

# Client Alert

February 2013

## **In a Bankruptcy Sale Free and Clear of Liens, Claims, and Interests, the First Circuit Bankruptcy Appellate Panel Adopts an Expansive Definition of the Term “Interest”**

On January 17, 2013, the United States Bankruptcy Appellate Panel for the First Circuit (the “First Circuit BAP”) rendered its opinion in *Massachusetts Department of Unemployment Assistance v. OPK Biotech, LLC (In re PBBPC, Inc.)*, BAP No. MB 12-042 (B.A.P. 1st Cir. Jan. 17, 2013), affirming a decision of the United States Bankruptcy Court for the District of Massachusetts (the “Bankruptcy Court”) (a) approving a sale of assets free and clear of all interests in the assets and (b) defining the term “interest” to include the unemployment tax rate assessed by the Commonwealth of Massachusetts against the Debtor. In this decision, the First Circuit BAP considers and adopts the expansive definition of “interest” as espoused by the Seventh, Fourth, Third, and Second Circuits. As a result, the purchaser of the debtor’s assets was not required to pay the higher unemployment tax rate assessed by the Commonwealth.

### **Case Background**

Simultaneously on July 16, 2009, Debtor PBBPC, Inc., formerly known as Biopure Corporation (the “Debtor”), filed its chapter 11 petition and a motion seeking approval of bid procedures and the sale of substantially all of its operating assets to OPK Biotech, LLC (the “Purchaser”), free and clear of all liens, claims, and encumbrances pursuant to Section 363(f) of the United States Bankruptcy Code (the “Bankruptcy Code”). The Bankruptcy Court approved the sale on August 20, 2009, and entered an order (the “Sale Order”) providing, among other things, that (i) the transfer to the Purchaser would be free and clear of all claims, including any claims pursuant to any successor or successor-in-interest liability theory; (ii) the Purchaser would not be deemed a successor of the Debtor; and (iii) the Purchaser would not have any liability for any obligation of the Debtor or any claim against the Debtor related to the purchased assets. As of the petition date, the Debtor only had five employees, but prior to the closing of the sale, the Debtor terminated all but one employee, resulting in a very high experience rating and an unemployment contribution rate of 12.27% under Massachusetts unemployment insurance law. Accordingly, in the sale order, the Bankruptcy Court found that the Purchaser would not have purchased the assets unless the transfer was free and clear of all encumbrances pursuant to Section 363(f).

After the closing, the Purchaser notified the Massachusetts Department of Unemployment Assistance (the “DUA”) of its acquisition of the Debtor’s assets. The DUA responded with a notice that it considered the Purchaser a “successor employer” under the Massachusetts statute, the Purchaser’s contribution rate for 2009 and 2010 was 12.27%, and the Purchaser was liable for any past or future benefit charges attributable to the Debtor. The Purchaser filed an administrative appeal, arguing that the DUA incorrectly imposed successor status because the Purchaser and the Debtor lacked substantially common ownership, interest, or control, which might give rise to successor status under Massachusetts law. The DUA refused to change its determination, and in March 2011, the Purchaser sought an order from the Bankruptcy Court (i) enforcing the Sale Order and declaring that the sale was free and clear of the Debtor’s experience rate and contribution rate; (ii) requiring the DUA to refund to the Purchaser any overpayments resulting from the DUA’s use of the Debtor’s experience rate; and (iii) compelling the DUA to assign the Purchaser a contribution rate of 2.89% as an employer new subject to the Massachusetts statute. In support of its motion to enforce the sale order, the Purchaser argued that (i) because the Debtor served notice of the sale on the Massachusetts attorney general, and neither the Commonwealth

nor the DUA objected, the DUA waived its right to object to the terms of the sale; (ii) Section 363(m) protected the sale order from attack and reconsideration; (iii) even assuming the sale order were subject to attack, the proper vehicle would have been a motion to reconsider or modify the order; (iv) the sale order should be enforced because at least four of the five requirements for a sale free and clear under Section 363(f) were satisfied; and (v) even if the DUA had timely objected to the proposed sale, the underlying principles of the Bankruptcy Code preempted the successor liability provision in the Massachusetts unemployment insurance statute.

In opposition, the DUA raised several arguments. First, the DUA argued that notice of the sale had been improper, and as a result, the DUA could challenge the notice and the sale order. Second, the DUA contended that the Purchaser did not meet the conditions for a sale free and clear under Section 363(f) because in the absence of proper notice, the DUA's lack of objection did not constitute consent, and a monetary satisfaction was not possible. Third, the DUA argued that while prohibiting the transfer of the Debtor's contribution rate to the Purchaser might enhance the amount of payments to the Debtor's creditors, such an enhancement would come at the expense of all other Massachusetts employers. Fourth, the DUA argued that the Debtor's contribution rate was not an "interest" within the meaning of Section 363(f); thus, the Bankruptcy Court lacked authority to protect the Purchaser from taxation on the basis of the Debtor's experience rating. Lastly, the DUA asserted that it correctly determined the Purchaser to be a successor within the meaning of the Massachusetts unemployment insurance statute.

### **The Bankruptcy Court Decision**

As a preliminary matter, the Bankruptcy Court concluded that it had authority to revisit the Sale Order because the DUA had not received proper notice of the sale.<sup>1</sup> The Court then turned to an analysis of Section 363(f), which provides, in pertinent part, that property may be sold free and clear of any entity's "interest" in such property if at least one of the following conditions is met:

- (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.<sup>2</sup>

Concluding that the DUA could be compelled to accept a money satisfaction, the Bankruptcy Court then considered whether the DUA's right of taxation could constitute an "interest" in property of the estate within the meaning of Section 363(f).<sup>3</sup> The Bankruptcy Court adopted an expansive definition of "interest" and concluded that an employer's contribution rate does constitute an "interest" in estate assets because it is being imposed on a buyer solely because that buyer purchased assets of a bankruptcy estate.<sup>4</sup> As a result, the Bankruptcy Court held that Section 363(f) applied to the DUA's interest and preempted any state law to the contrary.<sup>5</sup> In reaching its conclusion, the Bankruptcy Court rejected the case relied upon

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<sup>1</sup> See *In re PBBPC, Inc.*, 467 B.R. 1 (Bankr. D. Mass. 2012).

<sup>2</sup> 11 U.S.C. § 363(f).

<sup>3</sup> See *PBBPC, Inc.*, 467 B.R. at 8.

<sup>4</sup> *Id.* at 9.

<sup>5</sup> *Id.* at 10.

by the DUA,<sup>6</sup> and followed the reasoning of *United Mine Workers of Am. 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*.<sup>7</sup> The DUA subsequently appealed to the First Circuit BAP.

### **The First Circuit BAP's Decision**

The DUA raised two issues on appeal: whether the Debtor's experience rate is an "interest" within the meaning of Section 363(f) and if so, whether Section 363(f) preempts Mass. Gen. Laws ch. 151A, § 14A. However, because the DUA failed to brief the second issue, the First Circuit BAP concluded it had been waived and only considered the first issue.

Relying on the Sixth Circuit's decision in *Wolverine*, the DUA again argued that a debtor's experience rating should not be considered an "interest" under Section 363(f) because it is completely unrelated to recouping an unpaid prepetition obligation from a debtor corporation. Instead, the DUA contended that an experience rating is merely a tool used to calculate a loss expectation. In opposition, the Purchaser argued, among other things, that the sale of substantially all of a debtor's assets to a third party directly triggers the DUA's statutory right under Massachusetts law to tax the third party purchaser on the debtor's experience rating, which, according to the Purchaser, clearly supports the Bankruptcy Court's definition of "interest."

The First Circuit BAP ultimately affirmed the Bankruptcy Court's determination and adopted an expansive definition of the term "interest" to include a debtor's experience rating and contribution rate. Recognizing the absence of First Circuit precedent on the issue, the First Circuit BAP considered relevant case law from other circuits and adopted the more expansive definition espoused by the Seventh, Fourth, Third, and Second Circuits.<sup>8</sup> The First Circuit BAP distinguished *Wolverine*, explaining that in concluding that an employer's contribution rate was not an "interest" under Section 363, the Sixth Circuit framed the issue as whether the bankruptcy court could determine the tax rate applicable to the successor entity. The First Circuit BAP found this approach unpersuasive, noting that the DUA had two rates it could choose: the new employer rate or the Debtor's rate. Reasoning that the transfer of an employer's contribution rate to a successor purchaser is really just an attempt to recover what the employer would have paid had the sale not occurred, the First Circuit BAP held that the term "any interest" under Section 363(f) included the Debtor's experience rate. Because the right to tax the Purchaser at the higher rate arose from the sale of the Debtor's property, Section 363(f) permitted the Bankruptcy Court to authorize the sale free and clear of the higher rate.

### **Implications**

In the absence of a precise definition, different opinions have developed over how narrowly to interpret the meaning of "interest" as used in Bankruptcy Code Section 363(f). The First Circuit BAP's decision rejects the narrow approach, which limits "interest" to mean only *in rem* property interests. Instead, the First Circuit BAP further affirms the expansive view already adopted by a number of circuits defining "interest" to include all other obligations that may flow from the ownership of property. This approach

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<sup>6</sup> In support of its position, the DUA relied upon *Michigan Employment Sec. Comm'n v. Wolverine Radio Co., Inc. (In re Wolverine Radio Co., Inc.)*, 930 F.2d 1132, 1145-49 (6th Cir. 1991) (concluding that an experience rating was not an "interest" within the confines of Section 363(f)).

<sup>7</sup> 99 F.3d 574, 581-82 (4th Cir. 1996) (holding that Congress did not expressly indicate an intention to limit the scope of "interests in property" as used in Section 363(f) to *in rem* interests).

<sup>8</sup> The First Circuit BAP found the Second Circuit's decision in *Indiana State Police Pension Trust v. Chrysler LLC (In re Chrysler LLC)* particularly instructive because in *Chrysler*, the possibility of transferring the assets free and clear of all encumbrances was also a critical inducement to the sale. See 576 F.3d 108, 126 (2d Cir. 2009), *cert. granted and judgment vacated on other grounds*, 130 S. Ct. 1015, 175 L. Ed. 614 (2009).

provides bankruptcy courts with more flexibility to determine that a sale of substantially all of a debtor's assets may proceed free and clear of all encumbrances.

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