



## Who Will Think of the Tenants: Split in Authority Regarding the Interplay Between Bankruptcy Code Sections 363(f) and 365(h)(1)(A)

A useful tool granted to trustees (and debtors-in-possession) in bankruptcy is the ability to assume or reject leases.<sup>1</sup> The trustee can exploit this power to the estate's economic advantage, either assuming or rejecting the lease, in an attempt to maximize the value of the estate. For the lessee of a bankrupt landlord, who may rely on the lease to run a business, the trustee's decision to assume or reject can have a profound effect. Thus, the Code protects lessees when the debtor decides to reject its lease. Section 365(h)(1)(A) of the Code allows lessees to either: (i) treat the lease as terminated or (ii) stay in possession and continue to pay rent.<sup>2</sup>

Occasionally, the trustee will attempt to sell property subject to a lease without actually assuming or rejecting the lease. Under section 363(f), the trustee can sell property "free and clear of any interest" as long as one of the five enumerated conditions are met.<sup>3</sup> A 363(f) sale transfers the property free of any encumbrances, including any leasehold interests others might have possessed. Currently, there is a split of authority over whether a sale of leased property under section 363(f) extinguishes the lessee's interest and protections contained in section 365(h), or alternatively, whether a sale is tantamount to a rejection of the lease under section 365 and thus triggers the lessee's 365(h) protections.

In interpreting the relationship between these Code provisions, courts have taken at least four different approaches. While the 11th Circuit has not weighed in on the debate (and while it appears that only one U.S. Circuit Court has addressed the issue), the Southern District of Florida has read the provisions such that they do not come in conflict, and interpreted section 363(f) to permit a sale free of a leasehold interest without violating section 365(h).<sup>4</sup>

Much of the division over this issue arises from disagreement over whether the debtor-in-possession or trustee's failure to assume the lease, and subsequent sale of the property,

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<sup>1</sup> 11 U.S.C. § 365(a).

<sup>2</sup> 11 U.S.C. § 365(h)(1)(A).

<sup>3</sup> 11 U.S.C. § 363(f). The conditions listed therein are: (1) applicable nonbankruptcy law permits the sale free and clear, (2) the entity with an interest consents, (3) the price the property will be sold for is greater than the aggregate value of all liens on the property, (4) the interest is in bona fide dispute, or (5) the entity with an interest could be compelled to accept money satisfaction for its interest.

<sup>4</sup> *In re MMH Auto. Group, LLC*, 385 B.R. 347 (Bankr. S.D. Fla. 2008).

constitutes a rejection of the lease. The problem is amplified by the fact that neither section 363(f), nor 365(h), cross-references the other to indicate that section 363(f) is subject to the protections of 365(h), which some courts simply refuse to presume.<sup>5</sup> On the other hand, courts have stated that allowing a section 363(f) sale to extinguish the leasehold interest would simply debilitate section 365(h)'s protections.

## A. THE PRECISION INDUSTRIES VIEWPOINT

On one side of the argument, the case law holds that a tenant's section 365(h) rights may be extinguished by a section 363(f) sale, as long as the trustee meets one of the section 363(f) requirements. In other words, section 365(h) does not control a section 363(f) sale and force the buyer to recognize the lessee's interest in possession. As of now, the 7th Circuit and bankruptcy courts located within the 2nd and 11th Circuits follow this approach, although it appears to be the minority approach among courts in the country. This view follows the "plain meaning" approach, suggesting that section 363(f) should be read at its word and section 365(h) should be given a limited scope.

The *Precision Industries* line of cases gives a few rationales for its interpretation. First, those cases generally rely on two canons of statutory interpretation.<sup>6</sup> The first canon is that courts should afford a statute its plain meaning.<sup>7</sup> Because there were no cross-references between the two statutes, courts should not conclude that one controls the other.<sup>8</sup> The second canon is that courts should interpret provisions to "avoid conflicts between them if such construction is possible and reasonable."<sup>9</sup> The *Precision Industries* court, following this rationale, said that section 365(h) *only* applies when the debtor explicitly rejects the lease; the two provisions thus apply to separate circumstances (sale of property vs. rejection of lease).<sup>10</sup> Finally, courts in this line of cases hold that the adequate protection provision in section 363(e), not section 365(h), gives lessees a way to guard themselves when their leasehold interests are at risk.<sup>11</sup>

In *In re MMH Auto. Group, LLC*, the Bankruptcy Court for the Southern District of Florida followed the *Precision Industries* line of case law, and held that section 363(f) allows the trustee to sell the property free of the lease, as long as the lessee is given adequate protection for its interest.<sup>12</sup> The court said that section 365(h) only preserves the tenant's rights, not enhances them.<sup>13</sup> The tenant could not use section 365(h) to insulate itself from being subject to money satisfaction in exchange for the leasehold interest - the *MMH Auto* lease agreement put a value

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<sup>5</sup> *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 547 (7th Cir. 2003).

<sup>6</sup> *In re Zota Petroleum, LLC*, 482 B.R. 154, 160 (Bankr. E.D. Va. 2012).

<sup>7</sup> *Precision Indus.*, 327 F.3d at 547.

<sup>8</sup> *Id.* at 547.

<sup>9</sup> *Id.* at 547.

<sup>10</sup> *Id.* at 547.

<sup>11</sup> *Id.* at 547-48.

<sup>12</sup> *In re MMH Auto. Group*, 385 B.R. at 372.

<sup>13</sup> *Id.* at 366.

on the lessee's interest, and so adequate protection simply meant that the lessee was paid that value from the sale proceeds.<sup>14</sup> The 7th Circuit's view only requires adequate protection when a section 363(f) sale takes place; when the property is not sold and the debtor remains in possession and rejects the lease, section 365(h) comes into play and provides the lessee with the right to possession. This line of cases therefore allows the lessor to circumvent section 365(h) protections, so long as adequate protection is provided.

Moreover, the *Precision Industries* approach does not require a lessee's continued possession in order to provide adequate protection under section 363(e). The *Precision* court stated that "[a]dequate protection' does not necessarily guarantee a lessee's continued possession of the property, but it does demand, in the alternative, that the lessee be compensated for the value of its leasehold."<sup>15</sup> In these jurisdictions, it appears that courts will conclude that compensation for the value of the leasehold interest will qualify as adequate protection.

## **B. THE HASKELL, TAYLOR, AND CHURCHILL LINE OF CASES**

The other line of case law addressing this issue states that section 365(h) protects the possessory interests of lessees after a section 363(f) sale. Courts under this interpretation argue that extinguishing the leasehold interest by a section 363(f) sale "would be doing indirectly what [the debtor] could not do directly" under section 365.<sup>16</sup> This appears to be the majority view, and while no Circuit Court has adopted it to date, it is followed by bankruptcy courts across the country.<sup>17</sup> These bankruptcy courts conclude that section 365(h) does prevent a sale free and clear of the lessee's interests in the property.<sup>18</sup> Unlike the *Precision Industries* view, this line of case law holds that a sale free and clear is, by itself, enough to constitute a rejection of the lease, thus triggering the tenant protections contained in section 363(h).<sup>19</sup>

The *Haskell* line of cases gives two primary rationales for allowing section 365(h) to trump section 363(f). First, courts following this line of cases rely on the statutory construction principle that "the more specific provision should prevail over the general."<sup>20</sup> Because section 365(h) applies only to the lessee of the bankrupt landlord, and gives that person special protections upon rejection, arguably it should control the more general section 363(f) which applies to all persons with an interest in property for sale.<sup>21</sup> Second, these courts conclude that

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<sup>14</sup> *Id.* at 372.

<sup>15</sup> *Precision Indus.*, 327 F.3d at 548.

<sup>16</sup> *In re Haskell, L.P.*, 321 B.R. 1, 9 (Bankr. D. Mass. 2005).

<sup>17</sup> See e.g. *In re Haskell L.P.*, 321 B.R. 1, 3 (Bankr. D. Mass. 2005); *In re Taylor*, 198 B.R. 142, 167-68 (Bankr. D.S.C. 1996); *In re Zota Petroleums, LLC*, 482 B.R. 154 (Bankr. E.D. Va. 2012); *In re Samaritan Alliance, LLC*, 2007 WL 4162918, at \*4 (Bankr.E.D.Ky. Nov. 21, 2007).

<sup>18</sup> *In re Taylor*, 198 B.R. 142, 167-68 (Bankr. D.S.C. 1996).

<sup>19</sup> *In re Haskell, L.P.*, 321 B.R. at 9.

<sup>20</sup> *Zota Petroleums*, 482 B.R. at 161.

<sup>21</sup> *Id.* at 161.

the legislative history of section 365(h) evidences an intent that the “tenant will not be deprived of his estate for the term for which he bargained.”<sup>22</sup>

Lastly, this line of case law provides a different meaning for “adequate protection” under section 363(e). The *Haskell* court stated that adequate protection, in the context of a section 363(f) sale, requires “continued possession of the leased premises” rather than attachment to the sale proceeds, as *In re MMH Auto* allowed.<sup>23</sup>

### C. THE SPANISH PEAKS HOLDINGS APPROACH

The third approach, only used by one court to date, uses a case-by-case, fact-intensive, totality of the circumstances approach to govern whether section 363(f) or section 365(h) prevails in any given scenario.<sup>24</sup> The court in *Spanish Peaks Holdings* looked at whether one of the conditions of section 363(f) was satisfied, the circumstances in which the lease was executed, the fact that the lease rate was well below fair market value, and the fact that the lease was unrecorded.<sup>25</sup> Considering all of those factors, the court decided that section 363(f) trumped section 365(h), and the sale took place free of all encumbrances.<sup>26</sup>

### D. THE BAY CONDOS APPROACH

The final viewpoint on this issue, recently discussed by the Southern District of New York in *Dishi & Sons v. Bay Condos LLC*, stands out as something of a hybrid between the *Precision* and *Haskell* lines of case law. First, *Bay Condos* held that regardless of whether the trustee assumes, rejects, or does nothing concerning the lease, the lessee retains its appurtenant rights under the lease (including the amount and timing of payment of rent and the right to use, possess, quiet enjoyment, sublet, and assign).<sup>27</sup> Whether the trustee explicitly rejects the lease or not, the lessee’s appurtenant rights must be respected; this more or less follows the majority approach which states that the lessee’s protections don’t depend on explicit rejection of the lease. Second, the *Bay Condos* court held that nothing in section 365(h) prevents the trustee from terminating a lessee’s rights if another provision in the Code allows such an action.<sup>28</sup> Thus, section 363(f) authorizes the trustee to sell property free and clear, but only on the condition that one of the five grounds for extinguishment is met.<sup>29</sup> Because 365(h) does not grant the lessee any special rights, meeting one of the section 363(f) requirements does allow a sale free and clear of the lessee’s rights; this stance falls much more in line with the *Precision Industries* approach. However, *Bay Condos* did utilize a narrow interpretation of the section

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<sup>22</sup> *Id.* at 161.

<sup>23</sup> *In re Haskell, L.P.*, 321 B.R. at 10.

<sup>24</sup> *In re Spanish Peaks Holdings II, LLC*, 2014 Bankr. LEXIS 913, at \*51 (Bankr. D. Mont. 2014).

<sup>25</sup> *Id.* at \*52.

<sup>26</sup> *Id.* at \*56.

<sup>27</sup> *Dishi & Sons v. Bay Condos LLC*, No. 13 Civ. 8300(JPO), 2014 WL 2199819, at \*8-9 (S.D.N.Y. May 28, 2014).

<sup>28</sup> *Id.* at \*9.

<sup>29</sup> *Id.* at \*9.

363(f) requirements.<sup>30</sup> It strictly interpreted both section 363(f)(1) and (f)(5) and decided that the trustee could not sell the property free and clear under any of the five section 363(f) provisions.<sup>31</sup>

As for adequate protection under section 363(e), the *Bay Condos* court held that section 363(e) requires that the court prohibit or condition the sale of property in order to provide adequate protection such that the lessee will realize the “indubitable equivalent” of its interest.<sup>32</sup> The court went on to state that the lessee’s continued possession was appropriate for the facts in its case.<sup>33</sup> When it is improbable that the lessee gets compensated from a sale and it remains difficult to value the lessee’s interest, the court stated, adequate protection can only be achieved through continued possession.<sup>34</sup> This stance seems to fall more in line with the majority approach, as it finds that continued possession is the best way to provide adequate protection in certain circumstances.

## E. CONCLUSION

With the divergent approaches of courts in interpreting sections 363(f) and 365(h) of the Bankruptcy Code, the debtor, as well as its lessee, should be aware of the possible legal effects of attempts to sell property free of a leasehold interest in their jurisdiction. Until the split in interpretations gets resolved, these decisions could have considerable impact on the ability to sell the debtor-in-possession’s property free of all claims and encumbrances.

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<sup>30</sup> *Id.* at \*10-13.

<sup>31</sup> *Id.* at \*10-13.

<sup>32</sup> *Id.* at \*13.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*