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U.S. Supreme Court's Section 363(m) Holding Provides Negotiating Leverage to Purchasers and Parties in Interest in Bankruptcy Sales

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On April 19, 2023, the U.S. Supreme Court held that Section 363(m) is a not a jurisdictional provision. Thus, challenges to Section 363 sales that have closed can be heard on appeal notwithstanding a Section 363(m) finding in the sale order, so long as the appellate decision does not affect the validity of the sale to a good faith purchaser.¹

This holding creates further uncertainty for Section 363 purchasers in terms of total legal fees involved when purchasing property in a bankruptcy sale, as said sale can now be appealed. Purchasers should attempt to use this uncertainty to their advantage by raising it with the Debtor in Possession, where appropriate, to secure more favorable purchase terms. Further, Parties in Interest can take advantage of this uncertainty by threatening to object to a Section 363 sale that does not contain terms favorable to it, and to further appeal a Section 363 court order denying its objection. Such action, if taken, will now significantly increase Debtor's litigation costs associated with the sale, and could convince the Debtor to come to the table and seriously consider the Party in Interest's proposed sale terms at the outset.

Background

The original dispute arose between Mall of America owner MOAC Mall Holdings LLC and Transform Holdco LLC. In its Chapter 11 bankruptcy, Sears, Roebuck and Co. "sold most of its pre-bankruptcy assets to respondent Transform Holdco LLC, including the right to designate to whom a lease between Sears and petitioner MOAC Mall Holdings LLC should be assigned."² Thereafter, Transform "designated the Mall of America lease for assignment to its wholly owned subsidiary," Transform Leaseco LLC.³ MOAC objected to this assignment, "in part because Transform Holdco is a nonretail entity that does not plan to occupy the space, and is therefore not an appropriate assignee of the lease"⁴ under Section 365(f)(2)(B) of the Bankruptcy Code.⁵

The Bankruptcy Court did not find MOAC's argument convincing, and permitted the assumption and assignment of the lease.⁶ MOAC, "looking to §363(m)'s safe harbor for certain orders that are 'stayed pending appeal'"⁷ sought a stay on the assignment. The Bankruptcy Court denied MOAC's request, and "emphasized that Transform had explicitly represented that it would not invoke §363(m) against MOAC's appeal" of the assignment.⁸ On appeal, the District Court initially agreed with MOAC and concluded that the assumption and assignment of the lease did not satisfy Section 365(f) of the Bankruptcy Code. However, Transform sought rehearing, and for the first time argued that Section 363(m) barred "the District Court of Jurisdiction to grant MOAC's requested relief", "backing away from its previous disclaimers" on the Section 363(m) issue.⁹ The District Court, noting that it was "appalled" "by Transform's gambit of waiting to invoke §363(m) until after losing the merits of the appeal", nevertheless determined that Second Circuit precedent required that §363(m) be treated as jurisdictional, rendering it not subject to "waiver or judicial estoppel".¹⁰ Based on this, the District Court held that §363(m) was applicable, barring the appeal and leaving the Assignment Order in place.¹¹

At the appellate level, the Second Circuit Court of Appeals affirmed the District Court ruling, with the Supreme Court reversing the Second Circuit decision.

Bankruptcy Code Provisions At Issue

Sections 363(b)(1) and 363(m) of the Bankruptcy Code drive this issue. Section 363(b)(1) "generally permits a bankruptcy trustee, after notice and hearing, to use, sell or lease property that belongs to the bankruptcy estate outside of the ordinary course of business."¹² Section 363(m) "protects good faith purchasers at these bankruptcy sales, and states that the reversal or modification on appeal of a Section 363 bankruptcy sale or lease does not affect the validity of that sale or lease where the subject property was acquired in good faith, unless the sale or lease was stayed pending appeal."¹³

In full, Section 363(m) states that:

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 a 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.¹⁴

Judicial Interpretation of Section 363(m)

Prior to this Supreme Court case, Transform was successful in convincing appellate courts (both the District Court and the Second Circuit Court of Appeals) that MOAC lacked jurisdiction, arguing that Section 363(m)'s prohibition on appellate courts "affect[ing] the validity of a sale or lease" that has closed to a good faith purchaser prohibited those courts from hearing issues regarding such sales.¹⁵ As noted by the Second Circuit, such a jurisdictional bar reflects Congress' "uniquely important interest in assuring the finality" of Section 363 sales.¹⁶

The Supreme Court, disagreeing with the Second Circuit and overturning its decision, held that "Section 363(m) is not a jurisdictional provision."¹⁷ In doing so, the Supreme Court explained that "jurisdictional rules" (i.e. whether a Court can hear a dispute in the first place) "pertain to the power of the court", are

“impervious to excuses like waiver or forfeiture”¹⁸ and do not pertain to “the rights or obligations of the parties” (i.e. what rights a party has on appeal).¹⁹ As articulated by the Supreme Court, a statute only creates a jurisdictional bar on appellate courts hearing disputes when “Congress ‘clearly states’ as much”.²⁰ Regarding Section 363(m), because Congress did “not clearly stat[e] that the provision is a limit on judicial power, rather than a mere restriction on the effects of a valid exercise of that power when a party successfully appeals a covered authorization”,²¹ Section 363(m) does not prevent appellate courts from hearing issues stemming from Section 363 sales.

In sum, and as stated above, issues stemming from Section 363 sales that have closed can be heard on appeal, so long as the appellate decision does not affect the validity of the sale to a good faith purchaser.

Future Impact of Supreme Court Decision

The issue now becomes: What **can** an appellate court decide on appeal under this framework? If a successful appeal does not affect the validity of the underlying sale, what exactly does an appellant gain?

The Supreme Court does not provide substantive clarity on this question, leaving future parties to Section 363 sales at the helm of courts across the nation who may have differing perspectives on the issue. By way of example, the Third Circuit Court of Appeals, which has differed from the Second Circuit and did not consider Section 363(m) to be a jurisdictional barrier, requires that an appellate court consider “whether the grant of relief would, in effect, ‘claw back the sale,’” and further requires a Section 363 sale challenger to “demonstrate that the relief affects only ‘collateral issues not implicating a central or integral element of the sale’ for said challenger to be successful on appeal.”²²

In sum – the standard provides little prospective certainty for all parties to a 363 Sale, with the Court itself noting that the “requested relief may require more careful study depending on the nature of the claim and the type of relief sought[.]”²³ In other words, and in light of the complex negotiations and terms often found in Section 363 sales, following a successful appeal, courts now will have to grapple with whether a petitioner’s requested relief in response to a challenged sale term would affect the validity of the Section 363 sale with little concrete guidance and, if so, determine what alternative relief would be appropriate.

This lack of concrete guidance has led to past controversial opinions on Section 363(m) in jurisdictions not subject to the Second Circuit’s now overturned jurisdictional bar. By way of example, in *In re ICL Holding Co.*, the U.S. government appealed a Section 363 sale term wherein the 363 purchaser would place \$3.5 million dollars in trust for the benefit of general unsecured creditors, arguing that the arrangement would violate the Bankruptcy Code’s creditor-payment hierarchy. The Third Circuit Court of Appeals ultimately held that the \$3.5 million was not property of the Bankruptcy Estate and therefore not subject to the Code’s creditor-payment hierarchy. However, the Court separately noted that the \$3.5 million fund could have been altered (if the Court so chose) without violating Section 363(m), as doing so would not have changed a fundamental term of the transaction. The Third Circuit came to this decision despite the fact that: 1) both the Unsecured Creditors’ Committee and the Debtor felt differently; and 2) the \$3.5 million was negotiated in exchange for a commitment by the Unsecured Creditor’s Committee to not object to the Section 363 sale at the outset.²⁴

Although the Supreme Court's reasoning is sound, the uncertainty stemming from this decision can be used to a Section 363 purchaser's or Party in Interest's advantage. Purchasers can use this uncertainty to their advantage by raising it with the Debtor in Possession, where appropriate, to secure more favorable purchase terms, including, but not limited to, a more favorable sale price. Further, Parties in Interest can take advantage of this uncertainty by threatening to object to a Section 363 sale that does not contain terms favorable to it, and to further appeal a Section 363 court order denying its objection. As stated above, such action, if taken, will now significantly increase Debtor's litigation costs associated with the sale, and could further subject the Debtor to an unfavorable Court ruling on appeal as to a sale term that the Debtor finds integral to the sale. Therefore, the threat of objection could convince the Debtor to come to the table and seriously consider the Party in Interest's proposed sale terms at the outset, providing a Party in Interest with significant negotiating leverage.

The decision also may impact a purchaser's willingness to engage in the 363 sale process if there is a chance that the sale terms may change after the fact. Whether this uncertainty limits the pool of potential 363 purchasers, and therefore limits the value of Bankruptcy Estate property sold under Section 363, remains a possibility for future bankruptcy debtors. Further, prospective 363 purchasers that are willing to engage may insist on reduced purchase prices due to the risk of sale terms being changed on appeal, or may negotiate a sale process wherein a sale order is entered, but does not officially close until resolution of all appeals, requiring additional administrative costs during an interim period.

As the Third Circuit Court of Appeals has noted, Section 363(m) "certainly attracts investors and helps effect debtor rehabilitation. Without it, the risk of litigation would chill prospective bidders or push them to 'demand a steep discount.'"²⁵ In the future, the extent to which Section 363(m) attracts investors, prevents steep discounts of property sold in Section 363 sales and provides the much needed certainty that all parties involved in a 363 sale seek will fall entirely on how often courts in the applicable jurisdiction rely on Section 363 as authority to preserve challenged sale terms. For now, the uncertainty provides negotiating leverage to potential 363 purchasers and Parties in Interest, with such leverage set to potentially increase over time, depending upon how courts in the applicable jurisdiction rule on Section 363 appeals on a go forward basis.

This article was also featured in Omni Agent Solutions Bankruptcy Today

¹ See MOAC Mall Holdings LLC v. Transform Holdco LLC et al., Case No. 21-1270 (2023).

² See id. at syllabus.

³ See id.

⁴ See Thomas Loeb and Drew Parobek, What High Court Sears Case May Mean for Section 363 Sales (Jul. 18, 2022, 2:29 PM), <https://www.law360.com/articles/1512112/what-high-court-sears-case-may-mean-for-section-363-sales>; see also 11 U.S.C. § 365(f)(2)(B).

⁵ Section 365(f)(2)(B) only permits a trustee to assign an unexpired lease only where "adequate assurance of future performance by the assignee of such contract or lease is provided[.]"

⁶ See MOAC Mall Holdings LLC, No. 21-1270 at syllabus.⁴ See id.

⁷ See id.

⁸ See *id.*

⁹ See *id.*

¹⁰ See *id.*

¹¹ See Thomas Loeb and Drew Parobek, What High Court Sears Case May Mean for Section 363 Sales (Jul. 18, 2022, 2:29 PM), <https://www.law360.com/articles/1512112/what-high-court-sears-case-may-mean-for-section-363-sales>; see also 11 U.S.C. § 363(b)(1).

¹² See Thomas Loeb and Drew Parobek, What High Court Sears Case May Mean for Section 363 Sales (Jul. 18, 2022, 2:29 PM), <https://www.law360.com/articles/1512112/what-high-court-sears-case-may-mean-for-section-363-sales>; see also 11 U.S.C. § 363(b)(1).

¹³ See *id.*; see also 11 U.S.C. § 363(m).

¹⁴ 11 U.S.C. § 363(m).

¹⁵ See MOAC Mall Holdings LLC, No. 21-1270 at syllabus.

¹⁶ See *In re Sears Holdings Corp.*, 2021 U.S. App. LEXIS 37358, at *5 (2nd Cir. 2021).

¹⁷ See MOAC Mall Holdings LLC, No. 21-1270 at syllabus.

¹⁸ See *id.*, slip op. at 7 (internal citations omitted).

¹⁹ See *id.*, slip op. at 8 (internal citations omitted).

²⁰ See *id.*

²¹ See *id.*, slip op. at 13.

²² *In re Energy Future Holdings Corp.*, 949 F.3d 806, 821 (3rd Cir. 2020) (internal citations omitted).

²³ See *id.*

²⁴ See *in re ICL Holding Co.*, 802 F.3d 547 (3rd Cir. 2015); see also See Thomas Loeb and Drew Parobek, What High Court Sears Case May Mean for Section 363 Sales (Jul. 18, 2022, 2:29 PM), <https://www.law360.com/articles/1512112/what-high-court-sears-case-may-mean-for-section-363-sales>

²⁵ See *in re ICL Holding Co.*, 802 F.3d at 554 (internal citations omitted).