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Seventh Circuit Keeps The Door Open After Asset Sale And Limits The Scope of Section 363(m)

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Section 363 of the Bankruptcy Code provides a debtor with the power to sell its assets during the bankruptcy case free and clear of all interests. This permits the debtor to maximize the value of its assets and hence the recovery for creditors. But that is not always the end of the story. In [Trinity 83 Development, LLC v. ColFin Midwest Funding, LLC](#), the Seventh Circuit Court of Appeals faced the issue of whether a debtor can attempt to claw back the proceeds from a section 363 sale even though the sale had already been consummated. In its March 1, 2019, opinion, the Seventh Circuit held that the debtor's appeal presented live issues and that section 363(m) of the Bankruptcy Code did not bar the debtor's claims.

In 2011, ColFin Midwest Funding purchased from Midland Loan Services a note and mortgage issued by Trinity 83 Development. ColFin relied on Midland to collect the payments from Trinity, but in 2013, Midland inadvertently recorded a "satisfaction" document stating that Trinity's loan was repaid and that the mortgage was thereby released. In 2015, ColFin realized Midland's mistake and recorded a document cancelling the "satisfaction." Soon thereafter, Trinity stopped paying and ColFin filed a foreclosure action in state court. Trinity then filed bankruptcy and subsequently filed an adversary action against ColFin related to the foreclosure action.

Trinity contended in the adversary proceeding that Midland's 2013 release extinguished ColFin's security interest, but the bankruptcy court disagreed, instead holding that because the release was a unilateral error and no other entity recorded a security interest in the interim, ColFin retained its original lien rights. The district court affirmed and Trinity appealed to the Seventh Circuit. Before the appellate court heard the case, the property was sold to a third party under the bankruptcy court's auspices.

The cards were stacked against Trinity before its appellate argument. Not only had Trinity lost at both the bankruptcy court and district court level, but now Trinity's property had been sold with the proceeds distributed to ColFin. And from a legal basis, following the property sale, Bankruptcy Code section 363(m) seemingly rendered Trinity's appeal moot. Specifically, section 363(m) provides that a court-authorized bankruptcy sale or lease that is later reversed or modified on appeal *is still valid* so long as the purchaser or lessee took the property in good faith, regardless if the party was aware of the pending appeal.

ColFin argued just this – that the appeal was now moot under section 363(m) because no stay had been issued and that there was no actual controversy for the court to consider. To many people's surprise, the Seventh Circuit rejected this argument. Speaking plainly, the court insisted that real relief could still be granted, notwithstanding the sale, because "one side [Trinity] wants money from the other [ColFin]." The court opined that a party's claim is not rendered moot simply because the opposing party has a statutory defense (here, section 363(m)) since the defense relates to the merits of the party's claim, not whether there is any triable issue present for the court to decide. The court analogized the situation to the Norris-LaGuardia Act, which prohibits using injunctions in some labor disputes, noting that the Act's defenses can provide a substantive basis for dismissal of a suit, but do not make the suit moot. Furthermore, cutting straight to the point, the court noted that despite an earlier Seventh Circuit opinion, *In re River West Plaza—Chicago, LLC*, 664 F.3d 668 (7th Cir. 2011), since 1994 the Seventh Circuit had repeatedly held that section 363(m) does not make any dispute moot. Thus, the court made it clear that even if there is a statute that provides "an ironclad defense" to the claim being

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asserted, there is still a real case or controversy within the scope of Article III.

After sternly batting away ColFin's mootness assertions, the court faced a second intra-circuit conflict related to whether the scope of section 363(m) prohibits a party from recovering only the purchased property or also the proceeds from the sale. The court noted with interest that section 363(m) does not mention "one word about the disposition of the proceeds of a sale or lease." Indeed, the appeal was now a dispute about who was entitled to the proceeds, not the property itself. After once again refusing to support *River West* where the court held that section 363(m) prohibits the possibility of a recipient of sale proceeds being ordered to turn the proceeds over to the bankruptcy estate, the court held that in accordance with Seventh Circuit precedent, it is up to the bankruptcy court to decide what is done with the proceeds of a sale or lease.

Trinity 83 Development makes clear that, at least within the Seventh Circuit, section 363(m) may not offer secured creditors with the broad protections that they would typically expect. The Seventh Circuit held that section 363(m) does not prevent proceeds from the sale of estate property from being reconveyed back to the bankruptcy estate. Moreover, the court restricted the ability of a secured creditor to assert that a challenge to the sale is moot, holding instead that while section 363(m) provides a defense to a post-sale claim, it does not operate to deprive the court of jurisdiction to consider the claim. Secured creditors should learn from the Seventh Circuit's holding. In any sale in which secured creditors will receive the sale proceeds, the secured creditors should confirm that the bankruptcy court's sale order contains explicit language providing that such proceeds are the secured creditor's exclusive property and will not become part of the bankruptcy estate. While such language may not serve as a bar to the claim, it will provide a further defense in any post-sale litigation.

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