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Expert Analysis

It's Time to Bury *Clear Channel* (And Certainly Not to Praise It)

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Sometimes, judges simply get it wrong. Occasionally, decisions are rendered of head-shaking inexplicability.

Among commercial and bankruptcy practitioners, the evocation of two cases in particular provides ample demonstration of this. In *Twist Cap*,[1] a bankruptcy court restrained a third-party draw on a letter of credit, and in *Octagon Gas*,[2] accounts sold by a debtor prior to bankruptcy were nonetheless held to be property of the estate.

Now, another decision stands ready to join this dubious pantheon: the 9th Circuit Bankruptcy Appellate Panel's 2008 ruling in *Clear Channel*.[3] That decision jolted attorneys both by the sheer extent to which it ran counter to nearly universally understood law and practice (in this instance, failing to protect a good-faith purchaser of assets under Section 363 of the Bankruptcy Code) and by the flaws underlying its reasoning.

As with those earlier decisions, the virtually unanimous rejection of such reasoning by courts and commentators alike is leading it quickly to the legal dustbin.

While erroneous rulings often wind up reversed on appeal, *Twist Cap*, *Octagon Gas* and *Clear Channel* all provide an interesting window into the treatment the legal community affords to decisions that remain extant and that were, by overwhelming consensus, wrongly decided.

It seems that eventually such cases, if not either formally overruled or corrected by legislative action, simply fade into obscurity. Prior to such time, however, the potential consequences of such decisions tend to cause much consternation.

The timing of the *Clear Channel* decision was particularly auspicious, coming at the beginning of what many then expected (and has in fact turned out) to be the beginning of a substantial wave of Chapter 11 filings.

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With both recent Bankruptcy Code amendments and present turmoil in the credit markets making traditional stand-alone reorganizations far more difficult to achieve, Section 363 sales, particularly to sell a troubled business in its entirety, have been playing a far more prominent role than in past down cycles.

Section 363 sales can be accomplished far more quickly and less expensively than confirming a plan of reorganization. In many cases they are the only viable mechanism for a failing company to be maintained as a going concern.

Much of the functionality of Section 363 as a mechanism for preserving value lies precisely in the two subsections at issue in *Clear Channel*:

- The ability to sell property "free and clear" of liens and interests pursuant to Section 363(f); and
- The protections afforded to a good-faith purchaser under Section 363(m) from subsequent appellate review (in the absence of a stay pending appeal).

Accordingly, many bankruptcy practitioners and legal commentators expressed substantial concern at the time that the decision would sharply diminish the efficacy of one of the key remaining devices for realizing value from distressed enterprises.

As one commentator noted shortly after the decision was published:

> The ruling in this case portends the introduction of inefficiencies in the bankruptcy sale process as senior creditors have less incentive to participate and may be more inclined to commence state foreclosure proceedings prior to a bankruptcy filing, which in turn may cause debtors to precipitously file for bankruptcy. Whether other courts follow the 9th Circuit BAP's reasoning or move away from it will be an important development to watch for in 2009.[4]

Twist Cap

In *Twist Cap* the debtor had entered into a security agreement with a bank that secured, among other things, three standby letters of credit issued for the account of the debtor. After filing for bankruptcy, the debtor sought to enjoin the bank from honoring the letters of credit. The judge granted a preliminary injunction, suggesting that letter-of-credit payments from a secured bank to unsecured creditors might constitute preferential treatment of the unsecured creditors.

The reaction of the commercial lending community was immediate. In the words of one commentator:

> *Twist Cap* prompted howls of protest. … The very purpose of the standby [letter of credit], critics protested, was to insulate the standby [letter of credit] beneficiary from the possibility of the applicant's insolvency. The ruling destroyed the efficacy of a commercial bank product. … [I]t was not long before the district courts and the circuit courts of appeal weighed in with rulings that left the case standing all by itself. Here, it is fair to summon up the old saw that "the cases rejecting the rule are too numerous to cite."[5]

Octagon Gas

In *Octagon Gas* the 10th U.S. Circuit Court of Appeals ruled that accounts sold by a debtor prior to its bankruptcy were still property of the debtor's bankruptcy estate. The court reasoned that in the case of the commercial financing of accounts, the distinction between a security transfer and a sale is blurred. Therefore, a sale of accounts is covered by the Uniform Commercial Code whether intended for security or not, it said.

Accordingly, the UCC term "secured party" included the buyer of accounts, and the UCC term "security interest" included the interest of a buyer of accounts. According to the court, this meant that under the UCC "a sale of accounts is treated as if it creates a security interest in the accounts," and therefore the accounts remained the property of the debtor's bankruptcy estate.

Octagon Gas was roundly criticized.

"The *Octagon Gas* case fails to recognize that Article 9 [of the UCC] treats the sale of accounts and chattel paper as secured transactions solely for the purpose of applying Article 9's rules relating to attachment, perfection and priority, and should not be construed as precluding true sales of accounts or chattel paper," one critic said.[6]

Octagon Gas has now been finally and universally repudiated with the enactment of Sections 9-318(a) and 9-318(b) of Revised Article 9 of the UCC. As the official comment to those sections now notes, "The

fact that a sale of an account or chattel paper gives rise to a 'security interest' does not imply that the seller retains an interest in the property that has been sold."

As one commentator has noted, *Octagon Gas* "is now of only historical interest and has no real continuing relevance for securitization transactions."[7]

Clear Channel

In *Clear Channel* the 9th Circuit BAP made two distinct rulings regarding Section 363 of the Bankruptcy Code. First, the panel refused to find that the provisions of Section 363(m), which are expressly designed to protect a good-faith purchaser of assets under Section 363 of the Bankruptcy Code from the effects of a reversal on appeal, shielded the transaction from review with respect to the transfer of the assets "free and clear" of interests under Section 363(f).

Next, looking at the specific issue of whether the property could be sold "free and clear," the panel held that Section 363(f) does not permit a senior secured creditor to take assets free and clear of a junior lien, where the consideration given was less than the value of the aggregate liens on the property.

Clear Channel involved an effort by the trustee of a single-asset real estate entity to sell the debtor's real property pursuant to a so-called "credit bid" transaction. Under the deal, the debtor's senior lender proposed to bid the full amount of its claim of $40 million and provide $800,000 in cash for administrative expenses in exchange for title to the property.

Clear Channel, the holder of a $2.5 million junior lien on the property, objected to the trustee's motion to approve the sale of the property free and clear of all liens, claims and encumbrances under Sections 363(f)(3) and (f)(5) of the Bankruptcy Code.

Over the junior lienholder's objection, the Bankruptcy Court entered an order authorizing the sale free and clear of the junior lien and finding that the senior lender was a purchaser in good faith. The junior lienholder received no proceeds from the sale of the property and timely filed an appeal of the order. The Bankruptcy Court declined to stay its order pending the appeal.

On appeal the 9th Circuit BAP analyzed whether Clear Channel's appeal of the stripping of its lien was statutorily moot under Section 363(m). The Bankruptcy Court's finding that the senior lender was a good-faith purchaser was highly significant because Section 363(m) provides significant protections to good-faith buyers of bankruptcy estate property:

> 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 the 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.

Because the junior lienholder did not obtain a stay pending its appeal of the court's order, the trustee argued that the BAP could not reverse the Bankruptcy Court's order that the property be sold free and clear of all liens.

The BAP disagreed. Applying a highly literal reading of the statute, the panel noted Section 363(m) on its face only applies to subsections (b) and (c) of Section 363, and therefore it found the provision was only intended to extend protection to "changes of title or other essential attributes of a sale, together with the changes of authorized possession that occur with leases." Since the lien-stripping was effected pursuant to Section 363(f), the panel held that the Section 363(m) protection did not apply with respect to that specific issue.

The panel turned next to the merits of whether Section 363(f) permitted the sale to the senior lender free and clear of the junior lien. 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 non-bankruptcy law permits sale of such property free and clear of such interest;
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> (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 or such interest.

The panel focused its analysis primarily on Section 363(f)(5), which was the basis of the Bankruptcy Court's order, viewing the issue as whether the junior lienholder "could be compelled … to accept a money satisfaction" of such interest.

The BAP said Section 363(f)(5) referred to "the existence of [a] legal mechanism by which a lien could be extinguished without full satisfaction of the secured debt" under applicable non-bankruptcy law. However, it applied an extraordinarily narrow view of what would in fact constitute such a legal mechanism, ignoring the common use of state foreclosure remedies outside of bankruptcy by senior creditors to obtain property free of a junior security interest.

Under the BAP's narrow interpretation, the Bankruptcy Court was specifically required to make a finding of the existence of such a mechanism and the trustee must demonstrate how satisfaction of the lien "could be compelled." The Bankruptcy Court's decision was reversed, and the property transferred to the senior lender remained subject to the junior lien.

Reaction to Clear Channel

The reaction to *Clear Channel* has been unequivocal. It can typically be summed up with the comment by one analyst, who said, "Rather than show deference to a long line of cases and the avowed purpose of avoiding rigid application of absolute priority, the court [in *Clear Channel*] limited the usefulness of 363 sales by engaging in a statutory analysis that is at best debatable, and at worst could be paralyzing."[8]

Similar to the reactions spurred by *Twist Cap* and *Octagon Gas*, many commentators were taken aback by the lack of understanding of standard business transactions on the part of the panel and the fact that the judges seemed to be distancing themselves from the commercial realities behind the cases confronting them.

As was said of the judges in *Octagon Gas*, "Instead of considering the commercial context and the general effect of the precedent that the opinion will establish, they interpret[ed] the [the statute] as if it precluded the application of other law and then, worse, as if it were a penal statute to be strictly construed, like the Internal Revenue Code."[9]

Courts considering the issues raised by *Clear Channel* appear to be in full agreement. A recent decision by the 6th Circuit BAP was particularly scathing in its assessment of *Clear Channel*'s reasoning with respect to Section 363(m):

> *Clear Channel* cited no case law for its conclusion and the overwhelming weight of authority disagrees with its holding that the Section 363(m) stay does not apply to the "free and clear" aspect of a sale under Section 363(f). *See, e.g., Canzano v. Ragosa (In re Colarusso),* 382 F.3d 51, 61-62 (1st Cir. 2004); *Wintz v. Am. Freightways Inc. (In re Wintz Co.),* 230 B.R. 840, 844-45 (B.A.P. 8th Cir. 1999); *Whatley Ranch Joint Venture LTD v. Whatley (In re Whatley),* 169 B.R. 698, 701 (D. Colo. 1994); *In re Wieboldt Stores Inc.,* 92 B.R. 309, 311 n.1 (N.D. Ill. 1988); *Int'l Union v. Morse Tool Inc.,* 85 B.R. 666, 668 (D. Mass. 1988); *Apex Oil Co. v. Vanguard Oil & Serv. Co. Inc. (In re Vanguard Oil & Serv. Co.),* 88 B.R. 576, 579-80 (E.D.N.Y. 1988); *Key Bank N.A. v. IRS (In re Lake Placid Co.),* 78 B.R. 131, 135 n.1 (W.D. Va. 1987); *Hicks v. Pearlstein (In re Magwood),* 785 F.2d 1077, 1080-81, 251 U.S. App. D.C. 389 (D.C. Cir. 1986).
>
> Perhaps more significantly, in a case that *Clear Channel* ignored, the 9th Circuit had previously applied Section 363(m) to a free and clear sale under Section 363(f). *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 Robert L. Helms Const. & Dev. Co. Inc.,* 139 F.3d 702, 704 n.2 (9th Cir. 1998). Accordingly, *Clear Channel* appears to be an aberration in well-settled bankruptcy jurisprudence applying Section 363(m) to the "free and clear" aspect of a sale under Section 363(f).[10]

Even within the 9th Circuit, *Clear Channel* has gained no traction. In *In re Jolan*,[11] the U.S. District Court for the Western District of Washington concluded that the *Clear Channel* opinion was limited to the issues and arguments that were presented to the BAP on appeal, and the District Court permitted a sale free and clear of junior liens under Section 363(f)(5) notwithstanding *Clear Channel*.

The District Court said *Clear Channel* took an overly narrow and limited look at the "legal and equitable proceeding" options:

> The panel considered only a few hypotheticals in which a lienholder could be compelled to accept a money satisfaction of its interest: enforcement of a buyout arrangement among partners, liquidated damages, and agreed damages in lieu of specific performance before holding that the availability of cramdown under Section 1129 does not satisfy Section 363(f)(5), as that would circumvent the substantive and procedural protections of Section 1129(b). In so concluding, it disagreed with courts outside this circuit holding to the contrary.[12]

The *Jolan* court had no difficulty in pinpointing a "legal or equitable proceeding" in which a junior lienholder could be compelled to accept a money satisfaction: a senior secured party's disposition of collateral under the default remedies provided in part VI of Article 9 of the UCC.

Conclusion

More than a year has now passed since *Clear Channel* was decided. The fears expressed by commentators regarding its effects on Section 363 sales have not and almost certainly will not come to pass. Practitioners and commentators have published articles rejecting the rationale of *Clear Channel*, and courts have uniformly refused to follow it. As with its legal forebears, *Twist Cap* and *Octagon Gas*, *Clear Channel* will lie in legal oblivion.

Notes

1. *Twist Cap v. Southeast Bank,* 1 B.R. 284 (Bankr. M.D. Fla. 1979).
2. *Octagon Gas Sys. v. Rimmer,* 995 F.2d 948 (10th Cir. 1993).
3. *Clear Channel Outdoor Inc. v. Knupfer (In re PW LLC),* 391 B.R. 25 (B.A.P. 9th Cir. 2008).
4. John J. Rapisardi, Stamp Tax Exemption, Claims Trading, Financial Sector, N.Y.L.J., Jan. 8, 2009, at 5.
5. John F. Dolan, Standby Credits Do Not Protect Landlords from the Bankruptcy Code's Lease Cap, 121 Banking L.J. 383, 384-389 (2003).
6. Richard F. Kadlick, *Legal Issues in Asset-Based Securities Offerings,* 704 PLI/Comm 289, 296-297 (1994).
7. Jason H. P. Karvitt, Securitization of Financial Assets 5-46-5-47 (Aspen Publishers 1996 & Supp. 2007) (1991).
8. Corrine Ball, *'Clear Channel': A Sea Change in 363 Sales?,* N.Y.L.J., Apr. 23, 2009, at 5.
9. Joseph H. Levie & Barbara M. Goodstein, *Suburban Trust: Narrow Interpretation of UCC,* N.Y.L.J., Aug. 29, 1996, at 5.
10. *Official Comm. of Unsecured Creditors v. Anderson Senior Living Prop. LLC (In re Nashville Senior Living LLC),* 407 B.R. 222 (B.A.P. 6th Cir. 2009).
11. *In re Jolan Inc.,* 403 B.R. 866 (W.D. Wash. 2009).
12. *Id.* at 868-69.

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