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Transform Victory Good for Buyers, Experts Say

By Christopher Patalinghug

The United States Supreme Court on Dec. 5 heard oral arguments in *MOAC Mall Holdings LLC v. Transform Holdco LLC*, No. 21-1270, which involves a lease sale fight between formerly bankrupt retailer Sears and the Mall of America over the transfer of a store lease. MOAC is asking the High Court to determine whether 11 U.S.C. § 363(m) limits appellate courts' jurisdiction over any sale order or order deemed "integral" to a sale order, such that it is not subject to waiver, and even when a remedy could be fashioned that does not affect the validity of the sale.

Shai Schmidt, a Partner at Glenn Agre Bergman & Fuentes LLP's Bankruptcy, Restructuring & Distressed Debt group, says the Supreme Court agreed to hear the case because the law on this issue is inconsistent. "While the majority of circuits have adopted a per se jurisdictional bar to hearing such an appeal, other Courts of Appeals have held that the reviewing court is permitted to hear the appeal and fashion a remedy so long as it does not affect the validity of the sale itself," he explains.

Case Background

In 2019, Transform Holdco LLC, an entity formed by Sears Holding Corp.'s chairman, Eddie Lampert, and several other former Sears executives, gained control of substantially all of Sears' assets, including its many real estate holdings, through Sears' bankruptcy proceedings. Through a sale order entered by the U.S. Bankruptcy Court for the Southern District of New York under 11 U.S.C § 363(b), Transform, among other things, acquired the right to designate which assignee would assume Sears' leases. Included in this $5.2 billion deal is a lease at the iconic Mall of America shopping mall in Bloomington, Minn. After the sale closed, Transform gave notice it was designating and assuming the MOAC lease. The landlord, MOAC Mall Holdings LLC, however, was not interested in seeing Sears' three-story building leased out by Transform. MOAC wanted the lease to revert to it so it can control who gets to occupy the space. MOAC argued that the requirements of 11 U.S.C. § 365 were not met, Transform is not a retail business, Transform does not intend to occupy the space but instead to sublease it, and Transform is not an appropriate assignee. The bankruptcy court, nonetheless, approved the assumption and assignment of the lease to Transform's subsidiary, Transform Leaseco, LLC.

MOAC appealed to the U.S. District Court for the Southern District of New York and moved for a stay pending appeal in bankruptcy court. Transform opposed, arguing that a stay was not necessary because § 363(m) does not apply and Transform would not attempt to argue otherwise on appeal. The bankruptcy court agreed that § 363(m) does not apply because the assignment order involved only § 365,

not a sale under § 363. The bankruptcy court denied MOAC's motion for a stay pending appeal.

The district court initially vacated the bankruptcy court's assignment order, concluding it violated § 365(b)(3)(A). The district court held that Transform, a newly formed entity, never intended to occupy or operate the premises and did not satisfy the requirement of § 365(b)(3) that its financial condition and operating performance be similar to Sears' at the time Sears entered into the lease.

Instead of elevating the issue to the United States Court of Appeals for the Second Circuit, Transform asked the district court for rehearing, asserting for the first time that the district court lacked jurisdiction over the appeal all along, because the order appealed from was not stayed pending appeal. The district court stated it was "appalled by [Transform]'s behavior," noting Transform's counsel flatly stated to the bankruptcy judge that § 363(m) had no applicability to the assignment of the Mall of America lease, and Transform did not intend to argue otherwise, in order to induce the judge to deny MOAC's motion for a stay. However, with "great regret," the district court concluded that circuit precedent dictated § 363(m) is jurisdictional, making waiver and judicial estoppel unavailable. It also held that § 363(m) applied to MOAC's appeal, either because the lease assignment constituted a sale or because it was "inextricably intertwined" with the sale of Sears's assets. The court vacated its earlier decision and dismissed the appeal as statutorily moot.

MOAC sought its own rehearing, arguing for the first time Transform did not obtain the lease assignment "in good faith" as required by § 363(m). The district court rejected this argument, pointing out MOAC had not obtained a stay of the order appealed from pending its appeal; it had failed to convince the bankruptcy court to issue a stay, and it did not even seek a stay pending appeal from this court. The transaction was completed; the lease was assigned, the district court said.

MOAC appealed to the Second Circuit, which affirmed the district court. The Second Circuit found that, although the lease assignment was authorized under § 365 rather than § 363, it fell within the scope of § 363(m) because the assumption and assignment of Sears' leases was integral to a sale authorized under § 363(b). The Second Circuit said the "text [is] clear" that in the absence of a stay, § 363(m) limits appellate review to the parties' challenges to the "good faith" aspect of the sale and whether a transaction is integral to the sale authorized under § 363(b), such as removing the transaction from the sale would prevent the sale from occurring or otherwise affect its validity. The Second Circuit cited *Contrarian Funds LLC v. Aretex LLC (In re WestPoint Stevens, Inc.)*, 600 F.3d 231, 247 (2d Cir. 2010); and *Licensing by Paolo, Inc. v. Sinatra (In re Gucci)*, 105 F.3d 837, 838 (2d Cir. 1997).

The Second Circuit tossed MOAC's assertion that Transform has waived its ability to rely on § 363(m), or is estopped from doing so, because it raised its jurisdictional argument only after the district court ruled against it on the merits and Transform insisted before the bankruptcy court that § 363(m) was not applicable under the circumstances of this case. The Second Circuit said this argument is foreclosed by binding precedent in WestPoint Stevens, and added that the Supreme Court in *Arbaugh v. Y & H Corp.*, 546 U.S. 500, 514 (2005), warned courts not to conflate jurisdictional and nonjurisdictional statutory limitations.

MOAC also failed to persuade the Second Circuit that the lease assignment is not integral to the sale. The Second Circuit explained that the bankruptcy court already resolved MOAC's challenge to the assignment in Transform's favor and approved the Assignment Order after finding Leaseco had complied with all necessary contractual and statutory requirements. The Second Circuit also held that the district court was right in rejecting MOAC's alternative good-faith purchaser argument as untimely. The Second Circuit pointed

out that neither party raised the good-faith issue on Transform's motion for a rehearing, and the district court did not err in declining to address the issue sua sponte, as a court is not required to review the issue sua sponte before dismissing an appeal as moot under § 363(m).

Supreme Court Appeal

MOAC filed a petition for writ of certiorari, which the Supreme Court granted on June 7, 2022. MOAC contends at least six circuits have held that § 363(m) does not limit the appellate courts' jurisdiction to review unstayed bankruptcy court sale orders, but rather limits only the remedies available in such an appeal. MOAC also points out that the Supreme Court in *Arbaugh* clarified that limitations on judicial relief should not be treated as jurisdictional absent a clear statement by Congress. MOAC reminds the High Court the landlord had initially succeeded on its appeal before the district court vacated that ruling based on a ground Transform had affirmatively waived and would have been estopped from asserting but for the court's mistaken view that § 363(m) is jurisdictional.

In objecting to the review, Transform, among others, points out that even if MOAC were able to bypass § 363(m), the landlord lacks an effective remedy. The only remedy MOAC sought was to set aside the lease transfer under § 365. If for some reason the assignment order were set aside, according to Transform, it would simply mean the lease transfer was unauthorized because the order approving it has been reversed. The leasehold interest would revert to Sears' bankruptcy estate, not to MOAC.

MOAC is represented by Ropes & Gray lawyers Douglas Hallward-Driemeier in Washington, D.C., and Gregg M. Galardi, Andrew G. Devore and Daniel G. Egan in New York; and Gregory S. Otsuka of Larkin Hoffman Daly & Lindgren, Ltd., in Minneapolis, Minn.

Transform is represented by Amy R. Wolf and Michael H. Cassel of Wachtell, Lipton, Rosen & Katz in New York; R. Craig Martin and Ilana H. Eisenstein of DLA Piper LLP (US) in Philadelphia and G. Eric Brunstad, Jr., the counsel of record, and Carla G. Graff of Dechert LLP in New Haven, Conn.

Former Judges, Profs Weigh In

The Supreme Court received two amici curiae briefs: one from retired bankruptcy judges, Judith Fitzgerald and Bruce A. Markell, and a group of law professors; and the other from the U.S. Department of Justice. All expressed their support for MOAC.

The Hon. Judith Fitzgerald was formerly Bankruptcy Judge for the Western District of Pennsylvania. The Hon. Bruce A. Markell was formerly Bankruptcy Judge for the District of Nevada, and is now with Northwestern University's Pritzker School of Law. The law professors are Pamela Foohey of Cardozo School of Law at Yeshiva University; George Kuney at The University of Tennessee College of Law; Robert Lawless at University of Illinois College of Law; Jonathan Lipson at Temple University's Beasley School of Law; Nancy Rapoport of the William S. Boyd School of Law at the University of Nevada, Las Vegas; Richard Squire at Fordham University School of Law; Ray Warner at St. John's University; and Jack Williams at Georgia State University College of Law.

Fitzgerald et al. point out that § 365 is the exclusive Bankruptcy Code section that governs the assumption and assignment of commercial leases; § 363(m) deals with sales of estate property. Section 365 is a standalone provision with its own specific requirements, and operates independently of anything in § 363. Section 365(b) contains no mootness provision, and appellate review of orders under § 365(b) is not limited by § 363(m). Section 365(b) mandates that if a debtor-tenant in a commercial shopping center assigns its lease as part of a bankruptcy transaction, the landlord (such as a mall owner) must receive "adequate assurance of future performance." This statutory protection, Fitzgerald et al. note, was deemed critical to mall owners

when Congress adopted the Shopping Center Amendments in 1984, and has been recognized as vital in protecting mall owners from serious harm when retail tenants within a shopping center file for bankruptcy.

Fitzgerald et al. also note that the district court made detailed findings why Sears' proposed lease assignment to Transform Leaseco failed to satisfy the statutory standard of adequate assurances of future performance: The assignment would impair the "tenant mix" at the mall, and Leaseco failed to satisfy the test that its financial condition be similar to that of the original tenant when the lease was first signed. Both tenant mix and the tenants' creditworthiness, Fitzgerald et al. explain, are critical underwriting standards that lenders evaluate when providing financing for mall owners. "This is because a mall's value and economic viability depend heavily on tenant mix and tenant creditworthiness," Fitzgerald et al. state. "Congress addressed both issues when it amended § 365(b) by passing the Shopping Center Amendments."

Even when it dismissed the appeal as moot following a rehearing, Fitzgerald et al. note that the district court did not alter its finding that the assignment violated § 365(b), and the statutory defect with the proposed assignment was never corrected. The district court was even "appalled by Transform's behavior" because Transform had repeatedly told the bankruptcy court that § 363(m) did not apply. Nor did the bankruptcy court believe § 363(m) applied.

The district court held that because the assignment was "integral" to the sale order then the mootness provision of § 363(m) attached to § 365(b), thus denying appellate review of an otherwise invalid and harmful lease assignment. In doing so, Fitzgerald et al. state that the district court cited no authority "for the view that Congress intended to permit courts to append a mootness provision from § 363 to the highly specific requirements found in § 365(b)." The result was the district court created a judge-made rule that appended mootness when a lease assignment was somehow 'integral' or 'intertwined' with a prior sale. The court's reasoning, according to Fitzgerald et al., rests on federal common-lawmaking that did not survive *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938).

Fitzgerald et al. believe the Second Circuit decision will cause "serious harm" as it will substantially impair the rights of mall owners under § 365(b). The MOAC case "well illustrates the harm: the District Court held that the errant ruling by the Bankruptcy Court effectively 'rewrote' the Bankruptcy Code, and yet found itself powerless to correct the harm. Unrestricted assignment of leases in a shopping center can cause a host of financial issues, including cross-defaults in mortgage loans and tenant leases, and downgrading of securities that are collateralized by mall properties," Fitzgerald et al. state.

Fitzgerald et al. also express concern over the "abuse" of theories of mootness — be it statutory or equitable — quoting Justice Alito, then sitting on the Third Circuit, who noted that equitable mootness unduly restricts appellate review and "places too much power in the hands of bankruptcy judges."

"The same problem is evident here — where a purported statutory mootness provision is engrafted onto a Code section which has no such provision, and then is interpreted broadly as jurisdictional," Fitzgerald et al. state. "The harm is evident: an erroneous ruling by a non-article III court is then asserted to be immune from appellate review. This problem is exacerbated by the similar extension of finding many transactions to be either § 363 'transfers' or somehow 'integral' to a § 363 transfer — all in the name of invoking appellate immunity."

"We urge this Court not to permit an unwarranted expansion of the concept of mootness, be it statutory or otherwise."

Government Chimes In

The U.S. government says it has a substantial interest in the case. The government notes it is the Nation's

largest creditor, and in that capacity, it often raises objections to efforts to sell or lease assets under § 363(b) and (c). The Office of the United States Trustee is also charged with supervising the administration of bankruptcy cases, including those involving sale and lease orders under § 363(b) and (c).

According to the U.S. government, § 363(m) does not impose a jurisdictional limit on appellate review of sale or lease orders. The plain text of § 363(m) demonstrates it merely imposes a statutory restriction on the relief that a party may obtain when it appeals a bankruptcy court's order authorizing a sale or lease under § 363(b) or (c).

The government explains the provision does not speak in jurisdictional terms, and the statutory provisions governing bankruptcy jurisdiction are located in a different title of the United States Code to which § 363(m) establishes no link. Nor is there any other clear indication that § 363(m) should be deemed jurisdictional. Congress did not clearly indicate that § 363(m) is jurisdictional.

"To the contrary, § 363(m) is meaningfully distinct from another provision of the Bankruptcy Code that is unmistakably of a jurisdictional character, 11 U.S.C. 305(c), and from other statutory provisions that [the Supreme] Court has characterized as jurisdictional," the government says.

The government also notes the Second Circuit has not offered a convincing rationale for deeming § 363(m) jurisdictional and Transform's arguments also fail. Because § 363(m) is not jurisdictional, the Second Circuit erroneously failed to consider MOAC's waiver and judicial estoppel arguments. It also applied the wrong standard in assessing whether the appellate relief MOAC sought is barred by § 363(m).

"Such an outcome would place concrete limits on a purchaser's risk (and associated costs) and in some cases may lead to enhanced consideration to the estate and recoveries to creditors — a great victory for purchasers and debtors alike."

Implications

According to Glenn Agre's Schmidt, if the Supreme Court finds that § 363(m) is non-jurisdictional, appellate courts will retain jurisdiction to fashion remedies that are prejudicial to a buyer so long as the appellate court determines that the remedy does not affect the validity of the sale itself. "In some instances, this could create uncertainty for buyers and potentially affect the willingness of parties to buy assets from a bankrupt company," Schmidt says.

Rick Hyman, a Partner at Crowell & Moring, notes § 363(m) provides an important protection for good faith purchasers of assets in bankruptcy but also serves to maximize the value for the debtor's estate. According to Hyman, a ruling in favor of Transform — that is, that § 363(m)'s protections are jurisdictional and that higher courts cannot even hear an appeal on matters that are integral to the sale order — would provide even greater comfort to distressed purchasers that they will not find themselves in appellate courts defending their transactions.

"Such an outcome would place concrete limits on a purchaser's risk (and associated costs) and in some cases may lead to enhanced consideration to the estate and recoveries to creditors — a great victory for purchasers and debtors alike," Hyman says. "Aggrieved third parties would necessarily be forced to seek stays pending appeal in virtually any case in which the dispute arguably related to an integral element of the sale order. Indeed, the objecting party's motion for a stay would take on much greater import — for if it failed to show that the issue was not integral, there would be nothing to appeal." ¤

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