

Balancing and Protecting Competing Interests of a Landlord-Tenant Relationship in a Section 363 Sale

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Introduction

Section 363(f) of title 11 of the United States Code (the “Bankruptcy Code”) gives the trustee or debtor in possession a powerful tool to sell property of the estate “free and clear of any interest in such property.”¹ Before the estate can sell an asset “free and clear of any interest in such property,” the Bankruptcy Code requires that a debtor or trustee satisfy the statutory requirements enumerated in section 363(f). A sale of property of the debtor’s estate is permissible only if:

- (1) applicable nonbankruptcy law that permits such a sale,
- (2) the nondebtor entity consents,
- (3) the nondebtor’s property interest is a lien, and the sale price exceeds the value of all liens encumbering the property,
- (4) the nondebtor’s property interest is in bona fide dispute; or
- (5) the nondebtor entity could be compelled, at law or equity, to accept a money satisfaction of its property interest.²

Once a single condition is met, section 363(f) allows the estate to unlock the value of certain assets that would potentially be unmarketable or severely diminished in value by unknown claims against such assets.³

¹ 11 U.S.C. § 363(f) (2012).

² *See id.*

In the context of a debtor-landlord, section 363(f) can be invoked to extinguish the interests of unwanted tenants in the debtor-landlord's real property; thus "embod[ying] the general Bankruptcy Code policy of maximizing the value of the bankruptcy estate."⁴ Obviously, permitting such a 363 sale would adversely affect the interests of tenants who expect to continue occupying the leased premises. Cognizant of this tension, courts have yet to reach a unanimous decision permitting a "free and clear" sale of leasehold interests due to the existence of section 365(h) governing the assumption and rejection of leases.⁵

When a debtor-landlord or trustee rejects an unexpired lease of real property, section 365(h) allows the non-debtor tenant to either: (i) treat the lease as terminated and file a claim for breach; or (ii) "retain its rights under such lease . . . that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights."⁶ In permitting a debtor-lessor to reject an undesirable lease, section 365(h) simultaneously protects the lessee's property rights providing the lessee with certain statutory protections such as the right to stay. *Id.* Furthermore, after rejection of a lease, the debtor-lessor is not required to perform the covenants under the lease, but the lessee is entitled to offset the damages caused by nonperformance against rent.⁷ In enacting section 365(h), lawmakers sought to codify a delicate balance between the rights of a debtor-lessor and the rights of its tenants "by preserving the parties' expectations in a real estate transaction."⁸

³ See *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 548 (7th Cir. 2003).

⁴ *Toibb v. Radloff*, 501 U.S. 157, 163 (1991).

⁵ 11 U.S.C. § 365. See *IDEA Boardwalk, LLC v. Polo N. Country Club, Inc.*, No. CV 16-8683 (MAS), 2017 WL 4927667, at *6 (D.N.J. Oct. 31, 2017) ("[A]cknowledg[ing] the split between various courts regarding whether a debtor-lessor may sell real property free and clear under Section 363(f) and strip a lessee of its rights under Section 365(h).").

⁶ 11 U.S.C. § 365(h)(1)(A).

⁷ *Id.* § 365(h)(1)(B).

⁸ See *In re Lee Road Partners, Ltd.*, 155 B.R. 55, 60 (Bankr. E.D.N.Y. 1993) ("[R]ejection by a debtor-lessor does not terminate the lease so completely as to divest the lessee of his estate in property.").

Absent judicial resolution of the issue or legislative clarification, it is unclear whether a debtor-landlord may sell real property “free and clear” under section 363(f) and strip a lessee of its statutory rights under section 365(h). This memorandum explores this issue in a threefold approach. Part I addresses how courts construe “any interest in such property” under section 363(f). Part II discusses the apparent conflict between section 363(f) and section 365(h) of the Bankruptcy Code by examining the majority and minority positions. Part III concludes by analyzing the implications of these interpretations in the context of the landlord-tenant relationship whereby adequate protection must be demanded.

I. “Interest In Such Property” Includes Leasehold Interests

Because the Bankruptcy Code lacks a definition of the phrase “interest in property,” courts have struggled to determine whether particular rights asserted by a party satisfy the statutory requirement. Section 363(f) provides that the trustee may sell property “free and clear of any interest in such property.”⁹ In defining “interest” in other sections of the Bankruptcy Code, “interests in property” are creatures of state law in the absence of any controlling federal law.¹⁰ In the context of section 363(f), the term “any interest in property” encompasses those claims that are connected to or arise from the property being sold.¹¹

Under the expansive interpretation of “any interest” in section 363(f), possessory rights of lessees fall within the scope of the section.¹² In *In re Downtown Athletic Club of New York City, Inc.*, the parties disputed whether the term “any interest” included the defendant’s asserted right to obtain leases.¹³ Having asserted that right after the section 363 sale took place and title transferred, the court held that any interest that defendants had in their leasehold was

⁹ 11 U.S.C. § 363(f).

¹⁰ See *Barnhill v. Johnson*, 503 U.S. 393, 398 (1992).

¹¹ See *Ind. State Police Pension Tr. v. Chrysler LLC (In re Chrysler LLC)*, 576 F.3d 108, 126 (2d Cir. 2009).

¹² See *In re Downtown Athletic Club of New York City, Inc.*, No. M-47 (JSM), 2000 WL 744126, at *4 (S.D.N.Y. June 9, 2000).

¹³ *Id.*

extinguished upon the sale of the debtor's property.¹⁴ Thus, a tenant's leasehold interest must be within the scope of section 363(f) if it is extinguishable upon the transfer of title.

II. The Application of Section 365(h) Protections or Section 363(f) “Free and Clear” Sales

A. Majority Rule: A Trustee's Ability to Sell Property “Free and Clear” of Third Party Interests is Subject to a Tenant's Section 365(h) Rights to Stay

The majority of courts have found that section 363(f) and section 365(h) conflict, and that the rights of non-debtor lessees provided by section 365(h) prevail over a trustee's ability to sell property “free and clear” of third-party interests.¹⁵ To reconcile the conflict between section 363(f) and section 365(h), courts have applied the canon of statutory construction which instructs that “specific statutory provisions should prevail over more general provisions.”¹⁶ Because section 365(h) gives lessees the right to retain possession of leased real property notwithstanding rejection of the lease, lessees may also retain possession following a “free and clear” sale under section 363 when the lease has not been rejected.¹⁷ If the conflict between the two sections were resolved in favor of section 363(f), then the application of section 365(h) as it relates to non-debtor lessees would be rendered meaningless, leaving lessees unprotected when a landlord files for bankruptcy.¹⁸

Moreover, a lessees' interest is not necessarily terminated even upon the rejection of a lease or executory contract.¹⁹ In *Taylor*, the chapter 11 debtor sought to sell real property “free and clear” of various interests including recorded leases under which tenants operated various nursing home facilities.²⁰ The court held that the debtor's ability to sell the property “free and

¹⁴ *Id.*

¹⁵ *See Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696 (S.D.N.Y. 2014); *In re Haskell, L.P.*, 321 B.R. 1, 8–10 (Bankr. D. Mass. 2005).

¹⁶ *In re Churchill Properties III, Ltd. P'ship*, 197 B.R. 283, 288 (Bankr. N.D. Ill. 1996).

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *See In re Taylor*, 198 B.R. 142, 167 (Bankr. D.S.C. 1996).

²⁰ *Id.* at 144.

clear” was subject to the lessee’s section 365(h) right to stay. The court reasoned that because section 365(h) was specifically tailored to deal with the rights of debtor-landlords and non-debtor lessees, section 365(h) should be the sole provision to govern a landlord-tenant relationship.²¹ Thus, a debtor-landlord would be required to assume or reject a lease prior to a court approving a section 363 sale because if a lease is rejected, the lessee then has the option to treat the rejection as a breach or to remain in possession.²²

Furthermore, a debtor should not be permitted to dispossess a tenant through a “free and clear” sale because it would be “doing indirectly what it could not do directly” under section 365(h).²³ In *In re Haskell*, the court held that a debtor was unable to terminate a ninety-nine year lease through the operation of section 363(f).²⁴ Notably, the debtor could not compel the lessee to accept monetary compensation in exchange for the rejection of its lease.²⁵ The court reasoned that even if the debtor fulfilled the requirements of section 363(f), the lessee would still have the right under section 365(h) to remain in possession of its leasehold interest.²⁶

In *In re Revel AC, Inc.*, the terms of the lease allowed the tenant to operate in three venues rent-free unless the tenant’s operation was profitable as set forth in a “recoupment provision” in the lease.²⁷ When the debtor-landlord rejected the unexpired lease and the property was sold at the bankruptcy auction, the court entered an order selling the property “free and clear” of any interest but provided that the tenant retained its rights under the lease to the extent allowed by section 365(h).²⁸ The Third Circuit held that under the order permitting the section 363 sale, and by virtue of the tenant’s election under section 365(h), the tenant was entitled to

²¹ *Id.* at 164.

²² *Id.*

²³ *See In re Haskell*, 321 B.R. at 9.

²⁴ *Id.*

²⁵ *Id.* at 9.

²⁶ *Id.*

²⁷ *See Revel AC, Inc. v. Revel Entm’t Grp., LLC (In re Revel AC, Inc.)*, 909 F.3d 597, 603 (3d Cir. 2018).

²⁸ *Id.* at 600.

continue paying rent on the same terms under the lease even after its landlord rejected the lease and sold the premises.²⁹ While the court noted that equitable recoupment is an affirmative defense and not an interest extinguishable under section 363(f), the lessee was entitled to reduce its rental obligations regardless of whether its rights arose before or after the debtor filed its bankruptcy petition or rejected the lease.³⁰ Thus, in the majority of cases, section 363(f) does not permit a landlord-debtor to sell estate property free and clear of leases or its possessory interest.

B. Minority Rule: Section 363(f) Rights to Sell Property “Free and Clear” of “Any Interest” Supersedes Section 365(h) Right to Stay

A minority of courts have found that the application of section 365(h) is limited to when a debtor-landlord remains in possession of its property and rejects a lease.³¹ Moreover, section 365(h) does not grant the lessee special rights; it merely protects the lessee’s existing appurtenant rights if and when the lease is rejected.³²

When a debtor-lessor sells property pursuant to section 363(f), section 365(h) is inapplicable because the terms of section 365(h) do not supersede or limit the terms of section 363(f).³³ In *Qualitech Steel*, section 363 authorized the “free and clear” sale of all interests and the lessee neither objected nor sought adequate protection of its interest.³⁴ Thus, the court held that the section 363 “free and clear” sale extinguished the lessee’s possessory interest in the property under the lease.³⁵ The court reasoned that section 363(f) confers a right to sell property “free and clear” of any interest without excepting from that authority leases entitled to the

²⁹ *Id.* at 602.

³⁰ *Id.* at 604.

³¹ *See e.g., In re Downtown Ath. Club of N.Y. City*, 2000 U.S. Dist. LEXIS 7917, at *12-13 (S.D.N.Y. 2000).

³² *Dishi & Sons*, 510 B.R. at 707–08.

³³ *See Precision Indus., Inc.*, 327 F.3d at 547; *see also South Motor Co. of Dade County v. Carter-Prichett-Hodges, Inc. (In re MMH Automotive Group)*, 385 B.R. 347, 366 (Bankr. S.D. Fla. 2008) (“Had Congress intended the protections of section 365(h) to apply without limitation even when the property subject to the lease is sold, Congress could have made that clear. This omission . . . is telling.”).

³⁴ *Id.*

³⁵ *Id.* at 541.

protections of section 365(h).³⁶ On the contrary, the plain language of section 365(h) suggests that it has a more limited scope as it focuses on a specific type of event: the rejection of an executory contract by the trustee or debtor-in-possession.³⁷ Thus, because section 365(h) defines the rights of parties affected by the rejection of a lease and makes no reference at all about sales of estate property, section 365(h) and section 363(f) apply to different situations.³⁸

Moreover, “[w]here there is a sale, but no rejection (or a rejection, but no sale), there is no conflict.”³⁹ In *Spanish Peaks Holdings II, LLC*, the bankruptcy court authorized a 363 sale of the debtor’s resort property.⁴⁰ The trustee satisfied the statutory requirements of section 363(f)(1) and the tenants failed to request adequate protection of their leasehold interests.⁴¹ Thus, the Ninth Circuit held that section 365(h) does not act as an absolute bar to extinguishing a tenant’s leasehold interest in a section 363 sale.⁴² The court noted that no party was seeking to reject the lease and because the leases were not rejected prior to the sale, section 365(h) was never triggered.⁴³ However, the court noted a “case-by-case, fact-intensive, totality of the circumstances approach, rather than a bright line rule” should guide whether section 363(f) or section 365(h) governs.⁴⁴

III. Raising the Issue of Adequate Protection Under Section 363(e) may avoid the Conflict between Section 363(f) and Section 365(h)

Section 363(e) of the Bankruptcy Code provides that, upon the request of an entity that has an “interest” in property proposed to be sold by the trustee or debtor-in-possession, the court “shall prohibit or condition” the sale “as is necessary to provide adequate protection of such

³⁶ *Id.* at 547.

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Matter of Spanish Peaks Holdings II, LLC*, 872 F.3d 892, 899 (9th Cir. 2017).

⁴⁰ *Id.*

⁴¹ *Id.* at 900.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.* at 897.

interest.”⁴⁵ Section 361 provides three non-exclusive forms of adequate protection, including periodic cash payments to protect against any decrease in value of the interest, an additional or replacement lien, or other relief such as an administrative expense claim.⁴⁶ Notably, the broad definition of adequate protection in section 363(e) provides a “powerful check on potential abuses of free and clear sales.”⁴⁷

Moreover, adequate protection demands that the lessee be compensated for the value of its leasehold.⁴⁸ The court explained that section 363(e) protects lessees in allowing them to petition bankruptcy courts to “prohibit or condition such . . . sale . . . as is necessary to provide adequate protection of such interest.”⁴⁹ Thus, if a lessee asserts its right to protection, the Seventh Circuit held that the bankruptcy court is obligated to ensure that a lessee’s interests are adequately protected.⁵⁰

However, section 363(e) is focused upon protecting the entity whose interest is threatened, not other creditors or the purchaser.⁵¹ In *Dishi*, as part of the debtor’s reorganization plan, the debtor sought to sell a property to Dishi “free and clear” of third party interests under 363(f) and to reject all leases.⁵² Prior to entering the sale order, a lessee of the property submitted a letter to the bankruptcy court asserting its section 365(h) right to stay.⁵³ The bankruptcy court approved the auction sale to Dishi but held that the objecting lessee had a right to remain in possession of the property for the duration of the lease.⁵⁴ Dishi then appealed to the district

⁴⁵ 11 U.S.C. § 363(e).

⁴⁶ *Id.* § 361.

⁴⁷ *Spanish Peaks Holdings II, LLC*, 862 F.3d at 900.

⁴⁸ *See Precision Indus., Inc.*, 327 F.3d at 548.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *See Dishi & Sons*, 510 B.R. at 711.

⁵² *Id.* at 700.

⁵³ *Id.*

⁵⁴ *Id.*

court.⁵⁵ Considering the role of section 365(h) in isolation, the court found that the only right section 365(h) provides to the lessee is to maintain the rights that are appurtenant to the leasehold in the event a debtor exercises his rejection powers.⁵⁶ However, bankruptcy courts must provide “adequate protection” which may include the unquestionable equivalent of the threatened entity’s interest, namely, continued possession.⁵⁷ The court reasoned that where it is improbable that a lessee will receive any compensation for its interest from the proceeds of a sale and when it is difficult to value the lessee’s unique property interest, “adequate protection can be achieved only through continued possession of the leased premises.”⁵⁸

Conclusion

Courts remain split on whether section 363(f) and section 365(h) are in conflict with each other. The majority view limits a trustee’s ability to sell property “free and clear” of third party interests by the non-debtor lessee protections specifically afforded by section 365(h).

Conversely, the minority view permits leasehold interests and possessory rights under section 365(h) to be extinguished by a “free and clear” sale of property under section 363(f). However, when tenants raise the issue of adequate protection under section 363(e), or elect to retain their rights under section 365(h) at the bankruptcy court level, it is likely that tenants will receive some form of protection on account of their leasehold interest. However, when the retention of possession has been granted, the appropriate form of adequate protection in the landlord-tenant relationship remains ambiguous.

⁵⁵ *Id.*

⁵⁶ *Id.* at 705–06.

⁵⁷ *Id.* at 711.

⁵⁸ *Id.* at 711–12.