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New York Law Journal

Corporate Update

SECURED TRANSACTIONS

Free-and-Clear Federal Bankruptcy Sales and State Law Foreclosure Rules

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June 4, 2025

Introduction

The United States Bankruptcy Code is a carefully constructed balance between the competing objectives of debtor flexibility and creditor protections.

One area where this tension has been apparent is in the interpretation of Bankruptcy Code §363(f)(5) which provides that a trustee or debtor-in-possession may sell estate property free and clear of any liens in favor of a secured party if "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."

This provision is a cornerstone of bankruptcy asset sales, facilitating the ability of a debtor to sell encumbered assets with a clean break from secured creditors. At face value, section 363(f)(5) may seem straightforward: if the secured creditor's interest can be legally or equitably disposed of for monetary value, a free-and-clear sale is permissible.

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However, it has been an unsettled issue among courts regarding who must be able to "compel" the sale referenced in section 363(f)(5). On the one hand, this could be interpreted to mean only the debtor itself (in the narrowest construction) or, on the other hand, could include any third party to any conceivable hypothetical proceeding (in the broadest potential interpretation).

The recent decision by a U.S. Bankruptcy Court in the Southern District of New York in *In re Urban Commons 2 West LLC, 668 B.R. 42 (Bankr. S.D.N.Y. 2025)* supported a fairly expansive interpretation of 363(f)(5), thereby making a significant departure from a prior precedent case in that district.

In so doing, the *Urban Commons* court ruling enhanced a debtor's ability to sell assets in bankruptcy, with significant implications for secured creditors.

Factual Background

The debtors in this case were a group of five affiliated limited liability companies (Urban Commons) that collectively operated The Wagner, a hotel located at 2 West Street in Battery Park City in Manhattan, New York.

Urban Commons owned a long-term leasehold interest in the hotel (the Hotel Lease Interests), having purchased the Hotel Lease Interests in Sept. 2018 for the approximate purchase price of $147 million, financed in part by a $96 million mortgage loan provided by BPC Lender, LLC (the Lender). The hotel was part of a mixed-use condominium building which was also subject to a ground lease with the Battery Park City Authority (BPCA).

Urban Commons was unable to obtain refinancing upon the loan's maturity in 2020. Shortly thereafter, the COVID-19 pandemic prompted the hotel to cease operations, and it has remained closed to date.

Compounding the financial distress, the BPCA issued a termination notice in May 2022, alleging rent arrears exceeding $10 million and abandonment of the premises, and threatened to terminate the ground lease. This sequence of events led to Urban Commons filing for chapter 11 relief in Nov. 2022.

As of the petition date, the outstanding debt had grown to approximately $114 million, plus fees and costs, and Urban Commons had no cash on hand or current income to cover their ongoing obligations.

In Feb. 2023, Urban Commons secured the necessary approvals from the Bankruptcy Court to auction the Hotel Lease Interests.

The auction failed to attract any qualified bids other than the Lender's bid, which consisted of a $78.5 million credit bid, plus payment of tens of millions of dollars in disputed cure amounts that the debtors owed under their leases and other agreements with BPCA, the condominium and the hotel union.

In Aug. 2023, mediation commenced to address the various disputes under these leases and agreements and ultimately led to a global resolution the following Sept. 2024.

In Sept. 2024, the Bankruptcy Court held a combined hearing (1) to rule on Urban Commons' motion for approval of the free-and-clear sale of the Hotel Lease Interests to the Lender pursuant to sections 363(c) and

363(f)(5) and (2) confirm a proposed plan of liquidation of the debtors' estate.

The only party that objected was VIK XS Services, Inc. (VIK), a contractor asserting a claim for approximately $189,000 in unpaid prepetition services, secured by a mechanic's lien junior in priority to the Lender's first priority lien.

VIK objected to the sale of the Hotel Lease Interests free and clear of its lien on the basis that neither section 363(f)(5) nor any other subsection of 363(f) authorized free-and-clear treatment under the circumstances.

Overruling the objection, the court's bench ruling both approved the sale and confirmed the liquidation plan.

Case Analysis

The court characterized the question before it as "an important and unsettled issue concerning the circumstances in which a debtor may sell its property free and clear of liens and other interests pursuant to Bankruptcy Code §363(f)(5)."

Bankruptcy Code sections 363(b) and (c) permit the use, sale or lease by the debtor or its trustee- in-bankruptcy of property of the bankrupt estate. Section 363(f) contains the requirements for a sale of such property under 363(b) (which covers transactions in the ordinary course of business) or (c) (which covers transactions not in the ordinary course of business), free and clear of any interest in such property of an entity other than the bankrupt estate.

Specifically, a sale pursuant to section 363(b) or (c) will be free and clear of any security interests in the property in favor of any entity only if the sale satisfies at least one of the five conditions in section 363(f).

These five conditions are (1) if applicable nonbankruptcy law permits sale of such property free and clear of such interest, (2) the entity holding the interest consents, (3) the sale price exceeds the aggregate value of all liens on such property, (4) the interest is subject to a bona fide dispute, or (5) the interest holder "could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."

In this case, as is often the case when estate property is sold for less than the aggregate face value of any attached liens, subsection (5) stood out as the only subsection providing a legal basis for a free-and-clear sale.

When dealing with underwater assets, if the lienholder will not consent and the lien is not disputed, subsections (2), (3) and (4) are inapplicable. According to the *Urban Commons* court, judges also often construe subsection (1) narrowly, confining it to a narrow range of non-bankruptcy laws that permit non-judicial sales free and clear of liens (e.g., UCC Section 9-320, relating to the sale of inventory in the ordinary course of business) and, accordingly, its utility.

As a result, the interpretation of subsection (5) is pivotal in determining whether a bankrupt estate has the broad power to sell a secured creditor's collateral free-and-clear or if such sales are to be a rare exception.

In determining whether this sale satisfied the requirements of section 363(f)(5), the

Urban Commons court could follow one of two competing interpretations of the statute. Stating that no court or commentator has revisited or discussed the interpretation of section 363(f)(5) in approximately ten years, the court opted to undertake its own review of the text to support its conclusion.

The court first acknowledged that the majority view adopted by most courts considered it a settled point that foreclosure sales or UCC sales satisfied the requirements of section 363(f)(5), based on the reasoning that a foreclosure sale would extinguish the security interests in question. This broad interpretation has historically allowed for debtors to readily access section 363 bankruptcy sales.

In a departure from this majority view, in 2014 a U.S. District Court in the Southern District of New York adopted a much narrower construction of the statute in *Dishi & Sons v. Bay Condos LLC, 510 B.R. 696 (S.D.N.Y. 2014) ("Dishi")*.

The court in *Dishi* held that section 363(f)(5) may only be satisfied if the debtor itself, as the property's owner, had the ability to bring a legal or equitable proceeding under non-bankruptcy law to extinguish the interests in question.

This served to significantly limit the circumstances in which a debtor could sell encumbered assets since in real property foreclosure or UCC sales only a creditor, as opposed to the property's owner, is able to commence such proceedings.

According to the *Urban Commons* court, the *Dishi* court reasoned that, without this more confined interpretation, the scope of section 363(f)(5) would be seemingly "limitless." As an example, the *Dishi* court pointed to the government's right to take property by eminent domain, a procedure that is theoretically always possible, that eliminates other interests in the property, and that requires interest holders to accept monetary compensation.

By this logic, section 363(f)(5) would almost always be satisfied, and debtors would scarcely need to rely on subsections (1) through (4). Construction of the statute in this manner would run contrary to the principle that courts should construe a statute to give effect to all its provisions.

Bearing in mind these existing interpretations, the *Urban Commons* court went on to suggest that a middle ground between the narrow holding in *Dishi* and the extreme example case it positioned itself as rejecting was not only available and preferred by the court, but also aligned better with the plain text of the statute and the court's understanding of its statutory purpose.

Rather than the "hypothetical" standard propositioned in *Dishi*, the *Urban Commons* court employed a "realistic possibility" standard in its reading of section 363(f)(5).

The court accordingly viewed section 363(f)(5) as encompassing only those proceedings that might "realistically" be brought (such as real property foreclosures or UCC sales) and not any conceivable hypothetical proceeding that might compel interest holders to accept a monetary satisfaction of such interests.

The court noted as one example that foreclosure sales "do not extinguish all interests

in the property" and further, that some interests, "like easements and covenants running with the land," would "survive foreclosure."

Because section 363(f)(5) would not apply to these other interests, a debtor would have to turn to one of the other subsections, preserving the effect of all provisions of this clause.

Key to the *Urban Commons* court's interpretation was an analysis of the plain meaning of the text and statutory context. As to the text itself, the court noted that the statute was written in the "passive voice" and permitted a sale free of a secured party's lien so long as (quoting from 363(f)(5)), "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."

The court's reading did not identify any limitations in the plain text that would support the proposition advanced in *Dishi* that a free-and-clear sale would only be permitted if the trustee or debtor-in-possession of the property could compel such proceeding.

To the contrary, in the court's view the *Dishi* decision attempted to "transform" the textual language by imposing a limitation on who could achieve the "free-and-clear" result.

Moreover, the *Urban Commons* court reasoned that an overly narrow reading of section 363(f)(5) would undermine its statutory purpose.

The court pointed to other sections of the Bankruptcy Code (including provisions in sections 361, 362(a) and (d)(1), 363(b), (c) and (e) 506(a) relating to adequate protection) in support of its argument that an "out-of-the-money" lienholder, like VIK in this case, would be treated as an unsecured creditor elsewhere in the Bankruptcy Code because the value of its collateral had been reduced to nothing .

If the court were to follow the *Dishi* holding, the result would allow VIK, as a junior out-of-the-money lienholder, to enforce its lien for full value notwithstanding its collateral had none. Consequently, the court concluded that a broader interpretation was more consistent with the legal framework established by the Bankruptcy Code.

Conclusion

In rejecting the holding in *Dishi*, the *Urban Commons* court has restored doctrinal adherence to the application of section 363(f)(5). By adopting a broader construction of section 363(f)(5) and rooting its analysis in the statutory text and policy goals of the Bankruptcy Code, the court reaffirmed the importance of this section as a tool for debtors to be able to maximize recovery on assets while protecting lienholders based on the value of their security interests.