AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Problems in the Code

BY JAMES H. MILLAR

Fixing the *Qualitech* Problem by Revising § 365(h)

James H. Millar
Wilmer Cutler Pickering Hale and Dorr LLP; New York

James Millar is a partner in the Bankruptcy and Financial Restructuring Practice of Wilmer Cutler Pickering Hale and Dorr LLP in New York.

In 2003, the Seventh Circuit handed down the *Qualitech* decision, which considered whether a nondebtor lessee of commercial real property may retain its right to possession of the leased premises under § 365(h), notwithstanding that the debtor had sold the premises free and clear of all interests pursuant to § 363(f).[1] The Seventh Circuit held that under the facts, the lessee had no further rights to possession.[2] Moreover, because the lessee had failed to request adequate protection under § 363(e), it received no compensation whatsoever.[3]

That decision has generated significant criticism.[4] Before *Qualitech*, some courts opined that even though a debtor may satisfy § 363(f), which permits sales free and clear of liens and interests, a lessee could nevertheless retain its rights to possession of the leased premises under § 365(h) after the debtor's rejection of the underlying lease.[5] That rationale relied on the notion that §§ 363(f) and 365(h) stood in conflict, and that the more general of the two—§ 363(f)—must yield to the more specific § 365(h).[6] While § 363(f) provided for the sale of assets free and clear of interests, the specific language of § 365(h), which permitted a lessee to "retain its rights under such lease," would trump any effort to use § 363(f) to cut off a lease.

In *Qualitech*, the Seventh Circuit did not agree that the sections gave rise to any inconsistency and tried, unconvincingly to some, to harmonize the two sections. Since then, although several bankruptcy courts have addressed the issue,[7] no courts of appeals have provided further guidance. Given that situation, an amendment to § 365(h) would help clarify the parties' respective rights under the circumstances. Consider the following fact pattern.

Assume that a company borrows money to purchase a tract of land, which immediately becomes subject to a recorded mortgage in favor of the company's senior lender. The company then builds a warehouse on the property and leases the warehouse and surrounding property (the "premises") to a tenant. Thereafter, the company files for bankruptcy.

During its bankruptcy, the debtor seeks to sell the premises under § 363 free and clear of all interests, including the tenant's lease. The first question is whether the debtor can satisfy § 363(f), which states that the debtor may sell property "free and clear of any interest[8] 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;
2. such entity consents;
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 interest.[9]

1 *Precision Indus. Inc. v. Qualitech Steel SBQ LLC (In re Qualitech Steel Corp.)*, 327 F.3d 537, 540 (7th Cir. 2003).
2 *Id.* at 548.
3 *Id.*
4 *See, e.g.*, Michael St. Patrick Baxter, "Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in *Precision Industries v. Qualitech* Steel," 59 *Bus. Law.* 475 (February 2004).
5 *See In re Taylor*, 198 B.R. 142, 164-68 (Bankr. D.S.C. 1996); *In re Churchill Props. III Ltd. P'ship*, 197 B.R. 283, 286-88 (Bankr. N.D. Ill. 1996). *But see Cheslock-Bakker & Assocs. v. Kremer (In re Downtown Athletic Club of New York City Inc.)*, 2000 WL 744126, *4-5 (S.D.N.Y. June 9, 2000).
6 *Id.*
7 *Compare In re Haskell LP*, 321 B.R. 1, 9 (Bankr. D. Mass. 2005) (following *Taylor* and *Churchill*), and *In re Samaritan Alliance LLC*, 2007 WL 4162918, *4 (Bankr. E.D. Ky. Nov. 21, 2007) (finding *Haskell* instructive), with *In re R.J. Dooley Realty*, 2010 WL 2076959, *6-8 (Bankr. S.D.N.Y. May 21, 2010) (stating that *Downtown Athletic Club* remains good law); *S. Motor Co. of Dade County v. Carter-Pritchett-Hodges Inc. (In re MMH Auto. Group LLC)*, 385 B.R. 347, 366 (Bankr. S.D. Fla. 2008) (stating that § 365(h) does not prohibit debtor from selling property in which there is tenant in possession); *In re Ng*, 2007 WL 4365564, *1 (Bankr. N.D. Cal. Dec. 13, 2007) (holding that sale free and clear under § 363(f) extinguished all rights under § 365(h)), and *Hill v. MKBS Holdings LLC (In re Hill)*, 307 B.R. 821, 825 (Bankr. W.D. Pa. 2004) (finding *Qualitech* persuasive).
8 A leasehold qualifies as "any interest" in property. *Qualitech*, 327 F.3d at 545 (and cases cited therein).

The most relevant is likely (f)(1), which would permit the debtor to sell the premises free and clear of the tenant's lease if "applicable nonbankruptcy law permits sale of [the premises] free and clear of such interest."[10] By its plain language, this subpart seeks to achieve the same substantive result in bankruptcy that could be obtained under applicable nonbankruptcy law. Thus, the condition turns on an analysis of nonbankruptcy law: If applicable nonbankruptcy law would permit a sale free and clear of a given interest, then the debtor may sell the subject property free and clear of that interest in its bankruptcy case.

The "applicable nonbankruptcy law" at issue with respect to a lease is the underlying state real property law. Generally speaking, state real property law determines priority among competing interests in property according to the time of filing in the county recorder's office.[11] Here, the senior lender enjoyed priority over the tenant because its mortgage was filed first. Accordingly, state law would typically permit the senior lender, as the entity holding the first-priority lien on the premises, to cause a foreclosure sale free and clear of the tenant's lease.[12] Because applicable nonbankruptcy law would permit a sale free and clear of the tenant's interest, § 363(f)(1) would thus authorize the debtor to sell the premises free and clear of that interest as a matter of bankruptcy law.

This first part of the analysis, which concerns the application of § 363(f) and not its interplay with § 365(h), is not entirely free from controversy. One commentator, for example, has posited that § 363(f)'s reference to applicable nonbankruptcy law covers only sales "by the debtor," not by a foreclosing lienholder.[13] The statute, however, does not qualify the sale as one "by the debtor" or limit the sale under "applicable nonbankruptcy law" to a voluntary sale undertaken by the debtor, as opposed to a forced sale through the foreclosure process. Rather, it simply considers whether "applicable nonbankruptcy law permits sale."

While some will no doubt blanch at the idea of cutting off a lessee's interest and evicting it from the property, this construction of § 363(f)(1) does not produce any unjust results. A debtor could satisfy the applicable nonbankruptcy law standard through application of the state foreclosure statute *only* in instances where a senior lienholder has a right outside of bankruptcy to foreclose on the subject property and cut off the lessee's rights. Thus, the suggested result mirrors the substantive nonbankruptcy result, albeit through a bankruptcy sale process. As a practice pointer, to remedy this problem, the lessee should obtain a subordination, nondisturbance and attornment agreement (SNDA) from any senior lienholders.[14]

The first step concludes that the debtor could have sold the premises free and clear of the tenant's lease under § 363(f)(1). The next question is whether application of § 365(h)—and its language concerning the lessee's ability to retain its rights under the lease—operates to change that result. Section 365(h) provides:

> (h)(1)(A) If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and—
>
> (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
>
> (ii) if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as...possession...) 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.[15]

For § 365(h) to have effect, the debtor must "reject" the lease. If so, then the lessee has an election: On the one hand, it may choose to treat the lease as terminated. On the other hand, the lessee "may retain its rights under such lease...(including...possession)...that are in or appurtenant to the real property."[16]

Some courts have concluded that the post-rejection right granted to a lessee under § 365(h) to elect to retain its rights in the property trumps the purportedly more general provisions of § 363(f)—that is, rejection essentially provides an absolute right for the lessee to remain in possession.[17] Other courts take the position that § 363(f) operates during the sale process without regard to § 365(h).[18]

The problem with § 365(h) as presently enacted is that it sets only one condition—rejection of the lease—to the lessee's right to keep possession of the property. Viewed as a line of computer code, if the condition occurs (*i.e.*, rejection), then the result is dictated (*i.e.*, the lessee may choose to stay in possession). That statutory mechanic supports the view that upon rejection, the lessee has an absolute right to retain its rights, including possession, but that construction does not square with the underlying purpose of the provision.

Section 365(h) should function simply to preserve for the lessee the benefit of its bargain, even though the trustee rejected the lease. As Congressman Edwards remarked: "Section 365(h) is not intended to provide the debtor's lessee rights that would not otherwise exist outside of bankruptcy."[19] While rejection should not divest the lessee of its rights under the lease, it should not enhance them, either.

Perhaps most troubling, adopting the view that § 365(h) provides the lessee with an absolute right to retain possession could lead to a reordering of priorities among creditors. If, in the example, the senior lender were to foreclose under state law outside of bankruptcy, the foreclosure sale would transfer the property free of the lease. By contrast, in the debtor's bankruptcy case, applying the view that the post-rejection

9 11 U.S.C. §363(f).

10 Other subparts could also apply, such as subpart (f)(5) if the lease provided the debtor with a right to buyout the tenant. *See MMH Auto. Group*, 385 B.R. at 370-72.

11 *See, e.g.*, Ind. Code §32-21-4-1 (2011).

12 *See, e.g.*, Ind. Code §§32-21-4-1 and 32-29-7-10 (2011)); 4-37 *Powell on Real Property* § 37.37[6] (Matthew Bender & Co. Inc., 2011) ("If foreclosure is properly conducted, all interests arising after the time the mortgage was created and all subordinate interests (even if they were created prior to the mortgage) will be cut off.") (citing Nelson & Whitman, *Real Estate Finance Law* 507 (West 2d ed. 1985)).

13 Baxter, *supra*, at 489.

14 An SNDA typically includes three distinct concepts: (1) the lessee subordinates its leasehold to the lender's lien; (2) so long as the lessee performs its obligations under the lease, it can remain in possession notwithstanding foreclosure; and (3) the lessee acknowledges its obligations to the new landlord after foreclosure. Thomas C. Homburger, Lawrence A. Eiben, "Who's On First—Protecting the Commercial Mortgage Lender," 36 *Real Prop. Prob. & Tr. J.* 411, 415-21 (Fall 2001).

15 11 U.S.C. § 363(h).

16 *Id.*

17 *See, e.g., Haskell*, 321 B.R. at 9; *Taylor*, 198 B.R. at 164-68; *Churchill*, 197 B.R. at 286-88.

18 *See, e.g., Downtown Athletic Club*, 2000 WL 744126, *4-5; *MMH Auto. Group*, 385 B.R. at 366.

19 126 Cong. Rec. 31,917 (1980) (response of Congressman Edwards to Congressman Butler concerning lessee's right to treat lease as terminated).

right granted to a lessee under § 365(h) to remain in possession trumps a free-and-clear sale, then sale of the premises through a § 363 process would transfer title *subject to* possession by the lessee. Because the senior lender would not receive the benefit of a sale free of the lease, the interposition of bankruptcy would have reordered the otherwise applicable state law priorities by causing the lessee's interest to prime the lender's otherwise senior lien.

Section 365(h) should be amended to make clear that the rejection of a lease, in and of itself, does not deprive the lessee of its rights under the lease. That said, other sections of the Bankruptcy Code should remain applicable by their terms, and the lessee should enjoy no special privileges simply because the debtor has rejected the lease. Thus, a possible revision would be:

> (h)(1)(A) *The rejection by the trustee of an unexpired lease of real property under which the debtor is the lessor shall not, if the term of such lease has commenced, divest the lessee of its rights under such lease.*

Of critical importance, the revision would remove the "if/then" language that seemingly compelled a result that permitted the lessee to retain its rights and keep possession in all circumstances. Moreover, the proposed revision solves other problems with § 365(h). Courts have split on whether § 365(h), and a statutorily similar section, § 365(i), which gives special treatment to nondebtor vendees of land sale contracts, trump the avoidance powers of § 544(a)(3), which permits the trustee to avoid a lease if that lease is voidable by a BFP.[20] An absolute right in favor of the lessee to retain its rights under a lease conflicts with the debtor's right to avoid a lease under § 544's strong-arm powers. This revision makes clear that § 365(h) prevents the lessee from losing its rights because of a rejection, but the lessee does not receive an absolute to retain possession. Revised § 365(h) thus would not interfere with operation of the other sections, including free-and-clear sales and avoidance powers. **abi**

Reprinted with permission from the ABI Journal, Vol. XXXI, No. 6, July 2012.

20 *Compare Turoff v. Sheets (In re Sheets)*, 277 B.R. 298, 306 (Bankr. N.D. Tex. 2002) (rejecting argument that § 365(i) always trumps § 544 because that would "render a portion of § 544 that would otherwise apply in this case inoperative or superfluous") (internal quotations omitted), and *Webber Lumber & Supply Co. Inc. v. Trucklease Corp. (In re Webber Lumber & Supply Co. Inc.)*, 134 B.R. 76, 79 (Bankr. D. Mass. 1991) (reading § 365(h) and (i)'s concern for the protection of property interests to be no greater than § 544's directive to permit avoidance of subordinate property interests), with *McCannon v. Marston*, 679 F.2d 13, 17 (3d Cir. 1982) (stating in *dicta* that "[w]e agree that it is highly unlikely that Congress would enact section 365(i) while at the same time [allow] the trustee to avoid, under section 544(a)(3), the equitable interests of buyers in possession"), and *Smith v. Ball (In re Smith)*, 71 B.R. 754, 758 (Bankr. M.D. La. 1987) (concluding that § 365(i) supersedes the "broad provision" of § 544).