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Freer and Clearer Sales: Using § 363(f) to Strip Non-Traditional Interests from Distressed Assets

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Imagine that there is a business struggling with an unsustainable debt load. As a result of these pressures on cash flow, the business cuts corners, including worker safety, resulting in an increase in workplace injuries. The injury experience causes workers' compensation insurance premiums to escalate, which further burdens limited cash flows. As its debts continue to climb and credit defaults grow, the business and its major creditors agree that an asset sale is the only option to maximize value and protect jobs. A voluntary sale by the business is impossible because of junior liens, thus a "friendly foreclosure" or bankruptcy sale are the only viable options to effectuate a "free and clear" sale to a buyer. A foreclosure is likely quicker and cheaper, but it puts the senior lienholders rather than other constituencies in control of the sale process. A bankruptcy sale gives more constituents a voice in the sale process, but it comes with its own challenges, including increased administrative costs and potential opposition arising from the general uneasiness about the proliferation of "sale cases" in recent decades.

A recent decision from the U.S. Bankruptcy Court for the District of New Hampshire may serve to tip the scales in favor of a bankruptcy sale rather than a foreclosure sale under these circumstances. In *In re ARSN Liquidating Corp.*,[1] Hon. **Bruce A. Harwood** held that a debtor's workers' compensation experience rating is an "interest" for purposes of § 363(f), meaning that the assets can be conveyed to the buyer "free and clear" of the experience rating. This might be a critical consideration for the business and its creditors, because in a bankruptcy sale — unlike a foreclosure sale — the asset value will not be impaired by the debtor's prebankruptcy workers' compensation experience.

The Meaning of "Any Interest" Under § 363(f)

Under § 363(f), a debtor or trustee "may sell property ... free and clear of any interest in such property of an entity other than the estate."[2] However, the Bankruptcy Code does not define "any interest," and courts have been unable to supply a uniform definition. As a result, the scope of the term has been addressed on a case-by-case basis, leading to divergent opinions across the U.S.[3]

A distinct minority of courts have narrowly interpreted the term "interest" to encompass only *in rem* interests in property, such as liens.[4] This result is unsurprising, though clearly underinclusive, since § 363(f)(3) specifically provides that a debtor may sell free and clear of an interest if "such interest is a lien." However, since three of the other four subsections of § 363(f) refer to sales free of "interests" without reference to liens, "the trend seems to be in favor of a broader definition that encompasses other obligations that may flow from ownership of the property."[5] For example, the Fourth Circuit has held that a debtor may sell coal assets free and clear of successor liability for statutory employee retirement benefits;[6] the Third Circuit has blessed the sale of airline assets free and clear of liability for prepetition customer travel vouchers;[7] and the Seventh Circuit has upheld real estate sales free and clear of a lessee's possessory property interests.[8] Thus, there is a national consensus that assets might be sold free of interests beyond mere liens under § 363(f), though there remains disagreement about the outer boundaries of what constitutes "any interests" for this purpose.

PBBPC Inc.

In *In re PBBPC Inc.*, the First Circuit Bankruptcy Appellate Panel (BAP) addressed the question of whether the "free-and-clear" provisions of a sale order prevented the unemployment division of the Massachusetts Department of Workforce Development (the "state") from imputing the debtor's unemployment experience rating to the purchaser of the debtor's assets as a "succes-

1 *In re ARSN Liquidating Corp.*, No. 14-11527-BAH, 2017 WL 279472 (Bankr. D.N.H. Jan. 20, 2017).
2 11 U.S.C. § 363(f).
3 *See PBBPC Inc. v. OPK Biotech LLC (In re PBBPC Inc.)*, 484 B.R. 860, 867 (B.A.P. 1st Cir. 2013) (citing *Precision Indus. Inc. v. Qualitech Steel SBQ LLC*, 327 F.3d 537, 545 (7th Cir. 2003); *In re Trans World Airlines Inc.*, 322 F.3d 283, 288-89 (3d Cir. 2003); *Folger Adam Sec. Inc. v. DeMatteis/MacGregor JV*, 209 F.3d 252, 258 (3d Cir. 2000)).
4 *See, e.g., Fairchild Aircraft Inc. v. Campbell (In re Fairchild Aircraft Inc.)*, 184 B.R. 910, 917-18 (Bankr. W.D. Tex. 1995); *Mich. Emp't Sec. Comm'n v. Wolverine Radio Inc. (In re Wolverine Radio Inc.)*, 930 F.2d 1132, 1145-49 (6th Cir. 1991).
5 5 *Collier on Bankruptcy* ¶ 363.05[6][1] (Alan Resnick & Henry Sommer, eds., 16th ed. rev.).
6 *UMWA 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*, 99 F.3d 573, 582 (4th Cir. 1996).
7 *Trans World Airlines*, 322 F.3d at 289-90.
8 *Precision Indus.*, 327 F.3d at 545.

sor employer."[9] Prior to its bankruptcy filing in 2009, the debtor had laid off nearly all of its employees, resulting in a high unemployment experience rating with the state.[10] On the petition date, the debtor filed a motion seeking the authority to sell substantially all of its assets free and clear of liens, claims and encumbrances of any kind under § 363(f).[11] When the bankruptcy court approved the sale a few months later, the order specifically provided that the assets were being transferred free of successor liabilities for "claims that might arise under ... state unemployment compensation laws or any other similar state laws."[12]

After closing on the transaction, the purchaser commenced operations in Massachusetts and notified the state of its acquisition of the debtor's assets. Subsequently, the state notified the purchaser that it was a "successor employer" to the debtor under Massachusetts law and that its unemployment contribution rate would therefore be based on the debtor's experience rating.[13] Following unsuccessful administrative litigation and appeals, the purchaser filed a motion in the bankruptcy court seeking to enforce the sale order's free-and-clear provisions.[14] The bankruptcy court granted the motion, holding that the debtor's unemployment experience rating was an "interest" under § 363(f) and that the purchaser had therefore acquired the assets free and clear of this interest.[15] The state appealed, and the First Circuit BAP affirmed. Writing for a unanimous panel, Hon. **J. Michael Deasy** concluded that:

> the more expansive reading of the term "any interest" advanced by the Seventh, Fourth, Third, and Second Circuits ... is more consistent with the language of the Bankruptcy Code and the policy expressed in § 363. We therefore conclude that the term "any interest" as used in § 363(f) is sufficiently elastic to include the Debtor's experience rat[ing].[16]

Significant to the BAP's conclusion was 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."[17] Thus, the experience rating was an "interest" flowing from the assets that was stripped by § 363(f), and the state could not treat the purchaser as a "successor employer" to the debtor.

ARSN Liquidating Corp.

Before its bankruptcy in 2014, the debtor, American Resource Staffing Network Inc.,[18] was in the business of supplying temporary workers to a variety of businesses in New Hampshire and Massachusetts.[19] In its bankruptcy case, the debtor sought to sell substantially all of its assets, and the bankruptcy court ultimately entered a sale order in December 2014 pursuant to § 363(f).[20] The sale order specifically provided that:

> The Sale shall be free and clear of any and all liens, claims (as that term is defined in the Bankruptcy Code), mortgages, guarantees, security interests, pledges, charges, taxes (including Federal, States, SUTA and FUTA taxes as well as workers' compensation and other claims pending as of the closing date of the sale), obligations, rights, interests (including any retaining or possessory liens or interests) and encumbrances, whether arising prior to or subsequent to the filing of the Chapter 11 petition initiating this case, whether imposed by agreement, understanding, law equity or otherwise (collectively, the "Encumbrances").... The Purchaser is an entirely new and separate entity from the Debtor and is only purchasing the Assets of the Debtor free and clear of the Encumbrances.[21]

After the sale order was entered, the National Council on Compensation Insurance (NCCI) issued a letter ruling indicating that the purchaser was subject to the debtor's prior experience rating on the grounds that NCCI's *Rating Plan Manual* generally provides that a change in ownership does not modify a company's experience rating and the company's experience rating will be transferred to the acquiring, surviving or new entity.[22] After following NCCI's internal appeals procedure, the purchaser filed a motion to enforce the sale order on the grounds that NCCI had violated the free-and-clear provision of the sale order by imputing the debtor's experience rating to the purchaser.[23] NCCI objected, arguing that its imposition of the debtor's workers' compensation experience rating to the purchaser was distinguishable from the unemployment issues in *PBBPC*. NCCI argued that unlike unemployment taxes, a company's workers' compensation experience rating is not intended to recover money that the predecessor employer would have paid if it had stayed in business; rather, the purpose of the experience rating is to assist in underwriting the workers' compensation insurance and determine the applicable insurance rates going forward.[24]

The bankruptcy court rejected NCCI's arguments and determined that a workers' compensation experience rating is "similar enough" to the unemployment-tax contribution considered in *PBBPC* to enforce the free-and-clear provisions of the sale order.[25] In doing so, the bankruptcy court stated:

> Buyers at § 363 sales should be burdened (or benefited) by a debtor's workers' compensation experience rating where the sale order makes clear ... that the buyer is an entirely new and separate entity from the debtor and is only purchasing the debtor's assets free and clear of all liens, claims, interests, and encumbrances of any kind and nature.[26]

9 *PBBPC*, 484 B.R. at 866.
10 *Id.* at 862.
11 *Id.* at 861.
12 *Id.* at 862.
13 *Id.* at 862-63.
14 *Id.* at 863.
15 *Id.* at 864.
16 *Id.* at 869.
17 *Id.*
18 American Resource Staffing Network Inc. filed a chapter 11 petition on July 31, 2014. As part of the sale, the debtor was required to change its name. American Resource Staffing Network Inc. became ARSN Liquidating Corp. Inc. *ARSN Liquidating Corp.*, 2017 WL 279472, at *1, n.1.
19 *Id.*
20 *Id.* at *2.
21 *Id.*
22 *Id.* at *3.
23 *Id.*
24 *Id.* at *4.
25 *Id.* at *5.
26 *Id.*

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Practice Pointers

Counsel for both debtors and creditors should be aware of the recent decisions in *PBBPC* and *ARSN Liquidating* when faced with determining how to proceed with maximizing value in a distressed-business sale. These cases continue the national trend among bankruptcy and appellate courts of interpreting the outer boundaries of § 363(f) expansively (or, in the words of the First Circuit BAP in *PBBPC*, "elastic[ally]").

The types of interests burdening the value of distressed assets are often not merely liens securing monetary obligations, but as in *ARSN Liquidating* and *PBBPC*, non-traditional interests such as a debtor's poor unemployment or workers' compensation experience rating. Under these circumstances, voluntary and "friendly foreclosure" sales cannot unlock the full value of the assets, because neither type of sale can convey assets to a purchaser free and clear of such interests at state law. Instead, practitioners should strongly consider bankruptcy sales, which might enable the assets to be sold free and clear of the workers' compensation and unemployment ratings, as well as other non-traditional interests. Offering purchasers the broader relief available under § 363(f) might enable debtors and creditors to achieve a higher and better sale price, benefiting all constituencies of the estate.[27] abi

27 As previously noted, in determining whether a bankruptcy sale is the right option, practitioners should also consider other key sale issues, including whether a pre-plan sale of all the debtor's assets is supported by a sound business purpose. *See, e.g., Dai-Ichi Kangyo Bank Ltd. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)*, 242 B.R. 147, 153 (D. Del. 1999); *In re Gen. Motors Corp.*, 407 B.R. 463, 490 (Bankr. S.D.N.Y. 2009). In addition, assuming that all interest-holders do not consent to the sale, the debtor must be able to satisfy one of the other tests set forth in § 363(f), which is not without controversy. *See, e.g., Clear Channel Outdoor Inc. v. Knupfer (In re PW LLC)*, 391 B.R. 25, 47 (B.A.P. 9th Cir. 2009) (disallowing sale under § 363(f)(3) and (5) over objection of junior lienholder); *but see In re Jolan Inc.*, 403 B.R. 866, 866-67 (Bankr. W.D. Wash. 2009) (declining to apply *Clear Channel* and approving sale over junior lienholder's objection under § 363(f)(5)); *In re Boston Generating LLC*, 440 B.R. 302, 332 (Bankr. S.D.N.Y. 2010) (rejecting *Clear Channel* and approving sale under § 363(f)(5)); *In re WK Lang Holdings LLC*, No. 13-11934, 2013 WL 6579172, at *8 (Bankr. D. Kan. Dec. 11, 2013) (rejecting *Clear Channel* and approving sale under § 363(f)(5)).