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New York Bankruptcy Court Adopts Expansive View of Section 363 Free and Clear Assets Sales

SHMUEL VASSER AND DEBORAH SOHN

The authors explain that a recent bankruptcy court decision provides better protections to asset purchasers in bankruptcy sales and indirectly will likely result in higher sale prices for sales under Section 363 — maximizing the value of the bankruptcy estate for the benefit of creditors.

In a recent decision,[1] the Bankruptcy Court for the Northern District of New York broadly interpreted the meaning of "interest" in the context of determining the scope of a sale free and clear of "liens, claims, encumbrances, and interests" under Section 363(f) of the Bankruptcy Code. "Interest" is an undefined term under the Bankruptcy Code. By adopting an expansive scope of the term "interest," the court's interpretation provides better protections to asset purchasers in bankruptcy sales and indirectly, will likely result in higher sale prices for sales under Section 363 and therefore maximize the value of the bankruptcy estate for the benefit of creditors.

FACTS

In re Tougher Industries, Inc., involved the sale of substantially all of the assets of two debtors, whose cases were jointly administered by the bank-

Shmuel Vasser, a partner in the New York office of Dechert LLP, can be reached at shmuel.vasser@dechert.com. Deborah Sohn, an associate in the firm's New York office, can be reached at deborah.sohn@dechert.com.

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ruptcy court. The purchasers continued to conduct the business operated by the debtors prior to the sale. The sale of the assets was authorized by the court, and the sale order included an express finding that the assets were being sold free and clear of all liens, claims, encumbrances, and interests as allowed under Section 363(f). The sale order specified that this included interests "relating to taxes arising under or out of, in connection with, or in any way relating to the operation of the Assets prior to the Closing…."

After the sale, the New York Department of Labor (the "DOL") asserted that the debtors' experience ratings — which were used to calculate unemployment insurance tax premiums — will be used to calculate the premiums due from the purchasers. The purchasers filed a motion in the bankruptcy court seeking a clarification that under the sale order the DOL is barred from using the debtors' experience rating in calculating the premiums due from the purchasers.

THE ISSUE

The purchasers argued that "interests" included the experience rating calculated by the DOL to assess the debtors' tax liabilities. The DOL does not appear to have directly challenged the purchasers on this front, rather, relying on the *Victory Markets*[2] opinion and the Tax Injunction Act, the DOL challenged the bankruptcy court's subject matter jurisdiction, arguing that the court did not have jurisdiction to determine the tax liability of the non-debtor purchasers.[3]

THE DECISION

The Bankruptcy Court framed the issue as dependent on the meaning of "interest" in Section 363(f) and proceeded to adopt an expansive definition of the term "interest" to include the debtors' experience rating as calculated by the DOL. The court first noted that in contrast to other courts that have limited the meaning of "interest" to *in rem* property interests,[4] the Second Circuit has interpreted the term more broadly to reach obligations that "arise from the property being sold."[5]

In reaching its decision, the court in *Tougher Industries* followed the

Second Circuit's expansive reading of "interest," as well as a recent decision by the First Circuit Bankruptcy Appellate Panel. In *In re PBBPC, Inc.*, the question presented was whether "interest" under Section 363(f) included the experience and contribution rate for taxes owed to the Massachusetts Department of Unemployment Assistance (the "DUA").[6] As in *Tougher Industries*, the purchaser in *PBBPC* challenged the DUA's assertion that it could tax the purchaser using tax rates calculated according to the debtor's experience rating. The bankruptcy court concluded that the contribution rate was an interest, and the First Circuit Bankruptcy Appellate Panel affirmed.[7]

Both the *Tougher Industries* and *PBBPC* courts rejected the reasoning of an older case, *In re Wolverine Radio Co.*, where the Sixth Circuit held that an employer's contribution rate was not an interest under Section 363(f) because it did not "attach[] to property ownership so as to cloud its title."[8]

Finally, the court in *Tougher Industries* also explained that its interpretation of "interest" was appropriate because it was consistent with the policy of maximizing the value of the asset and the return to creditors. The court reasoned, "[i]f the sale had not been free and clear, [the purchasers] would presumably have paid less for the assets."

IMPLICATIONS

This decision reflects a recent trend, both in the Second Circuit and elsewhere, towards an expansive interpretation of "interest" when determining the scope of a "free and clear" sale.[9] The *Tougher Industries* court emphasized the fact that its interpretation would maximize the purchase price for asset sales, for the benefit of the bankruptcy estate and ultimately the creditors. In addition, a narrower interpretation of "interest" could interfere with the relative priorities of creditors: if concerns about potential liability to junior creditors depressed the sale price, this would essentially elevate the junior claims at the expense of senior creditors, who would see a smaller recovery. A clear rule that provides for a broad interpretation of "interest" ensures that concerns about potential liability will not lower the sale price in future sales and will provide certainty to asset purchasers.

NOTES

[1] *In re Tougher Industries, Inc.*, Case No. 06-12960 (Bankr. N.D.N.Y., Mar. 27, 2013). The sale order also provided that the purchasers shall not be deemed successors to the sellers, a finding not challenged directly by the DOL.

[2] *In re Victory Markets, Inc.*, 263 B.R. 9 (Bankr. N.D.N.Y. 2000).

[3] The DOL also argued that the Tax Injunction Act prevented the court from enjoining a tax assessment. The court rejected these arguments because the purchasers did not seek a determination of their tax liabilities, but rather an interpretation of the court's sale order.

[4] *See, e.g., Fairchild Aircraft Corp. v. Campbell (In re Fairchild Aircraft Corp.)*, 184 B.R. 910, 917–18 (Bankr. W.D.Tex. 1995), *vacated on other grounds*, 220 B.R. 909 (Bankr. W.D.Tex. 1998) ("Section 363(f) does not authorize sales free and clear of *any interest*, but rather of *any interest in such property*…. The sorts of interests impacted by a sale 'free and clear' are *in rem* interests which have attached to the property. Section 363(f) is not intended to extinguish *in personam* liabilities.").

[5] *See In re Grumman Olson Industries, Inc.*, 467 B.R. 694, 702–03 (S.D.N.Y. 2012) (quoting *In re Chrysler, LLC*, 576 F.3d 108, 126 (2d Cir. 2009), *vacated as moot*, 130 S.Ct. 1015 (2009)).

[6] 484 B.R. 860 (1st Cir. B.A.P., Jan. 17, 2013).

[7] *Id.* at 869 ("We therefore conclude that the term 'any interest' as used in § 363(f) is sufficiently elastic to include the Debtor's experience rate. Indeed, the record reflects that the transfer of an employer's contribution rate to a successor asset purchaser is really an attempt to recover the money that the predecessor employer would have paid if it had continued in business. The liability for the increased rate thus follows any purchase of substantially all of the assets of an employer.").

[8] 930 F.2d 1132, 1146 (6th Cir. 1991).

[9] *See also In re Leckie Smokeless Coal Co.*, 99 F.3d 573, 582 (4th Cir. 1996) (obligation to pay money into an employee benefit plan and fund was an "interest" that could be extinguished); *but cf. Thomas & Betts Power Solutions, L.L.C.*, Case Nos. 12-2440; 12-3029 (7th Cir., Mar. 26, 2013). In *Thomas & Betts*, the Seventh Circuit considered the extent of successor liability for a purchaser who had purchased the assets of Bray, a company that had been placed under receivership. Bray's main asset was its stock in a subsidiary (Packard), and the stock of Packard was sold to the purchaser "free and clear of all liabilities."

Packard was the defendant in an action brought by Packard employees under the Fair Labor Standards Act, and the plaintiffs then sought to substitute the purchaser as the defendant in their action.

The Seventh Circuit held that there is a general federal policy in favor of finding successor liability for liabilities under federal labor or employment laws, and found that the "free and clear" sale did not extinguish the purchaser's liability to the FLSA plaintiffs. Although this case appears to have important implications in the context of Section 363 sales, the decision is distinguishable and may in fact have a very narrow scope. The sale was characterized as an asset sale, because the purchaser bought all the assets of Bray. The "assets," however, consisted of the Packard stock and therefore, the sale of Packard was in fact an equity sale. Under established bankruptcy law, a purchaser who buys the equity interests of a company, rather than its underlying assets, does not purchase free and clear of liabilities against the company's assets. The result in *Thomas & Betts* is, therefore, unexceptional.