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Bankruptcy sales create opportunity, traps for unwary

April 06, 2010 - Financial Digest

In the current economic climate, bankruptcy sales offer opportunities and challenges to debtors, lenders and buyers. A "debtor in possession" may, with court approval, sell some or substantially all its assets outside the ordinary course of its business if, in the debtor's judgment, the sale will benefit the bankruptcy estate. Such sales can be approved and closed rapidly (as in the much-discussed Chrysler and General Motors cases) and may offer the only source of financing in an otherwise illiquid market.

For a debtor, a sale offers a chance to monetize assets quickly, even over objections by secured lenders and co-tenants. Property may be sold free and clear of "interests," which attach to the proceeds of sale. Although "interests" is not defined in the Bankruptcy Code, courts have held that the term encompasses a variety of liens, claims and encumbrances. For example, property may be sold free of liens if the sale price exceeds the aggregate value of all liens on the property. Some courts use an essentially circular definition of "value" that permits sale free of virtually any lien, and others permit the sale of over-encumbered property if the court concludes that the lender could be "crammed down" under a plan of reorganization. Property has also been sold free of the interests of tenants in common over strenuous opposition by the TICs. Debtor-tenants have forced lease assignments on unwilling landlords (even where the lease prohibits assignment) where the assignee demonstrates that it has the financial wherewithal to perform the tenant's obligations. Debtor-landlords have sold property free of tenant leasehold interests, although tenants may protect themselves by making timely demands for "adequate protection" of their interests.

For a buyer, the sale offers a chance to take good title to property purchased at a below-market price, since court-approved bidding procedures may not cause the bankruptcy estate to realize the full value of the property. Such procedures, often drafted with input from a "stalking horse" bidder, may impose strict bidder qualifications, allow no financing contingencies and offer little chance to conduct due diligence. A successful bidder generally requires and receives court findings that it is a good faith purchaser that paid reasonably equivalent value for the property and is not a successor in interest of the debtor. Such findings bind all of the debtor's creditors with notice of the sale. Where the buyer is found to be a good faith purchaser, the sale - and the buyer's title - will be unaffected even if the court order approving the sale is reversed on appeal, except in the (unlikely) event that the party challenging the sale persuades a court to stay the closing while the appeal is pending.

For a lender, the sale offers an opportunity to monetize its collateral without the cost, expense and delay of a judicial foreclosure or other litigation. Indeed, lenders have offered new financing contingent upon a quick bankruptcy sale (typically followed by a court-approved distribution of the debtor's residual cash to secured and unsecured creditors). The lender may be able to direct the timing and conditions of sale and, depending on the state of the title, may find a title company easier to deal with when the property will be sold free of interests by order of a federal court.

Bankruptcy sales have become increasingly prevalent, particularly in beleaguered sectors such as retail and restaurant, but their complexity creates traps for the unwary. Non-debtors must be particularly vigilant in protecting their interests when a bankruptcy sale is in prospect.

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