

Bankruptcy Ruling Shows Section 363's Magic Has Its Limits

By **Brian Shaw** (August 10, 2023)

Section 363 of the Bankruptcy Code permits, and sets the condition for, a trustee's or debtor-in-possession's use, sale or lease of property of the bankruptcy estate, and it is one of the statutory workhorses of the U.S. Bankruptcy Code.[1]

From the onset of a Chapter 11 business filing, where an operating debtor must seek authority to use its cash collateral under Section 363(c),[2] to many Chapter 11 cases' practical conclusion, where a debtor disposes of all of its assets under Section 363(b), Section 363 often finds itself at the forefront of commercial bankruptcy cases.



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In fact, it is also Section 363 that authorizes debtors-in-possession to continue to operate its business in the ordinary course without court authority.[3]

So, is there a limit on what this Swiss army knife of statutes can do for a debtor-in-possession?

As the U.S. Bankruptcy Appellate Panel for the Ninth Circuit recently noted, one of those limits where Section 363's magic fails is when a party attempts to use Section 363 to turn a nondebtor entities' property into property of a debtor's bankruptcy estate.[4]

The Ninth Circuit BAP and Groves

In *A&D Property Consultants LLC v. A&S Lending LLC*, or *In re: Groves*,[5] debtor Andrea Groves asked the U.S. Bankruptcy Court for the District of Arizona to ignore this limit, but the bankruptcy court refused, leading to an appeal to the circuit's BAP.[6]

In *Groves*, the individual who filed for protection under Chapter 13 of the Bankruptcy Code[7] jointly owned real property as tenants-in-common with her wholly owned, single-member limited liability company, *A&D Property Consultants*. [8]

A&D did not file for bankruptcy protection itself.[9] However, that did not stop the debtor from seeking bankruptcy court authority to sell both her and *A&D*'s interest in the real property, free and clear of all liens, including the lien perfected by the *A&D*'s secured creditor's deed of trust[10] on *A&D*'s undivided half interest in the real property.[11]

The basis of the debtor's aggressive request? The application of the interplay between Section 363(h) and 363(f)(4) that according to the debtor, authorized the requested relief.[12]

Specifically, the debtor argued correctly that Section 363(h)[13] enabled the debtor to sell both the debtor's and the nondebtor *A&D*'s undivided interests in the real property, even though the latter's interest was not property of the estate under Section 541.[14]

Unsurprisingly, the debtor also noted that the nondebtor *A&D*, of which she was the sole member, consented to the sale of its undivided interest in the real property as requested in the debtor's sale motion.[15]

The debtor then argued that because she was disputing the validity of her secured creditor's interest in her interest in the real property — which was now part of the bankruptcy estate — that bona fide dispute provided her with the foothold by which she could also use Section 363(f)(4) to strip the secured creditor's deed of trust from A&D's property.[16]

The debtor contended this was so, even though A&D was not a debtor under the Bankruptcy Code and its undivided interest in the real property was not part of Groves' bankruptcy estate.[17]

In response, the BAP said no, you cannot use Section 363(f) to cleanse liens from a nondebtor's interest in jointly owned property in a sale under Section 363(h), nor can you use it to turn a nondebtor's property into property of a debtor's bankruptcy estate.[18]

The BAP's opinion first noted that it could only find two previous decisions addressing the issue,[19] with each court ruling a different way.

There was a 2016 decision from the U.S. Bankruptcy Court for the District of Maine that supported Groves' position.[20]

In *Hull v. Bishop*, the court held that Section 105(a) of the Bankruptcy Code enabled the sale of nondebtor property to be free and clear of liens, essentially noting that if the whole of the property could be sold under Section 363(h) if not encumbered, why should the existence of an encumbrance change that result.[21] This was so, even though the Maine court conceded that such a result is not clear from the language of Section 363(f) and (h).[22]

In contrast, the other case that discussed the issue, *In re: Marko* from the U.S. Bankruptcy Court for the Western District of North Carolina, stated the opposite.[23]

In 2014, the North Carolina bankruptcy court noted that to allow a trustee to sell a nondebtor's interests free and clear of liens, would improperly extend bankruptcy relief only available to debtors to nondebtor parties, and noted that a bankruptcy court also had questionable jurisdiction over two feuding nondebtors.[24]

The BAP was persuaded by the North Carolina decision, and it noted the following:

- Section 363(h) allows for the sale of property that a debtor jointly owns with a nondebtor, even though the nondebtor's property is not part of the bankruptcy estate;
- Section 363(h) does not enable a sale of a nondebtor's interest in property to be free and clear of liens;
- Section 363(b), which authorizes the trustee or debtor-in-possession to sell property of the estate, is limited in scope to selling only property of the estate; and
- Section 363(f), which enables property of the estate to be sold free and clear of liens, is also limited in scope to property of the estate.[25]

Furthermore, the court lectured, none of this should have been a surprise, because while not specifically on point with the issue at hand, the BAP has made no secret in past decisions about its view that both provisions, Section 363(b) and Section 363(f), only apply

to property of the estate.

The BAP also noted that it had previously stated in another case, *In re: Silver Beach LLC* in 2009, that "a section 363(f) sale cannot be used to transform property of others into property of the estate." [26]

For that reason, the BAP affirmed the bankruptcy court that had approved the sale of the nondebtor property, but ordered that the proceeds from the sale of the nondebtor's interest in property be given to the nondebtor's secured creditor on account of its deed of trust on the nondebtor's undivided interest in the real property sold under Section 363(h).

Conclusion

On the one hand, the *Groves* decision is fairly straightforward.

Property in which the debtor has no interest cannot be magically transformed into property of the estate under Section 541 through the application of Section 363.

Further, the Bankruptcy Code and its related jurisdictional statutes generally do not give a bankruptcy the authority to settle disputes between a nondebtor and one of the nondebtor's creditors.

On the other hand, the position taken by the debtor, while conveniently ignoring the limitations set out in Section 363(b) that limit the use, sale and lease of property to property of the estate does flow from a conflation of Section 363(f) and (h), particularly when looked at in a vacuum.

So, it is not hard to understand how or why the debtor attempted to make Section 363 just a little too magical and why her efforts to do so were rebuffed by the bankruptcy court and the BAP.

Finally, *Groves*' practical lessons are important too.

First, a debtor generally cannot sell property in which it holds no interest.

Second, even when the debtor can cause jointly owned property of a nondebtor to be sold under Section 363(h), the proceeds from the sale of the nondebtor's property interest should go to the nondebtor. Commercial debtors must keep these limitations in mind when attempting to sell business operations that may not be entirely comprised of property of the estate.

Third, for those who find themselves co-owning an interest in property with a bankruptcy debtor, it is important to remember that sales utilizing Section 363(h) are not an outlier and despite the state of the law noted above.

In *Groves*, keen attention must be paid to the reach of Section 363(h), lest a creative debtor be able to magically turn jointly owned interests into property of its bankruptcy estate.

Brian L. Shaw is a member at Cozen O'Connor.

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[1] 11 U.S.C. § 363; all citations to "Section ____" herein, unless noted otherwise, are to the United States Bankruptcy Code, 11 U.S.C. § 101 et al.

[2] 11 U.S.C. § 363(c).

[3] 11 U.S.C. § 363(c)(2).

[4] A&D Property Consultants, LLC v. A&S Lending, LLC (In re Groves), ___ B.R. ___, 2023 WL 4233203 (9th Ct. BAP) (June 28, 2023).

[5] Id.

[6] Id.

[7] 11 U.S.C. § 1301 et al; the debtors use of Chapter 13 instead of Chapter 11 has no bearing on the application of, or limitations on, Section 363 as discussed herein.

[8] "A&D"

[9] Groves, 2023 WL 4233203 at * 1.

[10] In Arizona, deeds of trust, rather than mortgages, secure liens on real property.

[11] Groves, 2023 WL 4233203 at * 1.

[12] Id.

[13] Id., at *6.

[14] Id.

[15] Id.

[16] Id.

[17] Id.

[18] Id., at *8.

[19] Hull v. Bishop (In re Bishop), 554 B.R. 558 (Bankr. D.Me. 2016) and In re Marko, 2014 WL 948492 (Bankr. W.D.N.C.).

[20] Groves, 2023 WL 4233203 at *6.

[21] Id.

[22] Id., citing Bishop, 554 B.R. at 567.

[23] Id, at *7, citing Marko, 2014 WL 948492 at *4 (questioning how a non-debtor's interest in a lake house could be sold by trustee free and clear of liens under Section 363(h) and stating it was unlikely it could do so).

[24] Id.

[25] Id., at *8.

[26] Id., at *7.