Sale "Free and Clear" Does Not Extinguish Sublessee's Right to Remain in Possession

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The ability of a trustee or chapter 11 debtor in possession ("DIP") to sell bankruptcy estate assets "free and clear" of competing interests in the property has long been recognized as one of the most important advantages of a bankruptcy filing as a vehicle for restructuring a debtor's balance sheet and generating value. Still, section 363(f) of the Bankruptcy Code, which delineates the circumstances under which an asset can be sold free and clear of "any interest in such property," has generated a fair amount of controversy. This is so in part because the statute itself does not define "interest."

Although generally acknowledged to encompass liens and security interests, section 363(f)'s scope would appear to be much broader, taking into account both the language of the provision and its underlying purpose. Broadly applied, however, section 363(f) arguably conflicts with certain other provisions of the Bankruptcy Code.

One of those provisions is section 365(h)(1). Section 365(h)(1) provides that, if the trustee or DIP rejects an executory real property lease under which the debtor is the lessor, the nondebtor lessee (and any permitted successor or assign, pursuant to subsection (h)(1)(D)) has the option to retain its rights under the lease for the balance of the lease term. Courts disagree as to whether the rights of a lessee or sublessee under section 365(h)(1) are effectively extinguished if the leased real property (or the lease itself) is sold free and clear of any "interest" under section

363(f). This was the thorny question addressed by the bankruptcy court in *In re Zota Petroleums, LLC*, 2012 BL 259645 (Bankr. E.D. Va. Oct. 1, 2012).

Sales Free and Clear

Section 363(f) of the Bankruptcy Code authorizes a trustee to sell property "free and clear of any interest in such property of an entity other than the estate" under any one of five specified conditions. These include, among other things, if applicable nonbankruptcy law permits a sale free and clear, if the sale price exceeds the aggregate value of all liens encumbering the property, or if the interest is in bona fide dispute. A bankruptcy court's power to order sales free and clear of competing interests without the consent of the party asserting the interest has been recognized for more than a century. *See Ray v. Norseworthy*, 90 U.S. 128, 131–32 (1875); *Van Huffel v. Harkelrode*, 284 U.S. 225, 227 (1931). It promotes the expeditious liquidation of estate assets by avoiding delay attendant to sorting out disputes concerning the validity and extent of competing interests, which can later be resolved in a centralized forum. It also facilitates the estate's realization of the maximum value possible from an asset. A prospective buyer would discount its offer significantly if it faced the prospect of protracted litigation to obtain clear title to an asset. Pending the bankruptcy court's resolution of any disputes, section 363(e) of the Bankruptcy Code provides that the nondebtor is entitled to "adequate protection" of its interest. This most commonly takes the form of a replacement lien on the proceeds of the sale.

"Any Interest" Broadly Construed

Section 363(f) has been applied to a wide range of interests. Courts, however, have sometimes struggled to comprehend the precise scope of the term "interest," which is defined nowhere in the Bankruptcy Code or its accompanying legislative history. Most courts reject the narrow

approach adopted by courts that find section 363(f) to be confined to *in rem* property interests or only those claims which have already been asserted at the time the property is sold. Instead, the majority construe the term broadly to encompass other obligations that may flow from ownership of property, including, for example, successor liability claims. *See*, *e.g.*, *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003); *UMWA 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*, 99 F.3d 573 (4th Cir. 1996). *But see Olson v. Frederico (In re Grumman Olson Indus., Inc.)*, 445 B.R. 243 (Bankr. S.D.N.Y. 2011) (section 363 sale order cannot exonerate purchasers from successor liability claims by claimants who, at the time of the sale, had not yet been injured and had no contact or relationship with the debtor or its products).

Section 363(f) is problematic if a debtor-lessor seeks to sell property free and clear of the possessory interests of tenants or subtenants. This is so because section 365(h)(1) specifically protects such interests. As noted previously, section 365(h)(1) provides that, if the trustee or DIP rejects an executory real property lease under which the debtor is the lessor, the nondebtor lessee (and any permitted successor or assign) has the option either: (i) to treat the lease as terminated and file a claim for breach; or (ii) to retain its rights under the lease for the balance of the lease term (including any renewal or extension periods). Section 365(h)(2) provides similar protections to the purchaser of a debtor's time-share interest.

In enacting section 365(h)(1), lawmakers sought to "codify a delicate balance between the rights of a debtor-lessor and the rights of its tenants" by preserving the parties' expectations in a real estate transaction. *In re Lee Road Partners, Ltd.*, 155 B.R. 55, 60 (Bankr. E.D.N.Y. 1993). The

provision's legislative history indicates that lawmakers intended that rejection of a lease by a debtor-lessor should not deprive the tenant of its estate for the term for which it bargained. H.R. Rep. No. 95-595, 349–50 (1977); S. Rep. No. 95-989, 60 (1978).

The apparent conflict between sections 365(h)(1) and 363(f) was considered as a matter of first impression in the circuit courts of appeal by the Seventh Circuit in *Precision Industries, Inc. v. Qualitech Steel SBQ*, 327 F.3d 537 (7th Cir. 2003). In *Qualitech Steel*, a chapter 11 debtor sold substantially all of its assets (including a steel mill containing a warehouse leased to Precision Industries, Inc. ("Precision") for 10 years) to the mortgagee of the property. The order approving the sale provided that the assets were to be conveyed "free and clear of all liens, claims, encumbrances, and interests," except those specifically excepted. Precision was notified of the sale, yet chose not to object. Instead, it negotiated with the ultimate buyer of the property regarding the assumption of its (unrecorded) lease. Those negotiations proved futile, and Precision's lease agreement was deemed rejected in accordance with the terms of the debtor's chapter 11 plan.

Precision commenced litigation seeking a determination that it retained a possessory interest in the warehouse notwithstanding the sale of the property. The bankruptcy court ruled that, on the basis of the terms of both section 363(f) and the sale order, the new owner had obtained title to the property free and clear of Precision's leasehold interest. According to the court, that interest clearly qualified as "any interest" under the statute and was unequivocally "extinguished" by the terms of the sale order. It also implicitly rejected the idea that section 365(h)(1) somehow preserved Precision's rights.

Precision appealed to the district court, which reversed. Reasoning that the provisions of sections 363(f) and 365(h) are incongruous, the district court held that "the terms of section 365(h) prevail over those of section 363(f) as applied to the rights of lessees." It concluded that the more specific terms of section 365(h) must override the more general scope of section 363(f), observing that "[t]here is no statutory basis for allowing the debtor-lessor to terminate the lessee's position by selling the property out from under the lessee, and thus limiting a lessee's post-rejection rights solely to cases where the debtor-lessor remains in possession of its property." The new owner of the property appealed to the Seventh Circuit.

The Seventh Circuit reversed. Mindful of its obligation to construe the two statutory provisions in a way that avoids conflict if at all possible, the Seventh Circuit did precisely that. Despite the Bankruptcy Code's silence on the exact meaning of "any interest," the court emphasized, the term itself is sufficiently comprehensive to encompass a broad range of competing rights. Given the U.S. Supreme Court's observations in other contexts that "interest" is a broad term, the Seventh Circuit concluded that the right conferred by a leasehold upon the lessee "readily may be understood as an 'interest' in the property" within the meaning of section 363(f).

The Seventh Circuit faulted the district court's reliance upon an apparent contradiction between the two provisions as a basis for reversing the bankruptcy court. First, the Seventh Circuit noted, the provisions themselves do not suggest that one supersedes or limits the other, whereas other subsections of both sections 363 and 365 contain specific cross-references to other provisions that have a limiting effect on their scope. The court then observed that the plain language of

section 365(h) suggests that it is limited in scope. In particular, section 365(h) expressly applies only to situations where the trustee rejects a lease but retains possession of the property. In contrast, if the trustee does not reject the lease but sells the underlying property under section 363(f), the sale will be free and clear of the tenant's possessory interest (provided it meets one of the five conditions).

According to the Seventh Circuit, a lessee is not without recourse if its leasehold rights are extinguished in this way. Section 363(e) gives it the right to demand adequate protection of its interest in the property. This would most likely take the form of compensation for the value of its forfeited leasehold.

Qualitech Steel is the only circuit-court ruling to date addressing the interplay between sections 363(f) and 365(h)(1). A number of lower courts have reached the same conclusion as the Seventh Circuit for some or all of the same reasons. *See*, *e.g.*, *In re Downtown Athletic Club of New York City, Inc.*, 2000 WL 744126 (S.D.N.Y. June 9, 2000); *South Motor Co. v. Carter-Pritchett-Hodges, Inc. (In re MMH Automotive Group, LLC)*, 385 B.R. 347 (Bankr. S.D. Fla. 2008). Other courts have ruled to the contrary. *See*, *e.g.*, *In re Samaritan Alliance, LLC*, 2007 BL 156456, 2007 WL 4162918 (Bankr. E.D. Ky. Nov. 21, 2007); *In re Haskell, L.P.*, 321 B.R. 1 (Bankr. D. Mass. 2005); *In re Churchill Properties III, Ltd. Partnership*, 197 B.R. 283 (Bankr. N.D. Ill. 1996). Thus, in *Zota Petroleums*, the bankruptcy court joined a fray in which the combatants have been roughly evenly divided.

Zota Petroleums

Zota Petroleums, LLC ("Zota") leased 16 gas stations and convenience stores in Virginia. One of those businesses was located on a parcel of real property leased from Kelmont, LLC ("Kelmont"), which Zota subleased to D&MRE, LLC ("D&MRE").

Zota filed for chapter 11 protection in Virginia on August 7, 2011. Shortly afterward, a chapter 11 trustee appointed in the case sought a court order authorizing an auction process for the sale of substantially all of Zota's assets as well as the assumption and assignment of leases and executory contracts, including the lease between Zota and Kelmont. The trustee later moved to reject the sublease between Zota and D&MRE.

The bankruptcy court approved the sale of Zota's assets to LAP Petroleum, LLC ("LAP") on November 30, 2011. The sale order provided that:

> [t]o the extent of applicable law, the sale of the Assets shall vest LAP with good title to the Assets, and the Assets shall be free and clear of any and all liens, encumbrances and any and all 'claims' as defined in § 101(5) of the Bankruptcy Code . . . other than as provided in the [asset purchase agreement].

The order further provided that the trustee was authorized to assume and assign the identified leases, including the Kelmont lease. The bankruptcy court authorized the trustee to reject the D&MRE sublease by separate order entered on the same date.

D&MRE later filed a motion seeking a determination that section 365(h)(1)(A) gave it, as sublessee, the ability to retain its rights under the rejected sublease. LAP objected, arguing, among other things, that section 365(h) does not apply because LAP acquired Zota's assets, including the Kelmont lease, free and clear of all interests under section 363(f).

The Bankruptcy Court's Ruling

The bankruptcy court ruled in favor of D&MRE. The rationale underlying decisions prohibiting the extinguishment of a sublessee's section 365(h) rights through a section 363 sale, the court explained, "has been based in part upon the statutory construction principle that the more specific provision should prevail over the general." According to this reasoning, because Congress decided that lessees should have the option under section 365(h)(1) to remain in possession, "it would make little sense to permit a general provision, such as Section 363(f), to override its purpose." In addition, the *Zota Petroleums* court emphasized that such cases generally rely upon the legislative history of section 365(h), which, as noted, reflects lawmakers' desire to protect the rights of a debtor's tenants.

The court concluded that LAP's reliance on *Qualitech Steel* was misplaced. That case, the bankruptcy court emphasized, is distinguishable because, among other things, the Seventh Circuit specifically noted that it was *not* addressing whether a section 363 sale could divest a tenant of its rights after the rejection of an unexpired lease.

Instead, the *Zota Petroleums* court was persuaded by the reasoning of the courts in *In re Samaritan Alliance, LLC*, 2007 BL 156456, 2007 WL 4162918 (Bankr. E.D. Ky. Nov. 21, 2007), and *In re Haskell, L.P.*, 321 B.R. 1 (Bankr. D. Mass. 2005), which are more factually apposite and, in the bankruptcy court's view, better construe the interplay between sections 363(f) and 365(h):

> The court has evaluated the arguments contained in the *Qualitech* and *Haskell* lines of cases and, as did the court in *Samaritan Alliance*, agrees with the conclusion reached by the court in

> *Haskell*. The rights of the tenant may not be extinguished by a § 363 sale; to hold to the contrary would give open license to debtors to dispossess tenants by utilizing the § 363 sale mechanism. The court cannot countenance this result, especially under the facts of this case, when, as previously noted, 1) the transaction was titled as a sale free and clear and an assumption and assignment, and 2) all parties had notice therefore that the provisions of § 365 were thus implicated, 3) the [asset purchase agreement] itself contained an Exhibit listing the leases to be assumed and assigned and giving cure amounts, and 4) the sublease was specifically rejected pursuant to the provisions of § 365. The court also notes that there is no adequate protection proposed. This result will also be in accord with the legislative history of § 365, which indicates the desire of Congress to preserve the rights of a party to a real property lease that a lessor debtor has rejected.

Outlook

Zota Petroleums is undeniably a positive development for both commercial and residential lessees and sublessees of landlords that file for bankruptcy protection. According to the court's reasoning, the protections provided in section 365(h)(1) cannot be nullified by structuring a transaction that includes, or effectively results in, rejection of a lease or sublease as part of a sale of the underlying real property or the debtor's leasehold interest "free and clear" under section 363(f).

However, *Zota Petroleums* is only one lower court's take on a divisive issue. Moreover, the only authority at the circuit level regarding this question is at least arguably to the contrary. Therefore, whether a nondebtor lessee or sublessee can rely on section 365(h)(1) to preserve its rights under a rejected lease or sublease in the section 363 sale context is very much an open question that may hinge on the venue of the debtor's bankruptcy case.