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**Conflict in the Bankruptcy Code: Ramification of a trustee's 363(f) right to sell property
"free and clear" on the lessee's 365(h) right to retain property**

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Cite as: *Conflict in the Bankruptcy Code: Ramification of a trustee's 363(f) right to sell property
"free and clear" on the lessee's 365(h) right to retain property*, 8 ST. JOHN'S BANKR. RESEARCH
LIBR. NO. 16 (2016)

Introduction

Section 363(f) of title 11 of the United States Code (the "Bankruptcy Code") allows a trustee to sell property "free and clear of any interest in such property" that a third party might have if certain conditions are met.¹ Section 365(h) of the Bankruptcy Code allows the lessee of a rejected lease to either retain the property with all rights appurtenant to the estate, or treat such lease as terminated and sue for damages.² Courts are split on if these sections of the Bankruptcy

¹ See 11 U.S.C. § 363. Section 363(f) provides for a "free and clear" sale if "(1) applicable non-bankruptcy law permits the sale of such property free and clear of such interests; (2) such entity consents to the sale; (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; (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 interests." *Id.* The ability to sell property "free and clear" of any interest allows debtors to maximize the profits of a sale for the benefit of unsecured creditors. See Basil H. Mattingly, *Sale of Property of the Estate Free and Clear of Restrictions and Covenants in Bankruptcy*, 4 Am. Bankr. Inst. L. Rev. 431, 431 (Winter 1996).

² 3-365 Collier on Bankruptcy P 365.11 (Because the lessor rejected the lease, he will have no obligation to provide ancillary duties contained in the lease, such as heat, or trash disposal. The lessee can only offset damages from the rejection only through rent).

⁴ *Id.* See *In re Revel AC, Inc.*, 532 B.R. 216, 220 (Bankr. D.N.J. 2015) (holding 365(h) rights trump a trustee's 363(f) rights to sell property "free and clear." See also *Precision Indus., Inc. v.*

Code are compatible.³ The majority of courts have found these sections are not compatible, and a trustee's ability to sell property "free and clear" of third party interests is subject to the rights of the non-debtor lessee to stay.⁴ A minority of courts have found these sections are compatible, and have held that a trustee can sell property free and clear of a leasehold interest.⁵

This article explores these conflicting opinions. Part I discusses the seminal case deciding a trustee's ability to sell property "free and clear" of third party interests is subject to the rights of the non-debtor lessee to stay. Part II discusses the decisive cases deciding Section 363(f) rights to sell property "free and clear" of third party interests supersedes a lessee Section 365(h) rights to stay.

I. Majority View: A trustee's ability to sell property "free and clear" of third party interests is subject to the rights of the non-debtor lessee to stay.

A majority of courts have found a trustee's ability to sell property "free and clear" of third party interests is subject to the rights of the non-debtor lessee's 365(h) right to stay. The South Carolina bankruptcy court, in *In Re Taylor*,⁶ was the first court to record a decision reaching this conclusion.⁷ Henry Thomas Taylor ("Taylor") was the owner of four nursing home properties

Qualitech Steel SBQ, LLC, 327 F.3d 537, 546 (7th Cir. 2003) (holding "the terms of section 365(h) do not supersede those of section 363(f)").

⁴ See *In re Revel AC, Inc.*, 532 B.R. at 220.

⁵ See *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 701 (S.D.N.Y. 2014).

⁶ *In re Taylor*, 198 B.R. 142 (Bankr. D.S.C. 1996).

⁷ See *Id.* Two other cases had previously addressed how 365(h) deals with rejected executor contracts. See *In re LHD Realty Corp.*, 20 B.R. 717 (Bankr. S.D.Ind. 1982) ("It is the court's view that Congress' intent in enacting [§ 365] was to make that section the exclusive remedy available to a debtor in an executory lease situation. In the name of equity, the court cannot disregard the plain language of § 365 and the mandate of Congress embodied therein."); see also *In re Robinson Truck Line, Inc.*, 47 B.R. 631 (Bankr. N.D.Miss.1985) (If Section 365 "is the exclusive remedy for debtors faced with an unexpired lease within Chapter 11 proceedings, then it necessarily follows that it should also govern executory contracts within the context of a Chapter 11 plan.").

and was the sole stockholder in a company that owned a fifth nursing home.⁸ On April 1 1993, Taylor leased all five of the properties to Magnolia Entities (“Magnolia”), a management company, for \$110,850 per month plus taxes. Thereafter, Magnolia Entities disputed the amount Taylor claimed was due for taxes. On August 3, 1994 Taylor filed a petition for relief under Chapter 11 of the Bankruptcy Code. In January of 1996, Taylor requested an order approving the sale of all five properties “free and clear” of Magnolia’s leases to Delta Health Group. Magnolia objected to the proposed sale, arguing that notwithstanding the sale, they should be permitted to retain possession of the property under Section 365(h) of the Bankruptcy Code.⁹

The *Taylor* court held that the debtor’s ability to sell the property “free and clear” was subject to Magnolia’s 365(h) rights to stay. First, applying the principle of *generalia specialibus non derogant* (the specific governs the general), the court reasoned that because 365(h) was specifically tailored to deal with the rights of debtor lessors and lessees, 365(h) should be the sole provision to govern the relationship between them.¹⁰ Second, it would make no sense that the debtor could do under 363(f), what he specifically could not do under 365(h).¹¹ Third, the legislative history of section 365(h) indicated that it was meant to protect the lessee’s rights and prevent the modifications or changing of the lessees’ leasehold estate during bankruptcy proceedings. A 1978 Senate report remarked that under the terms of section 365(h), “the tenant will not be deprived of his estate for the term for which he bargained.”¹² The section-by-section analysis of the 1994 Amendments to the Code¹³ states “section 365(h) of the Bankruptcy Code ... mandate(s) that lessees cannot have their rights stripped away if a debtor rejects its obligation

⁸ *In re Taylor*, 198 B.R. 142, 164 (Bankr. D.S.C. 1996).

⁹ *Id.* at 144-46

¹⁰ *In re Taylor*, 198 B.R. at 164.

¹¹ *Id.* at 165.

¹² *Id.*

¹³ *Id.*

as a lessor in bankruptcy”¹⁴ and that section 365(h) “will enable the lessee to retain its rights that appurtenant to its leasehold.”¹⁵ These three reasons would be cited by every other court that has held that a trustee’s ability to sell property “free and clear” of third party interests is subject to the rights of the non-debtor lessee to stay.¹⁶

Although referred to as a majority,¹⁷ only five courts have directly addressed this issue and adopted the view that trustee’s ability to sell property “free and clear” of third party interests is subject to the rights of the non-debtor lessee to stay.¹⁸ The South Carolina bankruptcy court,¹⁹ New Jersey bankruptcy court,²⁰ Massachusetts bankruptcy court,²¹ the bankruptcy court for the Eastern District of Virginia,²² and the bankruptcy court for the Eastern District of Kentucky²³ have all ruled this way. Indeed, the bankruptcy court for the Eastern District of Kentucky has ruled the lessee’s rights to stay via Section 365(h) trump the debtor/tenant’s rights to sell the property free and clear of all interests.²⁴

II. “Minority” view: Section 363(f) rights to sell property “free and clear” of third party interests supersedes a lessee Section 365(h) rights to stay.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ See *In re Churchill Properties III, Ltd.*, 197 B.R. 283, 288 (Bankr. N.D. Ill. 1996), *In Re Haskel, L.P.*, 321 B.R. 1, 7, 9 (Bankr. D. Mass. 2005), *In re Zota Petroleums, LLC*, 482 B.R. 154, 158 (Bankr. E.D. Va. 2012); *In re Revel AC, Inc.*, 532 B.R. 216 (Bankr. D.N.J. 2015).

¹⁷ See *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 699 (S.D.N.Y. 2014).

¹⁸ The Northern district in Illinois had also adopted this view in *In Re Churchill* but that case should be considered abrogated via *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003). See *In re Churchill Properties III, Ltd.*, 197 B.R. 283, 288 (Bankr. N.D. Ill. 1996).

¹⁹ *In re Taylor* 198 B.R. 142, 164 (Bankr. D.S.C. 1996).

²⁰ *In re Revel AC, Inc.*, 532 B.R. 216 (Bankr. D.N.J. 2015).

²¹ *In re Haskell L.P.*, 321 B.R. 1, 9 (Bankr. D.Mass. 2005).

²² *In re Zota Petroleums, LLC*, 482 B.R. 154, 158 (Bankr. E.D.Va. 2012).

²³ *In re Samaritan Alliance, LLC*, No. 07–50735, 2007 WL 4162918 (Bankr. E.D.Ky. Nov. 21, 2007).

²⁴ *Id.*

A number of courts, including the highest court to have addressed the conflict, have found Section 363(f) rights to sell property “free and clear” of third party interests supersedes a lessee Section 365(h) rights to stay.²⁵

1. The Seventh Circuit held there is no conflict between section 363(f) and section 365(h).

In *Precision Indus., Inc. v. Qualitech Steel*, the 7th Circuit found that there is no conflict between Sections 363(f) and 365(h) of the Bankruptcy Code. Qualitech Steel Corporation (“Qualitech”) owned and operated a steel mill.²⁶ Before petitioning the court for relief of its debts under Chapter 11, Qualitech entered into two contracts with Precision Industries (“Precision”).²⁷ The first contract was a supply agreement, that provided Precision would construct a supply warehouse on Qualitechs property and operate it for a ten-year period. The second contract was a land lease agreement, which granted Precision exclusive possession of the underlying property for a period of ten years in exchange for \$1.²⁸ According to the land lease agreement, Precision had the right to remove all improvements from the property if the lease was terminated early. Precision then built and operated the warehouse in accordance with the first contract. Qualitech filed a voluntary chapter 11 petition three months later. Upon Qualitech’s request, the bankruptcy court issued an order approving a sale of all of Qualitech’s assets “free and clear of all liens, claims, encumbrances and interests” under section 363(f).²⁹ Precision was

²⁵ See *In re Downtown Athletic Club of New York City, Inc.*, No. M-47 (JSM), 2000 WL 744126, at *1 (S.D.N.Y. June 9, 2000); *In re R.J. Dooley Realty, Inc.*, 2010 Bankr. LEXIS 1761, 2010 WL 2076959 (Bankr. S.D.N.Y. May 21, 2010); *In re Hill*, 307 B.R. 821, 825 (Bankr. W.D. Pa. 2004).

²⁶ *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 540, 541 (7th Cir. 2003).

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id. at 544*

given notice of the sale but did not object.³⁰ The sale order specifically provided that the purchaser retained the debtor's rights to assume and assign executory contracts and leases under Section 365(h).³¹ After a period of prolonged contract negotiation with the new owners, Precision was locked out of the leased property.³² In response to the lock out, Precision sued the new owners arguing that they had the right to stay on the property along with all appurtenant rights for the remainder of the lease term under 365(h). The bankruptcy court held that the sale was "free and clear" of Precisions leasehold interests. The case was appealed to the district court, which reversed. The case was then appealed to the Seventh Circuit, which held the terms of section 365(h) do not supersede those of section 363(f) and simply apply in different scenarios.³³

The Seventh Circuit provided four reasons for its holding. First, in examining the language of section 363(f), the court found that the words "any interest" were broad enough to encompass those of a lessee.³⁴ Second, Sections 363 and 365 "contain cross-references indicating that certain provisions are subject to other statutory mandates."³⁵ Since sections 363(f) and 365(h) lack similar cross-references, courts should not read Section 363(f) as subordinate to Section 365(h). Third, the court found that the language of section 365(h) plainly only applies when "the trustee [or debtor-in-possession] *rejects* an unexpired lease of real property."³⁶ If a debtor "cancels" the lease via a section 363(f) sale, a lessee cannot invoke their section 365(h)

³⁰ *Id.*

³¹ *Id. at 546*

³² *Id.*

³³ *Id. at 547*

³⁴ *Id.*

³⁵ *Qualitech*, 327 F.3d at 547.

³⁶ *Id.*

rights because the scope of section 365(h) is limited to rejection by the debtor.³⁷ The court's final point was that the statute does provide the lessee with protection.³⁸ Section 363(e) allows a lessee to petition bankruptcy courts to "prohibit or condition such ... sale ... as is necessary to provide adequate protection of such interest."³⁹ The reasoning the Qualitech court used in coming to this conclusion has been used by *almost* every other court that has held 363(f) sales supersede a lessee's rights under 365(h) to stay on the leased property.⁴⁰

By concluding that 363(f) and 365(h) apply to separate scenarios, the Qualitech court arguably sidestepped the question of what actually happens if a lease is actually rejected under 365(h) and a 363(f) sale occurs.⁴¹ The court in *Dishi & Sons vs. Bay Condos LLC*, addressed that issue head on.

2. Dishi v. Bay Condos: Different reasoning but same result.

While coming to the same conclusion as *Qualitech*, the *Bay Condos* court used different reasoning. In *Bay Condos*, the debtor filed a voluntary petition for Chapter 11 relief.⁴² As part of the reorganization plan, debtor Bay Condos sought to sell two of its commercial condominiums "free and clear" of third party right under 363(f).⁴³ The reorganization plan provided that all leases were rejected. As part of the reorganization plan, the bankruptcy court issued an order approving the bidding and sale procedures, and an auction was held for the condominiums.

³⁷ *Id.* ("Nothing in the express terms of section 365(h) suggests that it applies to any and all events that threaten the lessee's possessory rights.")

³⁸ *Id.*

³⁹ *Qualitech*, 327 F.3d at 548.

⁴⁰ *See In re Downtown Athletic Club of New York City, Inc. (Cheslock-Bakker & Assocs., Inc.)*, 2000 U.S. Dist. LEXIS 7917, 2000 WL 744126, *4-5 (S.D.N.Y. June 9, 2000); *In re R.J. Dooley Realty, Inc.*, 2010 Bankr. LEXIS 1761, 2010 WL 2076959, *6-8 (Bankr. S.D.N.Y. May 21, 2010).

⁴¹ *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 704 (S.D.N.Y. 2014).

⁴² *Id.*

⁴³ *Id.*

Dishi was the successful bidder of a property at the auction. Before the sale order was entered, a lessee of the property, The Ginger Man (“TGM”), submitted a letter to the court “asserting its right to retain possession of the unit under Section 365(h).” A hearing was held and the bankruptcy court issued the Sale Approval Order, which approved the Sale to Dishi and held that TGM had a right to remain in possession of the property for the duration of the lease under 365(h). Dishi then appealed to the district court.

In determining whether the debtors ability to sell property “free and clear” of third party interests is subject to the rights of the non-debtor lessee to stay once the lease is rejected, the district court examined the purpose of section 365(h) in isolation and found that the primary function of section 365(h) is to prevent the lessors’ “obligations under the lease” from “outweighing the benefits to the estate”.⁴⁴ The only right 365(h) provides to the lessee is to maintain the rights that are appurtenant to the leasehold in the event a debtor exercises his rejection powers.⁴⁵ In other words, 365(h) was not intended to provide debtor’s lessee with rights that they would “not enjoy outside of bankruptcy.”⁴⁶ The *Bay Condos* court found this reading persuasive since Section 365(h) does not prevent a trustee from “avoid[ing] interests as a bona fide purchaser, or to avoid interest that was fraudulently transferred by the debtor.”⁴⁷ The court found this reading of sections 365(h) and section 363(f) prevents an inapposite reading of the Bankruptcy Code and allows both sections to function harmoniously with one another despite the contradictory language in both sections.⁴⁸

⁴⁴ *Id.* at 705.

⁴⁵ *Id.*

⁴⁶ *Id.* at 707.

⁴⁷ *Id.*

⁴⁸ *Id.*

While the *Bay Condos* Court went to some length to try to differentiate itself from *Qualitech*,⁴⁹ the results reached are the same. The only real difference is that the *Bay Condos* decision clarifies that even when a contract is rejected under 365(a), a property can be sold “free and clear” of third party interests if the Section 363(f) elements are found.

There have been four courts that have directly held that sales “free and clear” of third party interests can occur when a tenant claims his rights to stay under 365(h). The seventh circuit follows this view⁵⁰ as does the Southern District of New York⁵¹ and the bankruptcy court in the Western District of Pennsylvania.⁵²

Conclusion

Courts are split on if Section 363(f) and 365(h) of the Bankruptcy Code are in conflict with each other. The majority view is that a trustee's ability to sell property “free and clear” of third party interests is subject to the rights of the non-debtor lessee to stay. The minority view is that Section 363(f) rights to sell property “free and clear” of third party interests supersedes a lessee's Section 365(h) rights to stay. The argument for both views is based largely on statutory interpretation. Until a higher court or Congress addresses the relationship between section 365(h) and 363(f), the debtor lessor and the lessee's rights will largely be determined by geographic location.

⁴⁹ *Id.* at 699 (“This Court reaches the same result, but declines to endorse the majority interpretation. 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 interests. Rather, it clarifies that the lessee may retain its appurtenant rights . . . Section 363(f), in turn, authorizes the trustee to extinguish the lessee's appurtenant rights—like any other interest in property—but only if one of five conditions is satisfied”)

⁵⁰ See *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003).

⁵¹ See *In re Downtown Athletic Club of New York City, Inc.*, No. M-47 (JSM), 2000 WL 744126, at *1 (S.D.N.Y. June 9, 2000); *In re R.J. Dooley Realty, Inc.*, 2010 Bankr. LEXIS 1761, 2010 WL 2076959 (Bankr. S.D.N.Y. May 21, 2010); *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 701 (S.D.N.Y. 2014).

⁵² *In re Hill*, 307 B.R. 821, 825 (Bankr. W.D. Pa. 2004).