

Does a Tenant's Right of Possession Trump a Sale Under Section 363?

By Bruce Buechler

The interplay between sections 363(f) and 365(h) of the Bankruptcy Code continues to plague various courts. This article explores several recent decisions evaluating whether a tenant's rights under section 365(h) survive a sale of the debtor's assets free and clear of all liens, claims, and encumbrances pursuant to section 363(f). In many cases, the issue boils down to the language of section 363(f), which permits a sale "free and clear of any interest in such property of an entity other than the estate ..." (emphasis added). Courts have grappled with the question of whether the phrase "any interest" in the context of a real property sale includes not only fee interests, security interests and other ownership interests, but also a tenant's possessory right under section 365(h). Some courts have construed the broad language of "any interest" to encompass leasehold interests and thus have determined that section 363(f) trumps section 365(h), permitting debtors and trustees to sell real property free and clear of leasehold interests. Other courts have reached different conclusions.

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IN THE COURTS

In the lone circuit court decision that has dealt with the issue, *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003), the U.S. Court of Appeals for the Seventh Circuit determined that there was no conflict, holding that sections 365(h) and 363(f) "apply to distinct sets of circumstances." *Id.* at 547. The *Qualitech* court reconciled the alleged conflict by stating that the terms of section 363(f) apply when a trustee or a debtor-in-possession seeks to sell property of which it is a lessor, whereas section 365(h) only deals with the assumption or rejection of unexpired leases of real property. By contrast, the district court in *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696 (S.D.N.Y. 2014), recently reconciled these apparently conflicting Bankruptcy Code sections differently. The district court affirmed the bankruptcy court's order, which authorized a sale of real property pursuant to section 363(f), but also permitted the existing tenant to remain in possession of the premises under section 365(h) after the purchase (*i.e.*, the sale was not free and clear of the lease), concluding that:

Although § 365(h) is applicable to § 363(f) sales, it does not give the lessee absolute rights that take precedence over the trustee's right to sell free and clear of interest. Rather, it clarifies that the lessee may retain its appurtenant rights notwithstanding the trustee's rejection of the lease. Section 363(f), in turn, authorizes the trustee to extinguish lessee's appurtenant rights — like any other interest in property — but only if one of the five conditions

is satisfied with respect thereto. The two sections thus work in harmony to establish that the lessee's appurtenant rights may not be terminated by rejection and must be taken into account in any proposed free and clear sale. If § 363(f) authorizes the trustee to sell property free and clear of such rights, nothing in § 365(h) mandates a contrary result. As this case demonstrates, however, § 363(f) will rarely permit such a sale, and consequently, the lessee's rights will generally be enforceable against the transferee of the property. In any event, the bankruptcy court did not abuse its discretion in holding that the lessee was entitled to continue possession as adequate protection of its interest.

Id. at 698-99.

Dishi & Sons

Dishi & Sons marks a clear repudiation of the *Qualitech* rationale, reading these two statutory provisions in harmony. In addition, its decision construes the apparent conflicting Bankruptcy Code provisions in a way that provides both with meaning in all situations and does not render section 365(h) nugatory in the context of a free-and-clear sale under section 363(f). By analogy, the bankruptcy court in *In re Crumbs Bake Shop, Inc.*, 522 B.R. 766 (Bankr. D.N.J. 2014), recently held with respect to an analogous provision of § 365 dealing with intellectual property rights, that "a sale under § 363(f) does not trump the rights granted to Licensees by § 365(n)." *Id.* at 774.

In addition, the legislative history of section 365(h) evidences a clear

congressional intent to protect lessees when a lessor files for bankruptcy. See, e.g., *In re Zota Petroleums, LLC*, 482 B.R. 154, 161-162 (Bankr. E.D.Va. 2012). Conversely, many courts have concluded that these two provisions are indeed irreconcilable and that because section 365(h) is more specific, it trumps section 363(f) and provides the “exclusive remedy available to the debtor in an executory lease situation.” *In re LDH Realty Corp.*, 20 B.R. 717, 719 (Bankr. S.D. Ind. 1982). The decision in *Dishi & Sons* clearly holds the promise of a more rational interpretation of these provisions because the decision to reject a lease is merely a decision not to obligate the estate to continue in an unprofitable agreement, as opposed to terminating the lease. Thus, section 365(h) provides the lessee with rights to continue in possession as long as it continues to honor its obligations under the lease.

THE REVEL CASINO BANKRUPTCY DECISION

More recently, a decision in the Revel Casino bankruptcy proceedings reflects a possible change in course away from the *Qualitech* rationale by another court of appeals. The bankruptcy court approved the sale of the defunct Revel Casino property in Atlantic City, NJ, free and clear of all liens, claims and encumbrances, including possessory rights of tenants under section 365(h). The sale order entered by the bankruptcy court expressly provided that “the sale of Debtors’ Assets pursuant to 11 U.S.C. § 363(f) shall be free and clear of existing tenancies and/or possessory rights, irrespective of any rights a tenant may hold under 11 U.S.C. § 365(h), *including, but not limited to, all possessory rights*” under § 365(h). See *In re Revel AC, Inc.*, 525 B.R. 12, 22 (D.N.J. 2015) (emphasis added).

The district court in *Revel* dealt with an emergency application for a stay of the sale order by, among other parties, a group of appellants that were lessees of portions of the Revel casino facility and accompanying properties, which the district court referred to as the “365(h) Appellants.” The 365(h) Appellants asserted irreparable harm and

a likelihood of success on the merits of their appeal, in which they sought reversal of the bankruptcy court’s decision to extinguish their possessory rights under section 365(h). The district court, following *Qualitech*, held that the 365(h) Appellants had failed to demonstrate a strong likelihood of success on the merits and denied their request for a stay of the sale order. *Id.* at 30-31, 35. The 365(h) Appellants then sought an emergency stay of the sale order from the U.S. Court of Appeals for the Third Circuit. The Third Circuit issued an order on Feb. 6, 2015 reversing the district court’s decision. *In re Revel AC, Inc.*, 2015 U.S. App. LEXIS 1936 (3d Cir. Feb. 6, 2015). The Third Circuit remanded the matter for a stay as to one particular appellant, maintaining a stay of the sale order in effect “until the District Court enters a stay order in conformity herewith.” *Id.*

On remand, the district court granted a stay of the specific provision of the sale order foreclosing certain parties’ rights under section 365(h) to a larger group of appellants noting that “the Court need not belabor Revel’s assertions, because the Court cannot ignore the inescapable conclusion that the Court of Appeals’ order, regardless of the specific underlying rationale, significantly called into question — and indeed reversed in part — this Court’s January 21, 2015 decision.” *In re Revel AC, Inc.*, 2015 U.S. Dist. LEXIS 15816, *10 (D.N.J. Feb. 10, 2015). Thus, it would appear that the Third Circuit may be telegraphing that section 363(f) does not trump lessees’ rights under section 365(h) in a sale.

ADEQUATE PROTECTION OF A TENANT’S INTEREST

In addition, as noted by the court in *Dishi & Sons*, even in the free-and-clear sale context, section 363(e) entitles a tenant to adequate protection of its interest. The *Dishi* court noted that it must follow the plain language of the Bankruptcy Code and further stated that the phrase “adequate protection” may include the indubitable equivalent of the interest. *Dishi & Sons*, 510 B.R. at 711. For a lessee of real property, whose interest is purely possessory (as

opposed to a lender, whose interest is purely financial), that would mean continued possession of the premises. See *id.* The *Dishi & Sons* court noted that if the lessee’s lease were rejected, and its claim simply treated as a general unsecured prepetition claim, in many sales under section 363(f) it would not receive any compensation from the proceeds of its sale and that “adequate protection can be achieved only through continued possession of the leased premises.” *Id.* at 712 (citation omitted).

The *Qualitech* court similarly noted that in a sale under section 363(f), where the real estate is sold free and clear of the tenant’s possessory rights, a tenant has the right to request adequate protection of its interest under section 363(e). However, court did not address what form of adequate protection should or could be provided because the tenant in that case did not object to the sale or seek protection under section 363(e). 327 F.3d at 548. The *Qualitech* court noted that if the tenant requests adequate protection under section 363(e), “the bankruptcy court is obligated to ensure that their interests are adequately protected.” *Id.*

CONCLUSION

The decisions in *Dishi & Sons* and *Revel* seem to portend that the rationale and decision in *Qualitech* may not be the last word on the interplay between sections 363(f) and 365(h), and that the rationale and result espoused by the *Dishi & Sons* court is more persuasive. Thus, purchasers of real estate assets and potentially their secured lenders need to be concerned that tenants of leased real estate sold free and clear under section 363(f) may nevertheless remain entitled to exercise their rights under 365(h) and remain in possession of the leased property.