Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

'Free And Clear' Means Free And Clear

Law360, New York (June 21, 2013, 1:21 PM ET) -- In bankruptcy sales outside a plan of reorganization, Section 363(f) of the Bankruptcy Code permits estate property to be sold "free and clear of any interest in such property." In the absence of a Bankruptcy Code definition of "interest," the scope of the free and clear power of section 363(f) has been addressed by the courts on a case-by-case basis.

A clear trend toward an expansive definition of the term "interest" has emerged, with many courts — including those in the Second, Third and Fourth Circuits — concluding that the term is not limited to liens or other in rem rights in the transferred assets and can include successor liability claims against the asset purchaser, protecting the purchaser against such claims when the sale order so provides.

A recent decision of the U.S. Bankruptcy Appellate Panel for the First Circuit reflects a view following the emerging trend. In Massachusetts Department of Unemployment Assistance v. OPK Biotech LLC (In re: PBBPC Inc.), 484 B.R. 860 (B.A.P. 1st Cir. 2013), the appellate panel affirmed an order of the U.S. Bankruptcy Court for the District of Massachusetts, enforcing the sale of a debtor's assets free and clear of any "interest" in such property, including the right of the Massachusetts Department of Unemployment Assistance to tax the purchaser at the debtor's unemployment contribution rate, effectively cutting off the successor liability of the purchaser under Massachusetts' unemployment insurance statute.

The PBBPC Litigation

Immediately following its filing for Chapter 11 bankruptcy on July 16, 2009, PBBPC Inc., formerly known as Biopure Corp., filed a motion with the U.S. Bankruptcy Court for the District of Massachusetts seeking approval of the sale of substantially all of its operating assets to OPK Biotech, pursuant to section 363(f). The bankruptcy court approved the sale to OPK in an order specifically stating that the transfer to OPK was "free and clear" of all liens, claims, encumbrances and interests, including "any claims pursuant to any successor or successor-in-interest liability theory." The sale closed in September 2009, and OPK commenced operations in Massachusetts in October of the same year.

Following the sale, OPK was notified by the Massachusetts Department of Unemployment Assistance that, as a result of OPK's purchase of substantially all of Biopure's assets, OPK was considered a "successor employer" within the meaning of the Massachusetts unemployment insurance statute, Chapter 151A of the Massachusetts General Laws, and that OPK was accordingly assigned Biopure's experience rating for purposes of contributions to Massachusetts' unemployment compensation fund.

As a result of Biopure's termination of nearly all of its employees prior to the sale, its experience rating was especially high, and the DUA's assignment of that rate to OPK saddled the purchaser with a contribution rate much steeper than the rate that would have applied to it otherwise.

Placing on hold its administrative appeal to challenge the DUA's imposition of successor status, OPK moved the bankruptcy court to enforce the sale order, contending that the DUA was violating the order by charging OPK for unemployment insurance contributions according to Biopure's higher experience rating. Specifically, OPK argued, among other things, that its successor liability (if any) under the Massachusetts unemployment insurance statute was preempted by Section 363(f) of the Bankruptcy Code.

Bankruptcy Court Decision

On Feb. 27, 2012, the bankruptcy court issued a memorandum of decision holding that the DUA's right to tax OPK according to Biopure's higher experience rating was an "interest" in property within the meaning of section 363(f), and that the application of the federal statute to that "interest" preempted any state law to the contrary, including the Massachusetts unemployment insurance statute. In re: PBBPC Inc., 467 B.R. 1 (Bankr. D. Mass. 2012) (Bailey, J.).

Subsequently, on July 2, 2012, the bankruptcy court, relying on the reasoning set forth in its earlier decision, entered an order declaring that the sale of Biopure's assets to OPK pursuant to the sale order was free and clear of Biopure's experience rate and contribution rate.

In concluding that the DUA's right to tax OPK as a "successor employer" according to Biopure's higher experience rating was an "interest" that could be cut off in a "free and clear" sale order under section 363(f), the bankruptcy court first acknowledged that the DUA's taxation right under the Massachusetts statute was not "a lien or a right to take specific assets, or any assets, in satisfaction of a claim." In other words, the DUA did not have an in rem claim against the assets transferred to OPK.

Nevertheless, the bankruptcy court focused on the "clear relationship" between the DUA's right to tax OPK as a "successor employer" and the asset transfer on which that right was predicated under the Massachusetts statute, which imposed a debtor's experience rating on a buyer "precisely because, and only because, the buyer purchased estate assets." See Mass. Gen. Laws ch. 151A, § 14(n)(1) ("[i]f the entire organization, trade or business of an employer, or substantially all the assets thereof, are transferred to another employer ..., the transferee shall be considered a successor ....").

The bankruptcy court concluded that the relationship between the DUA's taxation right under the Massachusetts statute and the asset transfer was dispositive, converting the taxation right to an "interest" in property, within the meaning of section 363(f).

In reaching its holding, the bankruptcy court noted that no binding precedent on the issue existed in the First Circuit and determined to follow the reasoning of the Fourth Circuit in United Mine Workers of America 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re: Leckie Smokeless Coal Co.), 99 F.3d 573 (4th Cir. 1996), which, in determining the limits of section 363(f)'s "free and clear" power, had observed: "Congress did not expressly indicate that, by employing such language [i.e., 'interests in such property' in § 363(f)], it intended to limit the scope of section 363(f) to in rem interests, strictly defined, and we decline to adopt such a restricted reading of the statute."

In Leckie Smokeless, the Fourth Circuit held that the rights of certain employer-sponsored benefits plans to collect taxes from coal operators pursuant to federal statute constituted "interests" in property that could be extinguished in a sale pursuant to section 363(f), regardless of whether the purchasers of the coal operators' assets had successor liability for the taxes under the federal statute.

In concluding that the rights to collect the taxes were "interests" in property within the meaning of section 363(f), the Fourth Circuit focused on the relationship between the right of the plans to collect the taxes, on one hand, and the use of the transferred assets, on the other hand: "[I]f [the coal operators] 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 [plans] would have no right to seek premium payments from them."

As one court has observed, Leckie Smokeless suggests that the term "interests," within the meaning of section 363(f), is intended to refer to "obligations that are connected to, or arise from, the property being sold." Folger Adam Sec., Inc. v. DeMatteis/MacGregor, (3rd Cir. 2000). In concluding that the DUA's taxation right was an "interest" in property, the bankruptcy court in PBBPC, expressly following Leckie Smokeless, relied on a similar connection between the DUA's taxation right and the asset transfer.

Bankruptcy Appellate Panel on Appeal

On Jan. 17, 2013, the First Circuit Bankruptcy Appellate Panel affirmed the order of the bankruptcy court enforcing the sale of Biopure's assets free and clear of any interest in those assets, including the DUA's right to tax OPK as a "successor employer" according to Biopure's higher experience rating.

With the DUA having waived the issue of whether section 363(f) preempted the Massachusetts unemployment insurance statute, the sole issue on DUA's appeal to the appelate panel was whether the DUA's taxation right under the Massachusetts statute was an "interest" in property, within the meaning of section 363(f).

In concluding that the term "interest" was "sufficiently elastic to include [Biopure's] experience rate," the BAP reviewed case law across circuits, taking specific note of key cases utilizing section 363(f) to cut off any successor liability of the asset purchaser, including:

(1) The Fourth Circuit's decision in Leckie Smokeless, 99 F.3d 574 — Successor liability of purchasers of coal operators' assets for taxes owed to employer-sponsored benefits plans could be extinguished in section 363(f) sale.

(2) The Third Circuit's decision in In re: Trans World Airlines Inc., 322 F.3d 283 (3d Cir. 2003) — Successor liability of purchaser American Airlines for employee discrimination claims and claims related to travel voucher program awarded in settlement of class action could be cut off in section 363(f) sale.

(3) The Second Circuit's decision in Indiana State Police Pension Trust v. Chrysler LLC (In re: Chrysler LLC), 576 F.3d 108 (2d Cir. 2009) that a sale order could, under section 363(f), properly cut off new Chrysler's successor liability for product defects in vehicles produced by old Chrysler, certiorari granted and judgment vacated on other grounds, 130 S. Ct. 1015 (2009).

In OPK, while the bankruptcy appellate panel shared the bankruptcy court's focus on the relationship between the DUA's taxation right under the Massachusetts statute and the asset sale, it also emphasized the bankruptcy policy goals achieved by bringing the DUA's taxation right within the "free and clear" power of section 363(f), noting that the possibility of transferring assets free and clear of successor liability was a "critical inducement" to the sale.

Implications

The First Circuit Bankruptcy Appellate Panel's decision in PBBPC is part of a continually developing body of case law identifying claims that can (and cannot) be cut off in a "free and clear" sale order under section 363(f). In PBBPC, the appellate panel agreed that section 363(f) cuts off a state's right to tax a purchaser of a debtor's assets for unemployment insurance according to the debtor's experience rating because that rating is an "interest" in property.

The appellate panel's decision was recently followed by another decision by the U.S. Bankruptcy Court for the Northern District of New York, which determined that a section 363(f) sale order cut off similar successor liability claims under New York Labor Law. See In re: Tougher Indus., (Bankr. N.D.N.Y. Mar. 27, 2013).

Moreover, although the BAP followed the expansive reading of the term "interests" now espoused by a number of circuits and expressly followed the Fourth Circuit's decision in Leckie Smokeless, it is possible to read PBBPC as establishing a new test for when claims have a sufficient nexus to transferred property as to be converted to "interests" in that property — one that is slightly different from the test set out in Leckie Smokeless.

In Leckie Smokeless, the court focused on the relationship between the claims and the use of the transferred assets in bringing the tax claims within the "free and clear" power of section 363(f). There, the fact that the tax claims would not have existed but for the use of the assets in the coal-mining industry was dispositive.

In PBBPC, however, both the bankruptcy court and the bankruptcy appellate panel focused on the relationship between the tax claims and the sale of the transferred assets in reaching the same result. Although the difference is nuanced (and although PBBPC seems to implicitly focus on the lack of any conduct of the purchaser that would give rise to in personam liability), the PBBPC analysis could potentially be interpreted to extend section 363(f)'s "free and clear" power to a broader set of claims.

Under the PBBPC test, the liability arguably need only be imposed on the purchaser because of an asset sale in order to be converted to an "interest" in property — without any need for the liability to be premised or conditioned on the quality or use of the assets.

—By Douglas R. Gooding and Meg McKenzie Feist, Choate Hall & Stewart LLP

Douglas Gooding chairs Choate Hall & Stewart's finance group in Boston and Meg McKenzie Feist is an associate in the group in Boston.

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.