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A Landlord's Bankruptcy Sale Could Lead to the Tenant's Loss of a Leasehold

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Gardere

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A recent decision by the Ninth Circuit Court of Appeals has fanned the smoldering dispute among courts regarding the scope of asset sales in bankruptcy. In the *In re Spanish Peaks Holdings II, LLC* decision, the Ninth Circuit affirmed a lower court's holding that sale of commercial real estate can, in certain circumstances, be free and clear of all liens, claims, encumbrances, and interests, including a leasehold interest. In other words, a tenant of a bankrupt landlord could find itself with no interest in the property following the sale. The case addresses apparent tension between two different sections of the Bankruptcy Code. Bankruptcy Code section 363(f) permits free and clear sales, subject to certain important requirements that must be established by the moving party. Bankruptcy Code section 365(h) provides protections to non-debtor tenants, including allowing tenants to retain possession of the property following a bankrupt landlord's rejection of the lease. For commercial tenants, the *Spanish Peaks* case reinforces one of the oldest and most important adages in bankruptcy law: timely assert your rights, or risk losing your money and/or your property.

The *Spanish Peaks* case involved Spanish Peaks Holdings, LLC ("SPH"), a private resort in Montana that filed Chapter 7 bankruptcy in October of 2011. Among SPH's assets were developed parcels of real estate that SPH leased to other entities (the "tenants") for operation of two restaurants. SPH's principal was also an officer of both tenant entities and the leases were very favorable to the tenants, including rent that was a fraction of the market rate. The real estate was fully encumbered by the lien of a bank, which was significantly undersecured.

The Chapter 7 Trustee sought to sell the real estate free and clear of "any and all liens, claims, encumbrances, and interests." It was clear based on the pleadings that the Trustee included the leasehold among the interests that would be shed upon the closing of the sale. The tenants objected to the sale, arguing that section 365(h) protected their possessory interests in the property. Importantly, no memorandum of lease was recorded in the real property records and the leases, by their terms, were not protected from foreclosure by virtue of subordination or non-disturbance agreements. After a two-day hearing on the matter, the bankruptcy court authorized the sale free and clear, on the grounds that the Trustee had met the applicable requirements under section 363(f). The bankruptcy court also noted that the tenants had not requested adequate protection of their leasehold interests, as they were entitled to do under Bankruptcy Code section 363(e).

The district court affirmed. On appeal to the Ninth Circuit, the tenants argued that section 365(h), rather than 363(f), should govern their rights with respect to the real estate. The tenants separately argued that none of the subsections of 363(f) applied to these facts. The Trustee responded that section 365(h) did not apply because the Trustee was seeking to sell, rather than to reject, the lease. Furthermore, the Trustee argued that section 363(f)(1) authorized a free and clear sale. Specifically, section 363(f)(1) states that such a sale will be permitted if "applicable nonbankruptcy law permits sale of such property free and clear of such interest." The Trustee pointed out that if the bank had foreclosed on the real estate under state foreclosure law, it would have terminated the lease.

The court analyzed decisions from other jurisdictions and noted the view of a majority of courts is that section 365(h) would protect a tenant's possessory interests in these circumstances. The only other Circuit Court to address the issue, however, was the Seventh Circuit in the 2003 decision *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*. The *Qualitech Steel* court held that section 363, not section 365, governed and that therefore a sale could be free of a leasehold interest, as long as one of the elements of section 363(f) is established. The *Qualitech Steel* case also made clear that, while this result may appear to treat a non-debtor tenant harshly, the tenant can protect itself by demanding adequate protection under section 363(e).

The *Spanish Peaks* court adopted the "minority" approach as set forth in the *Qualitech Steel* case. The court noted that no party was seeking to reject the lease, and therefore section 365 did not apply. The court also agreed that foreclosure law could be relied upon to meet the section 363(f)(1) free and clear sale requirement. In addition, the court pointed out that section 363(e) provides a "powerful check on potential abuses of free-and-clear sales" and that, depending the circumstances, adequate protection could include permitting the tenant to remain in the premises. In this case, however, the tenants did not raise the issue of adequate protection until the appeal.

It should be noted that, while the *Spanish Peaks* and *Qualitech Steel* positions on this issue remain among the minority of courts to consider it, none of the majority viewpoint courts are circuit courts. This raises the interesting issue of how a bankruptcy court outside the Ninth or Seventh Circuit should consider the issue when presented with a motion to sell real estate and the real estate happens to be located within one of those circuits. Such a scenario would not be unusual due to the national nature of many retail bankruptcy cases. Given the well-accepted Supreme Court precedent (from *Butner v. United States*, among others) that state law governs property interests in bankruptcy cases, such a bankruptcy court would probably be on solid legal ground to consider state real property law in interpreting section 363(f), rather than relying on the *Spanish Peaks* or *Qualitech Steel* analysis.

It should be further noted that, given only a few changes in the facts, the *Spanish Peaks* case likely would have turned out very differently. Clearly, if the tenants had raised the issue of adequate protection at the trial (bankruptcy court) level, the tenants would have received something on account of their interest, up to and including remaining in possession. Also, if memoranda of the leases were recorded, or if the leases included subordination or non-disturbance agreements, then the Trustee likely would have been unable to use section 363(f)(1) to sell the real estate free and clear. In that circumstance, however, the Trustee may still have been able to sell the property free and clear under section 363(f)(4) by arguing that the self-dealing nature of the leases made them subject to a bona fide dispute.

The very significant issue in both the *Spanish Peaks* case and the *Qualitech Steel* case was that the tenants did not timely assert all of their rights under the Bankruptcy Code. Bankruptcy sales can move very quickly. Tenants are well advised to pay close attention and to make each and every argument available to protect their valuable leasehold interests.

Gardere - Jason B. Binford

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