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## Feature

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### Debunking the Perceived Conflict Between §§ 365(h) and 363(f)



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Let's begin with a hopefully noncontroversial proposition: Bankruptcy affects a debtor's *in personam* obligations, but it generally does not affect a nondebtor's *in rem* rights. A debtor's lease of real property to a nondebtor implicates both — *i.e.*, *in personam* obligations (*e.g.*, to provide quiet possession of the premises) on the part of the debtor/lessor, and *in rem* rights (*i.e.*, a leasehold estate in, and concomitant right to possession of, the subject real property) on the part of the nondebtor lessee. Under § 365(h) of the Bankruptcy Code, rejection of such a lease affects only the debtor/lessor's obligations and not the nondebtor lessee's rights because upon rejection, the nondebtor lessee may retain any rights under the lease “that are in or appurtenant to the real property for the balance of the [lease] term ... to the extent that such rights are enforceable under applicable nonbankruptcy law.”

Enter § 363(f), which provides for the sale of property of the bankruptcy estate “free and clear of any interest in such property of an entity other than the estate” if one of five conditions is met. This seems at odds with the aforementioned proposition regarding the inviolability of *in rem* rights, but § 363(e) saves the day. This section provides, in pertinent part, that “[n]otwithstanding any other provision of” § 363, if a party with an interest in property of the estate subject to a sale so requests, the court “shall prohibit or condition” the sale “as is necessary to provide adequate protection of such interest.” Under § 361, this “adequate protection” consists of (1) cash payments to the nondebtor, (2) the grant of additional or replacement liens in the nondebtor's favor, or (3) “other relief” that will provide the nondebtor with the “indubitable equivalent” of its property interest. When a nondebtor requests adequate pro-

tection under § 363(e), it must prove the nature, validity and priority of its property interest, at which point the estate must prove that such interest will be adequately protected.<sup>1</sup>

Against this backdrop, suppose that a debtor/lessor rejects a real-property lease and the lessee elects to retain possession under § 365(h). The debtor later proposes a § 363(f) sale free and clear of the subject property. If none of the five conditions in § 363(f) are satisfied, the debtor cannot sell the property free of the lessee's possessory rights in any event. If at least one of those conditions is satisfied, the sale can proceed, subject to the nondebtor lessee's right to request adequate protection under § 363(e). However, § 363(e) is one of the Bankruptcy Code's “you snooze, you lose” provisions.<sup>2</sup> Thus, if the nondebtor does not request adequate protection, the court is under no obligation to provide it, but if the nondebtor is *not* caught snoozing and is able to prove the validity of its leasehold interest, adequate protection must be provided. The most obvious form that this adequate protection would take is indubitable equivalence (*i.e.*, requiring the buyer of the real property to take it subject to the leasehold estate).

The foregoing hypothetical illustrates a well-functioning statutory scheme that strikes a proper balance between respecting the nondebtor lessee's *in rem* rights while permitting the debtor/lessor to divest itself of burdensome *in personam* obligations under the lease and to monetize its real estate assets. However, not everyone agrees, particularly when the § 363(f) sale occurs *before* the lease has been assumed or rejected by the debtor/lessor.

<sup>1</sup> See 11 U.S.C. § 363(p).

<sup>2</sup> See *In re Cont'l Airlines*, 146 B.R. 536, 539-40 (Bankr. D. Del. 1992) (holding that adequate protection may only be awarded after formal demand is made); *In re Best Products Co.*, 138 B.R. 155, 159 (Bankr. S.D.N.Y. 1992) (same); *In re Wilson*, 70 B.R. 46, 48 (Bankr. N.D. Ind. 1987) (same).

## Pre-Qualitech Case Law

In *In re Taylor*,<sup>3</sup> the bankruptcy court denied a proposed sale of real property by a debtor/lessor “free and clear” of the nondebtors’ leasehold interests, finding that none of the conditions in § 363(f) were satisfied. While this could have ended the analysis, the court discussed at length its concern about the use of § 363(f) to “circumvent” the protections afforded by § 365(h) where, as in the case before it, the real property was to be sold before the debtor had assumed or rejected the leases.<sup>4</sup> Even though there is “no express statutory provision that excludes the use of § 363(f)” in that situation, the court nonetheless concluded that § 365 was the “necessary avenue” that the debtor must follow before the court could authorize a sale of the real property.<sup>5</sup> The court appeared concerned that a debtor could satisfy the “bona fide dispute” condition in § 363(f)(4) by simply disputing (but not disproving) the validity of the leasehold interest;<sup>6</sup> however, the court appears to have overlooked the fact that the nondebtor lessee could request adequate protection in accordance with § 363(e), and under § 363(p), it would be the nondebtor’s burden to prove (but not the debtor’s obligation to disprove) the validity of its leasehold.<sup>7</sup>

In *In re Churchill Properties III LP*,<sup>8</sup> the bankruptcy court reached the same result, finding that a sale of real property free and clear of a lease prior to the debtor/lessor’s assumption or rejection of that lease would render § 365 “meaningless.” Under the accepted canons of statutory construction, the “clear and specific” language of § 365(h) also trumped the “general provision” of § 363(f).

## Qualitech and Its Detractors

In *Precision Industries Inc. v. Qualitech Steel SBQ LLC (In re Qualitech Steel Corp.)*,<sup>9</sup> the Seventh Circuit Court of Appeals reconciled the apparent conflict between §§ 365(h) and 363(f) by concluding that there was no conflict. In that case, the bankruptcy court approved the debtor/lessor’s “free and clear” sale of real property and lease-designation rights. At the time that the lease at issue was executed pre-petition, all of the debtor/lessor’s real property was encumbered by duly-recorded mortgages securing more than \$200 million in debt. The lessee never obtained a nondisturbance agreement from the secured lenders, and it never recorded its lease as required by state law.

A designee of the secured lenders purchased the debtor/lessor’s assets via a credit-bid of \$180 million. The lessee had notice of the sale but did not object to or request adequate protection of its leasehold interest. Following the sale, the lessee and the purchaser were unable to agree on a lease restructuring, and the lease was rejected by operation of law. Thereafter the purchaser occupied the premises, and the lessee sued the purchaser for trespass and related relief.

The district court referred the matter to the bankruptcy court for clarification of the scope and effect of the bankrupt-

cy court’s sale order. The bankruptcy court held that the sale order had extinguished the lessee’s possessory rights. The district court reversed, following the specific-trumps-the-general reasoning and finding “no statutory basis for allowing the debtor/lessor to terminate the lessee’s possession by selling the property out from under the lessee, and thus limiting the lessee’s post-rejection rights solely to cases where the debtor/lessor remains in possession of its property.”<sup>10</sup>

The court of appeals reversed, holding that the lessee’s possessory rights were an “interest in property” for purposes of § 363(f), noting the parties’ agreement that one or more of the conditions of § 363(f) had been satisfied. Thus, the sole issue on appeal was the “perceived” conflict between §§ 365(h) and 363(f). The court noted that neither § 365(h) nor § 363(f), by its terms, superseded or limited the other (despite the fact that §§ 365 and 363 each contain cross-references to other Code provisions). Moreover, by its terms, § 365(h) applies only to lease rejection, whereas § 363 applies to sales.

In any event, § 363(e) provides a mechanism for nondebtor lessees to protect their interests, which the lessee in that case failed to do. Accordingly, the court concluded that both §§ 365(h) and 363(f) could be “given full effect without coming into conflict with one another and without disregarding the rights of lessees.” The court noted that this reading avoided grafting a limitation onto § 363(f)’s general language permitting the sale free and clear of interests “except a lessee’s possessory interest.”<sup>11</sup>

*Qualitech* has been criticized by some commentators<sup>12</sup> and, despite being the only circuit-level authority on point, has not been regularly followed by the lower courts.<sup>13</sup> Other commentators have noted the questions left open by *Qualitech*, particularly, what would have happened had the lessee objected to the sale and demanded adequate protection?<sup>14</sup> The reasoning of *Qualitech* was endorsed (and Prof. Baxter’s core criticisms of the decision refuted) in 2008 by *In re MMH Automotive Group LLC*,<sup>15</sup> which came and went with little fanfare from commentators.

## Dishi & Sons v. Bay Condos LLC

In *Dishi & Sons v. Bay Condos LLC*,<sup>16</sup> decided last May, the district court revisited — and thoroughly debunked — the perceived conflict between §§ 365(h) and 363(f). In so doing, the court tackled head-on some of the questions left open by *Qualitech*.

The debtor/lessor in *Bay Condos* sought to sell real property free and clear of a nondebtor lessee’s possessory interest after the lease was rejected and the tenant elected to remain under § 365(h). The bankruptcy court denied the proposed

10 *Precision Indus. Inc. v. Qualitech Steel SBQ LLC (In re Qualitech Steel Corp.)*, Case No. 00-247-C/H/G, 2001 U.S. Dist. LEXIS 8328, \*3 (S.D. Ind. April 24, 2001).

11 *Qualitech*, 327 F.3d at 547-48 (emphasis in original).

12 See, e.g., Michael St. Patrick Baxter, “Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in *Precision Industries v. Qualitech Steel*,” 59 *Bus. Law.* 475 (2004); Robert M. Zinman, “Precision in Statutory Drafting: The *Qualitech* Quagmire and the Sad History of § 365(h) of the Bankruptcy Code,” 38 *J. Marshall L. Rev.* 97, 106-18 (2004); Bruce H. White and William L. Medford, “Rejection via Sale of Real Estate: Is Your Leasehold Interest Protected?,” 26 *ABI Journal* 7, 28, September 2007.

13 See, e.g., *In re MMH Auto. Grp. LLC*, 385 B.R. 347, 363 (Bankr. S.D. Fla. 2008) (noting “vast majority” of lower court decisions come out differently than *Qualitech*); *In re Haskell LP*, 321 B.R. 1, 9 (Bankr. D. Mass. 2005) (declining to follow *Qualitech*).

14 See, e.g., Jeffrey J. Graham, Jerald I. Ancel and Marlene Reich, “Can a Section 363 Sale Dispossess a Tenant Notwithstanding Section 365(h)?,” *ABI Journal*, July/August 2003.

15 *In re MMH Automotive Group LLC*, 385 B.R. 347, 361-67 (Bankr. S.D. Fla. 2008).

16 *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 698-99 (S.D.N.Y. 2014).

3 *In re Taylor*, 198 B.R. 142, 167-68 (Bankr. D.S.C. 1996).

4 *Id.* at 163-67.

5 *Id.* at 167.

6 *Id.* at 165.

7 At the time that *Taylor* was decided, subsection (p) was designated as subsection (o). It was not until the enactment of the 2005 amendments that subsection (o) became subsection (p).

8 *In re Churchill Properties III LP*, 197 B.R. 283, 286-88 (Bankr. N.D. Ill. 1996).

9 *Precision Industries Inc. v. Qualitech Steel SBQ LLC (In re Qualitech Steel Corp.)*, 327 F.3d 537, 547 (7th Cir. 2003).

sale, following the majority specific-trumps-the-general approach to §§ 365(h) and 363(f). Alternatively, the court held that even if § 363(f) applied, the lessee was entitled to continued possession following the sale as adequate protection of its leasehold estate under § 363(e).

On appeal, the district court affirmed solely on the basis of the latter ruling. The court noted that *Qualitech* dealt with the “easy” case where there was no rejection triggering § 365(h) as a technical matter prior to the sale. Under such circumstances, the court concluded that the *Qualitech* reasoning “skirts the purported conflict [between § 365(h) and 363(f)] and thus fails to offer a real solution.”<sup>17</sup> Considering the purported conflict anew, the court likewise found that §§ 365(h) and 363(f) worked in harmony but that the specific-trumps-the-general approach “proves too much”:

If § 365(h) provides lessees with an absolute right to possession that trumps ... § 363(f), it is difficult to see why the lessee’s right does not also trump ... other powers, such as the [§ 544(a)] power to avoid interests as a bona fide purchaser ... or [the § 548(a)(1) power] to avoid interests that were fraudulently transferred by the debtor.... The purpose of § 365(h) is to clarify that rejection is not an avoidance power — not to give the lessee rights that may never be avoided by some other means.<sup>18</sup>

The district court found that the bankruptcy court did not abuse its discretion in concluding, where it was improbable that the sale proceeds would be sufficient to provide an adequate protection payment to the lessee and where the lessee’s “unique property interest” would be difficult to value in any event, that adequate protection “can be achieved through continued possession of the leased premises.”<sup>19</sup>

## Conclusion

The *Bay Condos* decision demonstrates that the purported conflict between §§ 365(h) and 363(f) is more imagined than real, and that the backlash against *Qualitech* is a tempest in a teapot. Had the lessee in *Qualitech* objected to the sale and sought adequate protection of its possessory interest as the lessee in *Bay Condos* had, the result would have likely been the same because the *Qualitech* lessee could not have satisfied its burden of establishing that its leasehold estate — which was unrecorded and subordinate to the prior recorded mortgage of the secured lenders — was valid and entitled to protection. In the more typical case where the nondebtor lessee is diligent in perfecting its leasehold estate and requesting adequate protection of its interest in the bankruptcy proceeding, the result should be the same as in *Bay Condos*. **abi**

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<sup>17</sup> *Id.* at 704.

<sup>18</sup> *Id.* at 707-08.

<sup>19</sup> *Id.* at 711-12 (quoting *Haskell*, 321 B.R. at 10).