

Managing the Right of First Refusal of Co-Owners of Property in 11 U.S.C Section 363(i)

by Andrea Dobin*

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in New Jersey.

During my first semester of law school, my Contracts professor kept reminding us that in order to truly understand a statutory section, you must read it in its entirety – not just the section that you believe provides you the answer you need. When it comes to section 363 of the Bankruptcy Code, compliance with Professor Summers' advice becomes a feet-on-the-desk, second-cup-of-coffee, event. By the time you get to section 363(i) you may not realize the complexities that confront the unwary Trustee.

Trustees are familiar with section 363(h) of the Code which allows a Trustee to sell the interests of a non-debtor along with the interests of the Estate when selling property.¹ Trustees know that this requires an adversary proceeding. Fed.R.Bankr.P. 7001(3). However, once a Trustee obtains the necessary judgment and now attempts to proceed through sale, the continuing rights of the co-owner create untold complexities and potential complications for the unwary Trustee.

Section 363(i) of the Bankruptcy Code provides the co-owner with a statutory right of first refusal that -- and this is the tricky part -- can be exercised at any time "[b]efore consummation of a sale of property to which subsection ... (h) applies...." [*emphasis added*]. In other words, a Trustee is able to obtain Court approval of the sale of jointly owned property and proceed merrily to closing. The co-owner is entitled, by law, simply to appear at closing without warning, tender the same amount of money and walk away with the property. Imagine the surprise and dismay of the proposed buyer! Does anyone owe this buyer reimbursement for his out-of-pocket costs (title search, legal fees and the like)? Is the Estate liable for reimbursement of these costs? Most buyers from bankruptcy estates believe that they are adequately protected by the Order Approving Sale. They understand that until that Order is entered, they are subject to higher and/or better bids. However, under 363(i), even after the Order is final and non-appealable,

they may lose their right to purchase the property as ordered. How does a Trustee protect the Estate from liability, maximize the value of the assets being sold, while at all times remaining in compliance with the provisions of the Bankruptcy Code. There are virtually no published opinions to give a Trustee guidance as to the practical manner in which 363(i) is to be implemented. Most references to 363(i) simply give it as an example of the manner in which the rights of co-owners are protected in the event that their property is ordered sold pursuant to 363(h).²

In light of the problems posed by the existence of the right of first refusal and the timing issue created by the express language of the Bankruptcy Code, Trustees are well-advised to obtain an Order conditioning the co-owner's exercise of his right of first refusal. For example, the Court, using its equitable powers under 11 U.S.C. Section 105, may require, for example, (i) that if the co-owner exercises his right of first refusal after a certain date (when the proposed purchaser will have spent significant funds preparing for closing), he must agree to reimburse the proposed purchaser for the pre-closing expenditures (or pay an established sum to the proposed purchaser) at the time of closing; or (ii) that the co-owner exercise his right of first refusal in court at the time of approval of the sale, at the conclusion of the auction, or at any other suitable time, so that the value of the property can be maximized by allowing additional non-affiliated bids to be solicited. See, *In re Febl*, 19 B.R. 310, 312 (Bankr. N.D.Cal. 1982) (noting that notice of sale was inadequate because it did not make provisions for the manner or the time within which the right of first refusal could be exercised).

In the event of public sale, the Trustee can protect himself quite easily. In exchange for the potential that the property will bring a lower price than if it were traditionally marketed, the benefit of an auction sale is that it ensures that the highest possible price is obtained through competitive bidding.

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There is certainly the potential that the existence of a co-owner holding a 363(i) right of first refusal will chill bidding as the bidders incorporate into their bids the risk that the co-owner will exercise his right of first refusal on the eve of closing causing a loss of the property. The fact that the co-owner could sit by and allow the bidding to be artificially depressed as a result of his presence and, thereafter, take advantage of it by exercising his right of first refusal at a later date is equally troublesome. Generally, the Bankruptcy Code does not countenance such bid-chilling. If the Court enters an Order obligating the co-owner to exercise his right of first refusal at the conclusion of the

third party bidding, the successful bidder is given an amount of certainty that the outcome of the auction is, truly, the outcome of the auction. Furthermore, by allowing the third party bidder to bid against the co-owner until such time as either the co-owner no longer matches the bid or the third party bidder is unwilling to raise the price, the value of the asset to the Estate is maximized. See the attached form of Order.

Sale of property jointly owned by a Debtor and non-debtor creates any number of complexities, compliance with 363(i) is the last in the series of issues that a Trustee will confront in bringing such property to sale. Without clear guidelines set forth in a Court-order, a savvy non-debtor co-

owner will be able to take advantage of the undervaluing of property and, at worst, expose the Trustee and the Estate to unanticipated administrative expenses. A Trustee must be wary in these situations.

Footnotes

- 1 Although most trustees are aware of the rights of a titled co-owner, in community property states and under similar state law, trustees must be aware of the rights of the non-debtor spouse that is not listed as being a record owner. See, *In re Brolier*, 165 B.R. 286 (Bankr. W.D. Okla. 1994)(applying Kansas law finding non-debtor wife to have the rights of a co-owner under section 363(i)).
- 2 *In re McDow*, 248 B.R. 466, 469 (Bankr. M.D.Fla. 2000); *In re Boswick*, 231 B.R. 843, 847 (Bankr. S.D.N.Y. 1999); *In re Hutter*, 207 B.R. 981, 987 (Bankr. D.Conn. 1997).

UNITED STATES BANKRUPTCY COURT

DISTRICT OF _____

IN RE:

JOHN DOE,

Debtor.

CASE NO. 02-00001-BKC-MS

ORDER AUTHORIZING TRUSTEE TO CONDUCT PUBLIC SALE AND GRANTING RELATED RELIEF

THIS MATTER having been opened to the Court upon the Motion of Andrea Dobin (the "Trustee") through her counsel, Sterns & Weinroth, a Professional Corporation, for the entry of an Order Authorizing the Trustee to Conduct a Public Sale and Granting Related Relief (the "Motion") and the Court having read and considered the papers filed in support of the Motion and the opposition, if any, and having heard and considered the arguments of counsel, if any, and the Court finding that cause exists for granting the relief requested and for other and good cause shown:

IT IS ORDERED that the Motion is **GRANTED**.

IT IS FURTHER ORDERED that the Trustee is authorized to sell the real property located at located at 21 Elen Street, Trenton, New Jersey (the "Property") by public sale on or about Friday, August 16, 2002 at 10:00 a.m.

IT IS FURTHER ORDERED that Jane Smith ("Smith") shall provide access to the Property to the Trustee's Auctioneer and any person interested in purchasing the Property on the following dates and times:

Tuesday, July 23, 2002, 9:00 a.m. – 12:00 p.m.

Thursday, August 8, 2002, 11:00 a.m. – 3:00 p.m.

Wednesday, August 14, 2002, 9:00 a.m. – 1:00 p.m.

Friday, August 16, 2002, 9:00 a.m. – conclusion of auction.

IT IS FURTHER ORDERED that Smith is restrained from taking any action which would diminish the value of the Property, including, but not limited to remodeling, painting or demolishing.

IT IS FURTHER ORDERED that, absent a separate agreement with the successful bidder at the auction, within fifteen (15) days after conclusion of the auction, Smith shall remove any and all of her personal possessions and those belonging to her family from the Property or same will be deemed abandoned in place.

IT IS FURTHER ORDERED that if Smith desires to exercise her rights under 11 U.S.C. § 363(i) (the "Refusal Right"), she must do so immediately following the conclusion of the bidding conducted among non-affiliated third parties. If she fails to positively state that she is exercising her Refusal Right within five (5) minutes of the inquiry by the Auctioneer, Smith will be deemed to have waived her Refusal Right as to the Property.

IT IS FURTHER ORDERED that if Smith indicates a desire to exercise her Refusal Right, the preexisting highest bidder shall be given the opportunity to raise his offer to make said offer higher and/or better than Smith's at which time Smith will, again, be given the opportunity to exercise her Refusal Right. This process shall continue until such time that either the bidder or Smith fails to submit a bid that would be deemed higher and/or better by the Trustee as a result of law (i.e., pursuant to 11 U.S.C. § 363(i)) or fact.

IT IS FURTHER ORDERED that the proceeds of sale of the Property shall be distributed as follows:

- (i) First, in payment of the secured claim of Savings Bank;
- (ii) Second, in payment of costs associated with the closing, including, but not limited to, the pro rata share of real estate taxes, water and sewer charges and closing charges (not including the auctioneer's commission);
- (iii) Third, in establishing an escrow equal to the expected fees and expenses due the auctioneer, together with the expenses to be charged and a legal fee of \$750.00 to cover the expenses associated with the closing borne by the Estate;
- (iv) Fourth, fifty (50%) percent of the remaining balance to Smith, or Doe's judgment creditors, to the extent that same have a valid lien on the Property; and
- (v) Fifth, the remainder shall be retained by the Estate and administered by the Trustee.

IT IS FURTHER ORDERED that any funds due to Smith from the sale of the Property shall be tendered to Smith within ten (10) days after the consummation of the sale of the Property.

IT IS FURTHER ORDERED that counsel to the Trustee shall serve a true and correct copy of this Order on all parties who received notice of the Motion within seven (7) days of the date hereof.

ORDERED in the _____ District of _____ on _____.

U.S. BANKRUPTCY JUDGE

Copies furnished to: