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OCTOBER 2017

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VOLUME 13

NUMBER 7

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Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)

ISBN: 978-0-7698-7988-8 (eBook)

ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT’S JOURNAL OF BANKRUPTCY LAW [page number] ([year])

**Example:** Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the “Rescue and Recovery” Culture for Business Recovery*, 10 PRATT’S JOURNAL OF BANKRUPTCY LAW 349 (2014)

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# May Real Property Be Sold Free and Clear of Leasehold Interests Under Bankruptcy Code Section 363? The Ninth Circuit Joins the Seventh and Says “Yes”

*By Peter C. Blain\**

*Courts have struggled with the question of whether Code Section 363(f) authorizes a sale of real property free and clear of leasehold interests. A majority of lower courts wrestling with this issue have concluded that Code Section 365 conflicts with—and consequently trumps—Code Section 363, and that real property cannot be sold free and clear of leasehold interests. However, the U.S. Court of Appeals for the Seventh Circuit stood alone when it held that real property may be sold under Code Section 363 free and clear of leasehold interests. The U.S. Court of Appeals for the Ninth Circuit recently joined the Seventh Circuit when it decided In re Spanish Peaks Holdings II, LLC. The author of this article discusses the decision.*

Many of the cases filed under Chapter 11 of the U.S. Bankruptcy Code<sup>1</sup> today result in a going concern sale of substantially all of the debtor’s assets out of the ordinary course of business under Code Section 363(b). This alternative is selected instead of confirmation of a Chapter 11 plan. Why is this so? There are a myriad of reasons, including the significantly reduced time and expense involved, which may be crucial to a struggling business and its customers, and often the ability of a senior secured creditor to control the case, sometimes as the debtor’s largest secured and unsecured creditor.<sup>2</sup>

One of the most attractive features of a Code Section 363 sale is the ability to obtain an order from the Bankruptcy Court conveying the assets of the debtor free and clear of any and all liens, claims, encumbrances and interests.<sup>3</sup> This guarantees a buyer that there are no trailing liabilities to be concerned about. However, where real estate is involved, courts have struggled with the

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<sup>1</sup> 11 U.S.C. § 101-1532 (hereinafter the “Code”).

<sup>2</sup> For a discussion of the Code Section 363 sale process, see Peter C. Blain, Michael D. Jankowski, L. Katie Mason, *Buying & Selling Businesses in Insolvency Proceedings*, J. of Tax’n & Reg. Fin. Institutions (May/June 2014, at 5).

<sup>3</sup> 11 U.S.C. § 363(f).

question of whether Code Section 363(f) authorizes a sale of real property free and clear of leasehold interests. This question is complicated by Code Section 365(h), which provides that where the debtor is a lessor and the lease is rejected under Code Section 365, the lessee is entitled to remain in possession for the balance of the lease term and any extension or renewal enforceable under applicable law.

A majority of lower courts wrestling with this issue have concluded that Code Section 365 conflicts with—and consequently trumps—Code Section 363, and that real property cannot be sold free and clear of leasehold interests. However, the U.S. Court of Appeals for the Seventh Circuit, the only circuit court to rule on the issue, stood alone when it held in *Qualitech Steel* that real property may be sold under Code Section 363 free and clear of leasehold interests.<sup>4</sup> In July 2017, the Seventh Circuit was joined by the U.S. Court of Appeals for the Ninth Circuit when it decided *In re Spanish Peaks Holdings II, LLC*.<sup>5</sup>

### THE FACTS OF *SPANISH PEAKS*

Timothy Blixseth and James Dolan, Jr. developed a 5,700 acre resort in Big Sky, Montana, which was financed by a \$130 million loan from Citigroup Global Markets Realty Corp. (“Citigroup”).<sup>6</sup> Citigroup later assigned its note and mortgage to Spanish Peaks Acquisition Partners, LLC (“SPAP”). In 2006, Spanish Peaks Holdings, LLC (“SPH”) leased restaurant space to Spanish Peaks Development, LLC (“SPD”), an entity owned by Dolan, for 99 years at a rate of \$1,000 per year. In 2008, SPD assigned its interest to Pinnacle Restaurant at Big Sky, LLC (“Pinnacle”), an entity created to hold the lease. In 2009, SPH leased a separate parcel of real property to Montana Opticom, LLC (“Opticom”), of which Dolan was the sole member, for a term of 60 years at an annual rent of \$1,285.

Following severe operational losses, SPH and two affiliates filed petitions for relief under Chapter 7 of the Code.<sup>7</sup> The trustee and SPAP, which held a valid claim for \$122 million, agreed upon a plan to liquidate all of the debtors’ assets

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<sup>4</sup> See *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003).

<sup>5</sup> *Pinnacle Res. at Big Sky, LLC. v. CH SP Acquisitions, LLC (In re Spanish Peaks Holdings II, LLC)*, 862 F.3d 1148 (9th Cir. 2017).

<sup>6</sup> For a discussion of another project developed by Mr. Blixseth, see Peter C. Blain, *Considering Service on a Creditors’ Committee? The Ninth Circuit Provides Barton Protection to Committee Members*, 13 Pratt’s J. of Bankr. L., 207 (2017).

<sup>7</sup> Although *Spanish Peaks* was a Chapter 7 proceeding, going concern sales and the issues discussed herein arise most often in Chapter 11 cases.

free and clear of all liens via an auction (held on June 3, 2013), setting a minimum bid of \$20 million. In its motion seeking authority to sell the assets and to approve the sale, the trustee represented that the assets would be sold “free and clear of any and all liens, claims, encumbrances and interests,” except for certain specified encumbrances and liens which were to be paid out of the sales proceeds or otherwise protected. The Pinnacle and Opticom leases were not mentioned as protected encumbrances, and Pinnacle and Opticom objected to the sale being free and clear of the leaseholds, asserting that under Code Section 365(h), the lessees had the right of continued possession notwithstanding the sale. CH SP Acquisitions, LLC (“Buyer”)<sup>8</sup> submitted the winning bid at \$26.1 million at the auction.

At the sale hearing, held on the same day as the auction, Pinnacle and Opticom again asserted that the proposed sale order was inconsistent with their asserted right of continued possession under Code Section 365(h). The Buyer testified that its bid was contingent on the property being free and clear of the leases. The trustee did not take a position on the issue. On June 13, 2013, the bankruptcy court entered an order approving the sale which provided that the sale was free and clear of any “Interests,” a term which was defined to include any leases “(except any right a lessee may have under 11 U.S.C. § 365(h), with respect to a valid and enforceable lease, all as determined through a motion brought before the Court by proper procedure.)”<sup>9</sup>

Pinnacle and Opticom moved for clarification that the sale order preserved their rights under the leases, and the Buyer sought clarification that its purchase was free and clear of the leases. The bankruptcy court indicated that it had not ruled either way, and that it would not consider the issue until an appropriate motion was filed and an evidentiary hearing was held. The trustee subsequently moved to reject the Pinnacle and Opticom leases on the ground that they were no longer property of the estate. The Buyer formally moved for a determination that the property was free and clear of the leases. Pinnacle and Opticom did not object to the trustee’s motion which was granted, but renewed their previous objections to the Buyer’s motion.

After a two day evidentiary hearing, the Bankruptcy Court made the following findings of fact:

- Pinnacle had not operated the restaurant since 2011;
- Pinnacle’s rent was far below the fair market rental value of \$40,000 to

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<sup>8</sup> Buyer had previously purchased SPAP’s interest in the note and mortgage and presumably made a credit bid under Code Section 363(k).

<sup>9</sup> *In re Spanish Peaks Holdings II, supra.*



\$100,000 per year;

- Opitcom's lease was not recorded;
- The leases were entered into at a time when all parties were controlled by Mr. Dolan;
- The leases were subject to bona fide disputes;
- Citigroup's mortgage was superior in priority to the leases; and
- The leases were not subject to protection from foreclosure by subordination agreements.

The bankruptcy court also noted that Pinnacle and Opticom had not requested adequate protection or provided any evidence that they would suffer economic harm if their possessory interests were terminated. Based upon those findings, the Bankruptcy Court indicated that analyzing the issues on a case by case basis and under the totality of the circumstances, the sale was free and clear of the leases. Pinnacle and Opticom appealed to the district court, which affirmed, and then appealed to the Ninth Circuit.

### **THE COURT'S DECISION—HOW DO CODE SECTIONS 363 AND 365 INTERRELATE?**

The court began by stating that the principal issue was interpreting the apparent conflict between two Code sections: Code Section 363(f), which, in certain circumstances,<sup>10</sup> allows a sale of assets free and clear of any interests in such property so long as the interest holder is provided with adequate protection of such interest,<sup>11</sup> and Code Section 365(h), which, upon rejection of a lease by the debtor as lessor, allows a lessee to remain in possession post rejection for the balance of the lease term and any renewal or extension permitted by applicable law.<sup>12</sup> The two Code sections often operate in isolation, said the court, but when one of the assets to be sold free and clear is real property subject to an unexpired lease, both provisions come into play and a

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<sup>10</sup> Code Section 363(f) provides that a sale free and clear of an interest may occur only if: (1) applicable non bankruptcy law permits sale of property free and clear of the interest; (2) the entity holding the interest consents; (3) such interest is a lien and the price at which the property is to be sold is greater than value of all liens on the property; (4) the interest is in bona fide dispute; or (5) the interest holder could be compelled in a legal or equitable proceeding to accept a money satisfaction of such interest.

<sup>11</sup> 11 U.S.C. § 363(e).

<sup>12</sup> *In re Spanish Peaks Holdings II*, *supra*.

dilemma arises.<sup>13</sup>

### THE MAJORITY APPROACH

The Ninth Circuit noted that a majority of courts considering the issue have found that Code Sections 363 and 365 overlap, with each providing an exclusive right that, when invoked, would override the other. Those courts held that under the canon of statutory construction that the specific controls over the general, Code Section 365 trumps Code Section 363. Those courts also relied upon specific legislative history that Congress intended to protect the rights of lessees, and to permit a sale free and clear of leasehold interests would render that protection nugatory.<sup>14</sup>

### THE MINORITY APPROACH

The court then observed that the Seventh Circuit reached a different conclusion in *Qualitech Steel*, concluding that the provisions of Code Sections 363 and 365 do not suggest that one supersedes or limits the other.<sup>15</sup> Upon examining the scope of the two Code sections, the Seventh Circuit found that Code Section 363 permits the sale of property free and clear of “any interest” without excepting from its ambit leases entitled to protections under Code Section 365. Code Section 365, on the other hand, has a more limited scope and applies only when leases are formally rejected, saying nothing about the sale of property subject to leases prior to rejection. This, said the Seventh Circuit, is the proper province of Code Section 363.<sup>16</sup> Moreover, lessees in possession of real property subject to a free and clear sale are protected by Code Section 363(e), which provides that to approve a free and clear sale of real property subject to an unexpired lease, upon request, the bankruptcy court must find that the interests held by the lessee are adequately protected. Reading the two Code Sections in this way, said the Seventh Circuit, demonstrated that they did not conflict.<sup>17</sup>

### THE NINTH CIRCUIT FOLLOWS THE SEVENTH

The Ninth Circuit must, it said, “read the statutes to give effect to each if we

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<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Qualitech Steel*, 327 F.3d at 547.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 548.

can do so while preserving their sense and purpose.”<sup>18</sup> The concept of “rejection” of a lease under Code Section 365 is an affirmative declaration that the estate will not take on the obligation contemplated by the lease. While a Code Section 363 free and clear sale of property subject to a lease is effectively rejection, it is not “rejection” contemplated by Code Section 365. Where there is a sale but no Code Section 365 rejection, the statutes do not conflict.<sup>19</sup>

Additionally, the mandatory nature of Code Section 363(e) obligates the bankruptcy court to award adequate protection for the termination of a leasehold interest due to a free and clear sale, so long as the lessee requests it. Code Section 361(3) provides that “adequate protection” includes any relief—other than the award of an administrative expense claim—that will give the requesting entity the indubitable equivalent of the terminated interest,<sup>20</sup> and may take the form of continued possession.<sup>21</sup> The court noted that the broad definition of adequate protection serves as a powerful check on potential abuses of free and clear sales. However, to be entitled to adequate protection, the lessee must ask for it. Because Pinnacle and Opticom did not ask for adequate protection until after the sale had occurred, “the question of what adequate protection the bankruptcy court could have or should awarded” was not before the court.<sup>22</sup>

The court agreed that free and clear sales are permitted only if one of the grounds set forth in Code Section 363(f) exist. Finding that Montana law allows a foreclosing lender to terminate a subordinate leasehold interest, the court concluded that the sale was governed by Code Section 363(f)(1) (“applicable non bankruptcy law permits the sale of such property free and clear of such interest”).<sup>23</sup> Finally, the court commented on the deficiency of the majority approach:

Our analysis highlights a limitation inherent in the “majority” approach. We agree that section 365 embodies a congressional intent to protect lessees. But that intent is not absolute; it exists alongside other purposes and sometimes conflicts with them. To some extent, protecting lessees reduces the value of the estate—property presumably fetches a lower

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<sup>18</sup> *In re Spanish Peaks Holdings II, LLC*, *supra* (citing *Watt v. Alaska*, 451 U.S. 259, 267 (1981)).

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* (citing *Dishi & Sons v. Bay Condos, LLC*, 510 B.R. 696 (S.D.N.Y. 2014)).

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

price if its subject to a lease—and is therefore contrary to the goal of “maximizing creditor recovery,” . . . another core purpose of the Code. The statutory text is the best assurance we have that we are balancing the competing purposes in the way Congress intended.<sup>24</sup>

Because the trustee did not reject the Pinnacle and Opticom leases, Code Section 365 was not implicated and the sale of the real estate free and clear of the leasehold interests under Code Section 363(f)(1) was authorized. The judgment of the district court was affirmed.<sup>25</sup>

## CONCLUSION

With *Spanish Peaks*, currently two Circuit Courts of Appeals have ruled that so long as unexpired leases are not formally rejected, and despite the fact that a sale free and clear of leasehold interests effectively terminates such interests, Code Section 363 trumps Code Section 365 and the protection of post rejection possession Congress awarded to lessees therein. In its decision, the Ninth Circuit seems to give preeminence to the policy of enhancing the estate via a higher sale price for real property sans leases, at the expense of the heightened protections Congress envisioned for lessees in Code Section 365(h).

While the court holds out the prospect that one form of adequate protection could be continued possession, this appears to directly collide with the apparently more important policy goal of obtaining a higher price for lease free real estate. Moreover, the granting of monetary adequate protection may not prevent the possible destruction of a business whose goodwill is tied to a specific location established over a significant number of years, or whose disruption of its production cycle may destroy its going concern value. In addition to the value of a specific location, a lessee may have made significant investment in irreplaceable leasehold improvements. Where a specific leased location is crucial to a business, a lessee may want to consider immediately filing a motion with the bankruptcy court to compel the debtor to assume or reject the lease at the earliest opportunity pursuant to Code Section 365(d)(2), thereby triggering the protections of Code Section 365(h). However, such motions are not favored by courts early in the case (and are often opposed by unsecured creditors' committees), as compelling an early decision regarding leasehold interests limits the debtor's flexibility as the case progresses.

Perhaps the most important takeaway from *Spanish Peaks* and *Qualitech* is that while adequate protection is mandatory if it is requested, if a lessee does

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<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

not request it, the right to adequate protection will evaporate. Lessees would be well advised to couple any objection to a sale of the premises that they occupy free of their leasehold interest with an alternative request for adequate protection under Code Section 363(e), and to begin preparing their evidentiary case as to what that adequate protection should be.