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Just How Final are Bankruptcy Sales "Free and Clear"

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Historically, Section 363(f) of the Bankruptcy Code has been a powerful tool available to trustees[1], especially in times of economic downturn. It gives a trustee the ability to sell property quickly for the best price available, free and clear of all liens and interests, thereby potentially maximizing the recovery of monies for the estate. A successful purchaser in a Section 363(f) sale can take clear title to the property purchased, over the objection of lienholders, pursuant to an order from a federal judge assuring the legality of the sale free and clear of all liens. In the past, once 363 sales were approved by the bankruptcy court, parties commonly would immediately close the sale. Appeal of the sale order was generally not a concern because pursuant to Section 363(m)[2] of the Bankruptcy Code, it was generally accepted that "good faith" purchasers had the additional protection that if the Section 363(f) sale was subsequently overturned on appeal, the purchaser would retain ownership of the property free and clear of all liens. This assurance has been called into question by the Ninth Circuit Bankruptcy Appellate Panel ("BAP") in its decision in Clear Channel v. Knupfer (In re PW, LLC)[3], questioning whether a senior secured lender may credit bid its interest and take free and clear of a nonconsenting junior lien[4].

In Clear Channel, the United States Bankruptcy Court for the Central District of California entered an order authorizing a sale of real estate to a credit-bidding senior lienholder, free and clear of claims held by an objecting junior lienholder.[5] The junior lienholder appealed, and requested a stay pending appeal which was denied by the bankruptcy court and appellate panel. The sale closed and the senior lienholder took possession of the property, believing it was unencumbered, and entered into transactions in connection with the property with certain third parties that were not involved in the sale process. With respect to the appeal, the trustee and senior lienholder asserted that the appeal was moot as a result of the junior lienholder's failure to obtain a stay pending appeal. The senior lienholder further argued that the lien stripping term in the sale order was an integral part of that order and could not be segregated from that portion of the order transferring title.

The BAP affirmed the sale (transfer of title), but reversed the stripping of the junior lien, and remanded the case to the bankruptcy court to consider whether there was a qualifying proceeding under nonbankruptcy law that would enable the court to strip the junior lien and make the sale, free and clear, under Section 363(f)(5). BAP held that although the appeal of that portion of the order regarding the sale of the property (transfer of title) was moot, the closing of the sale, even in the absence of a stay, did not moot the appeal with respect to the stripping of the junior lien, notwithstanding the "good-faith" purchaser protections afforded the senior lienholder in section 363(m) of the Bankruptcy Code. Although, the provision stripping the junior lien was an integral part of the sale order and a material condition on which the senior lienholder relied in bidding on the property, the BAP held that the "free and clear" portion of an order approving a sale of assets pursuant to § 363(f) could be segregated from the transfer of title and be reversed on appeal while the sale itself would remain final under § 363(m). As a result, the BAP denied the purchaser the benefits and protections it expected to receive under the § 363(f) sale by confirming the finality of the sale, but at the same time allowing the "lien stripping" terms of the sale to be altered on appeal, thereby forcing the purchaser to accept encumbered property in a sale where it had bargained for and agreed to purchase unencumbered property.

Upon determining that the appeal was not moot as to the lien stripping issue, BAP then addressed the issue as to whether Section 363(f) of the Bankruptcy Code permits the stripping of the junior lien. Section 363(b)(1) of the Bankruptcy Code provides that a debtor, "after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate . . . ."[6] Section 363(f) of the Bankruptcy Code provides, in pertinent part as fol-

continued on Page 4
see ***BANKRUPTCY. . .***

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Inside This Issue

Thank You to the Hot Sheet Editors:

Laurie Grushen
Justin Budare
Mike Kaluger
Regan Nagel
Keith Pearson
Vicki Perkowitz
John Tyler

Court Upholds a Powerful Tool for California Creditors against Guarantors of Real Property Secured Loans

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As a result of the deteriorating economic climate and real estate market, many banks across the country, including many community and regional banks in California, are suffering substantial losses or failing due to the numerous non-performing loans on their books. In particular, voluntary resolutions (or "workouts") have become tougher to accomplish due to the deterioration in real estate values and the erosion of most developers' financial condition. Due to those circumstances, lenders continue to look for ways to maximize their recovery and expand their negotiating leverage with defaulting borrowers and guarantors.

Fortunately for California lenders who are finding it difficult to maximize their recovery on defaulted loans, a recent California case reaffirmed the lender's right to independently pursue a guarantor in a real estate secured loan. On October 19, 2009, the California Court of Appeal issued a decision in United Central Bank v. the Superior Court of Orange County upholding a creditor's procedural right to pursue a writ of attachment against the guarantor of a loan secured by real property. In those situations where the guarantor continues to be viable, this procedural right allows a lender to assert the maximum pressure on a guarantor to get their loan repaid.

In United Central Bank v. the Superior Court of Orange County, United Central Bank (the "Bank") filed a complaint for breach of guaranty against the guarantor of three construction loans. The guarantor had executed three (3) separate guarantees, each containing the standard "Gradsky Waivers", which waived her right to require the Bank to proceed first against the real property security provided for the loans. Shortly after filing the lawsuit, the Bank filed an application for a right to attach order and the issuance of a writ of attachment against the guarantor. After a hearing, the trial court denied the Bank's application on the ground that writs of attachment are not available where the subject loan is secured by real property under California Code of Civil Procedure ("C.C.P.") Section 483.010 unless the value of the real property collateral has declined to less than the sum due on the loan. In its denial of the application, the trial court made no finding as to whether the Bank satisfied the evidentiary threshold required for the issuance of an attachment order under C.C.P. Section 484.090.

The Bank petitioned the California Court of Appeal after the trial court's denial of its application for a right to attach order and the issuance of a writ of attachment. Upon review of the trial court's ruling, the Court of Appeal ruled that the trial court erroneously misapplied Section 483.010 in its denial of the Bank's application and ordered the trial court to hold a new hearing to determine whether the Bank made a sufficient evidentiary showing entitling it to a right to attach order and the issuance of a writ of attachment against the guarantor.

In support of its decision, the Court of Appeal declared that, while Section 483.010 provides that an attachment may not be issued on a contract claim that is secured by an interest in real property, the trial court failed to realize that the Bank's claim was based on unsecured guarantees. The Court of Appeal went on to state the well-settled California law that a guaranty is a separate and independent obligation from that of the principal debt, and as such, the prohibition of Section 483.010 does not apply to guarantees of loans secured by real property. Accordingly, writs of attachment may issue on guarantees of loans secured by real property, so long as the guarantor waived the right to require the creditor to proceed first against the real property security for the primary obligation.

The Court of Appeals decision in United Central Bank upheld a powerful prejudgment tool available to creditors of real property secured obligations - the right to seek the issuance of writs of attachment against guarantors of loans secured by real property. However, a writ of attachment in California is only available against guarantors of real property secured loans if the guarantor waived the right to require the creditor to proceed first against the real property collateral before seeking other remedies and continuing with the litigation.

In the context of an under-secured loan with an insolvent or nearly insolvent borrower, the right to pursue a writ of attachment against a guarantor is very valuable for a creditor. First, upon its issuance and its attachment to the property of the guarantor, the creditor gains leverage for negotiating a larger and quicker settlement with the guarantor. Second, the issuance of a writ of attachment prevents the guarantor from liquidating and/or assigning its assets prior to the entry of a court judgment against it.

Upon the default of a guaranty of a real property secured loan and the filing of a lawsuit in California for breach of guaranty, a creditor should seriously consider pursuing a writ of attachment against the guarantor(s). Independent actions, including the pursuit of writs of attachment, against guarantors on loans that are unsecured or secured by both real and personal property or on loans secured by personal property only - such as inventory and/or accounts receivable - continue to be a valuable collection tool for lenders and should not be overlooked in attempts to maximize recovery. ■

Preventative Medicine for the *Ultra Vires*: The Corporations Code Section 1002 Certificate

by Ken Dzien,
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With any threat of a serious flu season, we all see a brisk business in flu vaccinations. Many people are strong proponents of the philosophy underlying the flu shot, that is, "an ounce of prevention is worth a pound of cure." This is a good philosophy to carry over into our lives as title insurance professionals. Just like with the flu shot, however, a person first needs to know where the best and most convenient remedy available is for the foreseen problem.

The California Corporations Code has buried within it just such a valuable and convenient protective measure. Corporations Code Section 1002 provides certain protections to those purchasing from or lending to corporations. A basic problem for any person dealing with any corporate entity (particularly in a real property transaction) is to be sure that those representing the corporation and signing documents on its behalf are acting within the power of authority provided to them by the corporation. When a corporate representative is acting beyond his or her authority, the actions are ultra vires. The term is a Latin phrase often utilized today by lawyers and judges. An ultra vires act then is an act beyond the scope of the authority or power of a corporation's agent. A corporation or its shareholders can seek to avoid or set aside any transactions based upon an ultra vires act. Section 1002 provides that a party dealing with a corporation who, in good faith, obtains the prescribed certificate properly executed by the corporate secretary has prima facie evidence that those actions on behalf of the corporation had proper authority, that is, the transaction was not ultra vires. The term "prima facie" is another Latin term so commonly used in the English language today that one can find it in the dictionary. It means "at first sight" in Latin. Prima facie means there is sufficient evidence and that the fact is presumed true unless proven otherwise.

As we all know, corporations are artificial entities and, as such, they can only act through their agents. For domestic for profit California corporations, the entity, depending upon the nature of the transaction, deals through appointed and elected officers, directors, and/or shareholders. Other kinds of corporations exist and will less often be encountered by title or escrow personnel. The foreign for profit corporation, the non profit public benefit corporation, the non profit religious corporation, the corporation sole, and the municipal corporation are all distinct entities requiring their own special handling. By way of example, the not for profit religious corporation will generally require member approval for a real estate transaction. Once it is determined who the members really are (and this is no easy task), their acts must be in conformity with not only civil law, but also the ecclesiastical law of the religious organization. A corollary provision to Section 1002 exists for such religious entities in the form of Corporations Code Section 9632, but the process of dealing with religious entities can be fraught with problems and requires advisory attention.

Back to the California for profit domestic corporation, the basic documents for its formation and operation include the Articles of Incorporation, Corporate Bylaws (with amendments) and a host of directors' and/or shareholders' resolutions. A corporation ceases to exist without State sanction of its articles of incorporation. As a general rule of title practice, then when title is vested in a corporation, the examiner must first determine that the corporation was validly created and in good standing at the time of acquisition and thereafter. Most title personnel are aware that the State has the power to terminate or suspend a corporation. This often will occur when the corporation fails to file or pay corporate franchise taxes. Reinstatement of the corporation is critical to any officer or director acting on behalf of the corporation, and the Section 1002 Certificate will not help in the absence of reinstatement.

Once determined that the corporation is still in good standing, the most important question is to determine if the sale or loan transaction requires mere officer approval or if the directors' approval or even shareholders' approval should be required. All ordinary corporate business and affairs are controlled by or are under the authority of the board of directors. Matters in the ordinary course of business for a corporation can be delegated in the bylaws and by board of directors resolution to the officers of the corporation. Generally, the officers of a corporation only have the powers set forth in the bylaws and those given to them by the directors through resolution or acquiescence. Evidence of such a resolution is generally obtained in the form of a corporate secretary certificate of resolution's adoption. When the very purpose of a corporation is to buy and sell real estate or deal in trust deeds, then by the very nature of the officers' obligation to run the business they have the power to act in the ordinary course of the business. Regarding such transactions, the trick is to understand what the business really is. For example, the power of officers of a tract home developer to deal in the single family residences constructed by the corporation does not give the officers the power to sell the corporate home office building. Also, the officers generally have no authority to make gifts of corporate assets or to self deal. It is the job of the corporate officers to run the corporation and make profits, not to give assets away. Any zero consideration or gift deed executed by corporate officers, even with board of directors' approval, requires careful handling. What could be the corporate purpose for such a deed? As stated, the officers of a corporation and even the board of directors have authority to run the corporate affairs, but not to effectively liquidate the corporation. If the corporate transaction involves the sale, lease, transfer or disposition of all or substantially all of the corporation's assets, a board of directors' resolution along with shareholders' consent and/or resolution must be obtained. As previously stated, when correctly drafted, executed and relied upon, the Section 1002 Certificate is prima facie evidence of such approval. This certificate, once obtained, is best annexed to the corporation's deed or trustor deed and recorded along with it. It is a good practice to obtain not only the certificate for recording, but also the certification by the corporate secretary certifying to the terms of the resolution itself. This certified copy of the resolution should be kept in the title or escrow file.

Even with proper and ideal paperwork, some transactions are inherently troublesome and require advisory help. Conveyances or encumbrances of corporate assets for the benefit of officers or directors fit into this category. Since the very nature of the transaction involves possible conflicts of interest and self dealing, advisory staff will have to solicit shareholder approval and carefully consider the nature of the transaction as well as the scope of the title insurance sought. An agent generally has no authority to engage in self dealing detrimental to the economics of the corporate principal. It is the corporation's property and not the property of the officers. Headlines in the past involving Tyco Corporation and its president, Dennis Kozlowski, should be an apt reminder of these facts. ■

continued from Page 1

BANKRUPTCY. . .

"(f) The trustee may use, sell, or lease property under subsection (b) or (c) of Section 363 free and clear of any interest in such property of an entity other than the estate, only if --
(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
(2) such entity consents;
(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
(4) such interest is in bona fide dispute; or
(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[7]

To obtain approval of a sale free and clear of liens, the sale proponent need only prove to the court that one of the five conditions of Section 363(f) are satisfied. BAP found that only subparagraphs (3) and (5) applied to the Clear Channel sale.[8]

With respect to Section 363(f)(3), Courts are divided on the issue as to whether the amount of "aggregate value of all liens" is measured by the face amount of claims secured by liens against the sale property or the "economic value" of the assets being sold instead of the value of the liens against the asset. BAP joined what appears to be a minority of courts in finding that the sale price did not equal the value of all other liens, and accordingly did not meet the requirements of Section 363(f)(3).

The BAP also rejected the Bankruptcy Court's ruling that Section 363(f)(5) was satisfied by the present case. The Bankruptcy Court reasoned that the sale free and clear satisfied Section 363 (f) (5) because the junior lienholder could be forced to accept a money satisfaction of its claim. The BAP found this ruling to be too broad. The BAP noted that since, all liens securing payment obligations can be satisfied by paying the money owed, any lien could meet the requirement of Section 363(f)(3), which would render the other four conditions of the Section superfluous since the five conditions of 363(f) are disjunctive. Instead, the BAP interpreted the language of Section 363 (f)(5) to mean "a legal and equitable proceeding in which the nondebtor could be compelled to take less than the value of the claim secured by the interest."[9] Although, the BAP considered certain situations where a nondebtor can be compelled to take less than the value of the claim secured by the interest, such as those related to settlement agreements for partnerships, surprisingly, the BAP did not consider the most obvious proceeding that would satisfy Section 363(f)(5), a real estate foreclosure under state law where a junior lienholder could be forced to accept less than full satisfaction for its claim. A foreclosure is clearly a proceeding where a senior lienholder can bid and eliminate junior liens. Additionally, BAP specifically found that a cramdown pursuant to Section 1129(b) of the Bankrupt Code did not satisfy Section 363(f)(5) as, according to BAP, to find otherwise would enable creditors to circumvent the plan process and protections provided therein.

Based upon the BAP's determination that neither 363(f)(3) or 363(f)(5) was satisfied under the circumstances, the BAP found that the junior lien should reattach to the property, and remanded the case to the bankruptcy court to enable it to consider whether the sale could meet the conditions set for in 363(f)(3) or 363(f)(5), and, in particular, whether the parties could identify any legal or equitable proceeding under nonbankruptcy law where a nondebtor could be compelled to accept less than full satisfaction of its claim.

The Clear Channel decision creates significant risks not only to credit bidding senior lienholders, but potentially to third party purchasers of assets, in Section 363 bankruptcy sales in that it limits the use of "mootness" as a ground to prevent appeals, and it limits the use of § 363(f) to discharge subordinate liens on the property being sold, with the result that the sale may be "subject to" those subordinate liens. Further, as a result of this decision, title insurance companies are now hesitant to issue a title policy until the underlying order approving the sale is no longer subject to appeal, even in situations where there are no objecting lienholders[10]. The inability to obtain a title policy prior to obtaining a final order can be fatal to a sale if the seller is facing time restrictions closing the transaction.[11] Additionally, the Clear Channel decision may deter senior lienholders from credit bidding on assets if junior lienholders can later reassert their rights to be satisfied in full, resulting in lowering offering prices to account for a potential lien that can be reattached later, which will make it more expensive and more problematic for liquidating debtors to maximize the value of the assets of the estate. This threat could give "out-of-the-money" junior lienholders an effective veto over any sale to which they do not consent. Accordingly, despite the costs and delay involved in obtaining relief from stay and proceeding with a foreclosure under state law, a nonjudicial foreclosure sale becomes a more attractive alternative to a senior lienholder to overcome a nonconsenting junior lienholder.

Shortly, after the Clear Channel decision was published, the parties settled the case and as a result the Clear Channel decision was not vacated. Although the mootness issue raised by Clear Channel has not been addressed in any subsequent decisions, at least one court has rejected a broad reading of Clear Channel to the effect that assets cannot be sold free and clear of valid nonconsenting liens outside a plan of reorganization. In the case of In re Jolan Inc.,[12] several creditors relied on the Clear Channel decision to object to a Section 363(f) sale that would generate proceeds for an amount less than necessary to satisfy all liens. However, despite the Clear Channel decision, the Jolan court found that Section 363(f)(5) was satisfied because applicable state law provided for foreclosure of junior liens. According to the Jolan court, the appellees in Clear Channel relied solely on the possibility of a cramdown as satisfaction of Section 363(f)(5) and failed to argue that a state foreclosure would satisfy this condition. The Jolan court found that since junior liens could be foreclosed on and extinguished under applicable state law, the sale was authorized under Section 363(f)(5) over the objection of junior lienholders.

In light of the Clear Channel decision, prior to the sale, it is crucial to make sure no objections are filed or, if objections are filed, resolve them before the hearing and obtain consensual releases of junior liens. Negotiating releases of junior liens may be less expensive for the senior lienholder than moving for relief from stay

continued on Page 5
see ***BANKRUPTCY. . .***

and proceeding with foreclosure under state law. A strong record should be made at the bankruptcy court level that there is a legal and factual basis for selling the property free and clear of liens pursuant to Section 363(f), including setting forth applicable provisions of nonbankruptcy law which provide a proceeding in which a lienholder could be compelled to accept a money satisfaction of its lien for less than the full amount of the liens. Briefing state foreclosure law is strongly recommended. Taking these steps should diminish the likelihood of a successful appeal, thereby deterring junior lienholders from appealing 363 sale orders.

[1]Reference to "trustee" in this article also includes a debtor-in-possession entitled to exercise the rights of a trustee.

[2]Section 363(m) provides that "[t]he 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."

[3]Clear Channel Outdoor Inc. v. Knupfer (In re PW, LLC), 391 B.R. 25 (B.A.P. 9th Cir. 2008).

[4]BAP framed the issue before it as follows: "This appeal presents a simple issue: outside a plan of reorganization, does § 363(f) of the Bankruptcy Code permit a secured creditor to credit bid its debt and purchase estate property, taking title free and clear of valid, nonconsenting junior liens? We hold that it does not." Id. at 29.

[5]The senior lienholder held a first priority lien against the real estate totaling approximately $40 million and the junior lienholder, Clear Channel Outdoor, Inc., held a junior lien against the real estate totaling $2.5 million.

[6]11 U.S.C. § 363(b)(1).

[7]11 U.S.C. § 362(f).

[8]Id. at 38.

[9]Id. at 42.

[10]While the author could not find any cases addressing the right of a nonobjecting lienholder to appeal a 363 sale order, Section 363(f)(2) provides that a sale free and clear can be approved if such "entity consents". The majority view of courts regarding the condition of Section 363(f)(2) is that a lienholder or interest holder's consent to a sale may be found where proper notice of the sale is given, and the party does not object to the sale. "Lack of objection (provided of course there is notice) counts as consent." FutureSource, LLC v. Reuters Ltd., 312 F.3d 281, 285 (7th Cir.2002)." Notwithstanding the foregoing, where courts find that proper notice is not given, or where fraud is implicated, actual consent will be vitiated, and implied consent will not be found.

[11]Federal Rules of Bankruptcy Procedure, Rule 8002(a), provides in pertinent part that, "[t]he notice of appeal shall be filed with the clerk within 14 days of the date of the entry of the judgment, order, or decree appealed from. If a timely notice of appeal is filed by a party, any other party may file a notice of appeal within 14 days of the date on which the first notice of appeal was filed, or within the time otherwise prescribed by this rule, whichever period last expires." (emphasis added).

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