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Buyers vs. Tenants in a Bankruptcy Sale: A **Tension** Between §§363(f) and 365(h)

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Chapter 11 cases take less time from start to finish than they did 10 to 15 years ago. Companies often don't file these days to stay in business but to sell assets and liquidate. Sometimes the key assets are buildings where people have their homes or businesses sell their goods. Buyers will want to update buildings they purchase to attract new tenants who can pay more than current ones. But current tenants might want to stay where they are and not move.

The Bankruptcy Code offers support to both buyers and tenants. Section 363 lets debtors sell assets free and clear of liens, claims, and other interests. Such interests can include real property leases. But Bankruptcy Code §365 allows tenants with leases debtors reject in bankruptcy to retain their rights that are "appurtenant" to the real property for the lease term and any extension. This means tenants can stay in their homes or their businesses even when a debtor rejects a lease.

So how do bankruptcy judges resolve the competing desires of buyers and tenants? Must buyers bid for property knowing that tenants might have the right to stay if their leases are rejected? Are tenants in jeopardy that they might have to move elsewhere to live or work?

Two cases that address this issue have made it to the federal courts of appeal, *Pinnacle Rest. at Big Sky v. CH SP Acquisitions (In re Spanish Peaks Holdings II)*, 872 F.3d 892 (9th Cir. 2017); and *Precision Indus. v. Qualitech Steel SBQ*, 327 F.3d 537 (7th Cir. 2003), while other cases have been heard by bankruptcy and district courts. *See Dishi & Sons v. Bay Condos*,

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510 B.R. 696 (S.D.N.Y. 2014); *In re Crumbs Bake Shop*, 522 B.R. 766 (Bankr. D. N.J. 2014; *In re Zota Petroleums*, 482 B.R. 154 (Bankr. E.D. Va. 2012); *In re Haskell L.P.,* 321 B.R. 1 (Bankr. D. Mass. 2005); and *In re Churchill Props III, Ltd. P'shp*, 197 B.R. 283 (Bankr. N.D. Ill. 1996). And both majority and minority views have emerged in the case law.

The statutory language itself is straightforward. Section 363(f) permits debtors to "sell property [of the estate] … free and clear of any such interest in such property of an entity other than the estate" if one of five conditions is satisfied:

> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
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> (2) such entity consents;
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> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
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> (4) such interest is in bona fide dispute; or
>
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

11 U.S.C. §363(f).

Under §365(h), if a lease is rejected by a debtor-lessor (or a bankruptcy trustee in place of the debtor), the lessees have two options: They can (1) treat the rejection as a breach of the lease and terminated, or (2) retain the rights "appurtenant" to the lease, which includes the right to remain in possession for the balance of the lease term. The statute states:

> (i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection; or they retain the rights "appurtenant" to the lease, including staying in possession for the balance of the lease term.
>
> (ii) if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) 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 to the extent that such rights are enforceable under applicable nonbankruptcy law.

11 U.S.C. §365(h)(1)(A)(i)-(ii).

The majority view holds that (1) §§363(f) and 356(h) can't be reconciled, and (2) the rights of lessees under §365 take precedence over the rights of buyers under §363. In other words, lessees can stay in their homes or stores even when a debtor-landlord sells the property. Courts often give three reasons for this conclusion. The first is the cannon of statutory construction that the specific governs the general. The specific right in §365(h) for lessees should trump the general rights of buyers in §363. Second, the legislative history shows Congressional intent to protect lessees when property where they reside or work is sold in bankruptcy. Finally, allowing property to be sold free and clear of a lessee's interest would render §365(h) "nugatory." *See In re Churchill Props III, Ltd, P'shp*, 197 B.R. 283, 288 (N.D. Ill. 1996).

The minority view says that §365(h) applies only (1) if a debtor-landlord rejects a lease but (2) not when it sells real property under §363(f). Courts often cite three reasons for this position. First, as noted above, §363(f) permits sales free and clear of "any interest," and the

minority view says this includes interests of lessees of real property. Second, courts strive to interpret different statutory sections so they don't conflict with one another. Courts that support the minority view say that §365(h) applies when a debtor rejects a lease but not when property is sold. And, third, these courts note that even if real property can be sold free and clear of a lessee's interest, a lessee would still have a remedy: it could seek adequate protection under Bankruptcy Code §363(e), which courts say can include allowing a lessee to remain in possession. So even under the minority view, lessees could stay for the balance of the lease term when a debtor seeks to sell real property, if a motion for adequate protection is made and granted.

At least one court has said both views miss the mark. *Dishi & Sons v. Bay Condos LLC,* 510 B.R. 696 (S.D.N.Y. 2014). *Dishi* said the majority view is flawed because it can be read to give lessees an "absolute right to possession" that is not supported by the Bankruptcy Code. *Dishi,* 510 B.R. at 707. The majority would allow lessee's rights to "trump the trustee's other powers, such as the power to avoid interests as a bona fide purchaser, 11 U.S.C. §544(a)(1), or to avoid interests that were fraudulently transferred by the debtor, id. §548(a)(1)." Id.

Dishi said the problem with the minority view is that "it arguably results in the effective repeal of §365(h), allowing a lessor to evade its protections simply by selling property free and clear without a formal rejection of the lease." In other words, the minority view might have application only if the §365(h) isn't "triggered in the first place" when a sale is permitted under §363(f) and a lease isn't rejected. *Dishi,* 510 B.R. at 703. And yet, as noted above, the minority view affords lessees protection not via §365(h) but through adequate protection under §363(e).

Dishi offered another way to reconcile §§363(f) and 365(h). It emphasized that §365(h) permits rejection but preserves a lessee's "appurtenant" rights, including continued possession. While a buyer's rights under §363(f) will be respected if one of (f)'s five conditions is satisfied, the "appurtenant" rights of tenants in §365(h) should be respected. And the court also agreed that lessees can seek to maintain possession via a motion for adequate protection under §363(e). *Dishi,* 510 B.R. at 708

The upshot of the jurisprudence is that, notwithstanding how courts have construed §§363(f) and 365(h), they've shown how tenants can be protected when property is sold in bankruptcy. Even if a debtor-lessor seeks to reject a lease that it wants to sell, the minority view notes that tenants can try to stay in possession by seeking a ruling for adequate protection. This means that lessees must be vigilant when debtor-lessors file for bankruptcy. If a debtor doesn't seek to reject a lease before a sale, a lessee should consider making a motion to compel assumption or rejection. And unless a lessee knows that its lease will be assumed and assigned to the buyer, the lessee should consider making a motion for adequate protection.