a confirmed chapter 11 plan should be shielded from successor liability.

The case of *Mickowski v. Visi-Trak Worldwide, LLC*[32] demonstrates this principal. In *Mickowski*, the plaintiff John Mickowski obtained a judgment for patent infringement against Visi-Trak, which subsequently filed for bankruptcy. A complicated set of procedural facts ensued: Visi-Track confirmed a plan in which it was to sell its assets to Mickowski, had the plan revoked, and then sold its assets to its former management under a new plan. Mickowski then brought a successor liability claim against the asset purchasers.

The court held that, although the chapter 11 plan was revoked, the confirmation order was not. Therefore, the court reasoned, the previous debt to Mickowski remained extinguished and no successor liability could exist.

There is an exception to this protection from liability, however: liability for claims of creditors that have not been given adequate notice of the bankruptcy proceedings. This exception stems from the general rule that persons or entities cannot have their rights altered in court without constitutional due process of law. Without proper notice to future claimants, successor liability may still attach despite a confirmed chapter 11 plan.

An example of this is given in *Lemelle v. Universal Mfg. Corp.*[33] In that case, Winston Industries, a mobile home manufacturer, reorganized under chapter 11 and received a discharge from all liabilities. Winston then merged with Universal Manufacturing Corp. After the merger, the plaintiff sued Universal under successor liability for two deaths allegedly caused by a defective mobile home made by Winston before its bankruptcy filing. The court held that, despite the discharge granted in the confirmation order, the discharge was not effective as to the plaintiff because she did not receive notice of the discharge.

In situations like *Lemelle* where specific future claimants may be difficult or impossible to ascertain, debtors can use mechanisms to help meet the due process requirement. Typically, a debtor can discharge future claims by (1) having the court appoint a representative for the possible future claimants and providing the representative opportunity to advocate for the claimants, and (2) providing trust funds for the fair treatment of the possible future claimants

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[32] 415 F.3d 501 (6th Cir. 2005).
[33] 18 F.3d 1268 (5th Cir. 1994).

under the plan.[34] If a debtor uses these mechanisms, it can help shield buyers from successor liability from future claims.

d. Liability in Section 363 Sales

Under section 363(f), a trustee may sell property of the estate "free and clear of any interest" if one of five criteria is met. The issue of whether a 363 sale shields a buyer from successor liability initially turns on whether a successor liability claim is an "interest" in the property sold under section 363. Courts that have confronted this issue are split, with a slight majority holding that such a claim is an interest in property that can be extinguished by the sale.

Two recent cases on the issue are *In re Leckie Smokeless Coal Co.*[35] and *In re Trans World Airlines (TWA),*[36] both of which held that claims are interests in property that can be extinguished. In *Leckie Smokeless*, the debtor coal companies had liabilities for premiums owed under the Coal Industry Retiree Health Benefit Act. The debtors sought to sell their assets in a 363 sale free and clear of those liabilities. When confronted with the argument that claims for these premiums were not interests in property, the court stated,

> [The claims for premiums] are grounded, at least in part, in the fact that those very assets have been employed for coal-mining purposes: if [the debtors] had never elected to put their assets to use in the coal-mining industry, and had taken up business in an altogether different area, the [claimants] would have no right to seek premium payments from them. Because there is therefore a relationship between (1) [the claimants'] rights to demand premium payments from [the debtors] and (2) the use to which [the debtors] put their assets, we find that the [claimants] have interests in those assets within the meaning of section 363(f).

Accordingly, the court held that the sale of the assets under section 363 extinguished the claims for premiums against the buying company.

The *TWA* decision followed *Leckie Smokeless*. In *TWA*, the debtor airline sought to sell its assets free and clear of various claims relating to employment discrimination. The court allowed the debtor to do this because "it was the assets of the debtor which gave rise to the claims," and thus were interests in the property. Like that in *Leckie Smokeless*, the buyer was held not to be liable as a successor to these claims.

Conversely, some courts have held that claims are not interests in property under section 363 and therefore are not extinguished against the successor company. The leading case for this proposition is *In re Wolverine Radio Co.*[37] In *Wolverine Radio*, the debtor sold its assets "free and clear" of interests to JOSI Broadcasting Company under the debtor's chapter 11 plan. Later,

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[34] *See* Michael H. Reed, *Successor Liability and Bankruptcy Sales Revisited - A New Paradigm*, 61 Bus. Law. 179 (2005).
[35] 99 F.3d 573 (4th Cir. 1996).
[36] 322 F.3d 283 (3d Cir 2003).
[37] 930 F.2d 1132 (6th Cir. 1991).

the Michigan Employment Security Commission (MESC) brought a state tax claim against JOSI as the successor of the debtor. The court held that JOSI was liable for the taxes. Regarding JOSI's argument that a 363 sale free and clear of interests should extinguish the tax claims, the court stated,

> [Section 363] authorizes sales free and clear of *specific* interests in the property being sold, liens for example. General unsecured claimants, including tort claimants, have no specific interest in a debtor's property. Therefore, section 363 is inapplicable for sales free and clear of such claims.[38]

Additionally, some courts take the view that, although 363 sales do not extinguish successor liability claims, the court can provide for sales that extinguish such liability under its section 105(a) general equitable powers.[39] For example, in *In re White Motor Credit Corp.*,[40] the court held that a sale of assets free of all liabilities extinguished successor liability because it was approved by the court under section 105(a). The court added that, had the sale been made under only section 363, such liability would not have been extinguished.[41]

Finally, one should note that the due process notice requirements for a discharge to be effective under a confirmed plan, discussed *supra*, apply to section 363 sales as well. Thus, for a section 363 sale to have any chance of extinguishing successor liability claims, future claimants must receive notice of the sale or be otherwise provided for.

4. Claim Purchasers and Equitable Subordination

The recent decision in *In re Enron Corp*.[42] announced a warning to buyers of claims in bankruptcy: the claim you purchase may be subject to equitable subordination under section 510(c) of the Bankruptcy Code due to the conduct of the seller.

In *Enron*, Fleet National Bank was a participating bank in a group that loaned over $3 billion to Enron before it filed chapter 11. After Enron filed chapter 11, Fleet sold portions of its claim to various entities that eventually became the defendants in this proceeding.

Alleging inequitable conduct, including alleged participation in Enron's prepetition accounting scandal, by Fleet, the estate sought to equitably subordinate the claims originally held by Fleet and currently held by the defendants. The defendants argued that their claims should not be subject to equitable subordination because: (1) under 510(c), equitable subordination applies only to parties that have acted inequitably, not innocent parties; and (2) bankruptcy policy seeks to protect good faith purchasers, as it does to good faith transferees of property under section 550(b).

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[38] *Id*. at 1147 (fn. 23).
[39] That section states, "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."
[40] 75 B.R. 944 (Bankr. N.D. Ohio 1987).
[41] *Id*. at 948.
[42] 333 B.R. 205 (Bankr. S.D.N.Y. 2005).

The court rejected the defendants' arguments and held that their claims could be subject to equitable subordination. First, the court determined that there is nothing in the Code that prevents a court from equitably subordinating a claim in the hands of an innocent party. The court stated that the Code "affords a court discretion when it considers subordination of claims," and may always do so to assure that "fraud will not prevail."[43] Further, the court held that the protections afforded to good faith transferees under section 550(b) are inapposite to the present case. The court stated that section 550 concerns recovery of property for the benefit of the estate; section 510(c) concerns equitable distribution of claims against the debtor. The court also noted that any party that buys claims in a bankruptcy case should be aware that such claims are still subject to risks inherent in the bankruptcy process.

The lesson in *Enron* is for the party purchasing a claim to conduct due diligence of a selling-creditor's prior conduct, check the docket to see if there are allegations of misconduct or causes of action being preserved, and negotiate indemnity provisions in case the claim is later disallowed or subordinated.

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[43] *Id*. at 218.