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Tenants Take Caution, Ninth Circuit Allows Bankrupt Landlord to Sell Property Free and Clear of Leases

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Summary:

The United States Court of Appeals for the Ninth Circuit recently held that a purchaser in a sale pursuant to section 363 of the Bankruptcy Code¹ could, in certain circumstances, acquire commercial property free and clear of the unexpired leases burdening the property. In other words, a lessee's possessory interests in real property will not necessarily survive a "free and clear" sale of the property.²

Accordingly, as detailed further below, lessees will need to ensure that, in the event of a landlord's bankruptcy filing, they are prepared to take immediate and necessary actions to protect themselves, including by filing motions or objections in bankruptcy court demanding adequate protection promptly upon a motion by the landlord to sell the subject property "free and clear" pursuant to section 363.

Discussion:

The Ninth Circuit joined the Seventh Circuit in rejecting the majority view of federal courts that a lessee's possessory interests will survive a "free and clear" sale of property under section 363(f).³ The court in *In re Spanish Peaks Holdings II, LLC* considered the interplay of two sections of the Bankruptcy Code and their effect on the treatment of lessee interests when a landlord declares bankruptcy and proposes to sell its assets in a 363 sale:

1. Section 363 allows the sale of a debtor's assets free and clear of third-party interests, claims, and encumbrances, subject to certain requirements; and
2. Section 365 allows a debtor to assume or reject an unexpired lease and, in the event of rejection, permits the lessee to opt to retain certain existing rights, including a right to possession of the property.

Spanish Peaks involved a chapter 7 case filed by the owners and operators of Spanish Peaks, a private resort in Montana. Among the debtors' assets were parcels of real estate that were leased to two entities at below-market rates. The chapter 7 Trustee sought to sell substantially all of the debtors' real property "free and clear" of all liens, claims, and encumbrances. The lessees objected to the sale, arguing that section 365 protected their possessory interests in the property.



The bankruptcy court authorized the sale free and clear of any interests, on the grounds that the Trustee had met the applicable requirements under section 363(f),⁴ and the district court affirmed. The bankruptcy court also noted that the lessees had not requested adequate protection of their leaseholder interests as they were entitled to do under section 363(e).

The majority of federal courts have found that section 365(h) protects a lessee's possessory interests in these circumstances. According to the majority view, because section 365(h) gives lessees the right to retain possession of leased real property despite rejection of the lease, lessees may retain possession following a section 363(f) sale even when the lease has not been formally rejected by the debtor.

The Ninth Circuit, however, adopted the minority approach initially established by the Seventh Circuit (the only other circuit court to have addressed the issue) in *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*. The Ninth Circuit court found that section 365 governs the formal rejection of a lease and, therefore, did not apply because no party had sought to reject the lease. Rather, section 363 governed and the purchaser could acquire the assets free of a leasehold interest for the lessee. The court noted, however, that lessees could protect themselves by demanding adequate protection under section 363(e) prior to the sale and that this protection provides a "powerful check on potential abuses of free and clear sales." The court further noted that adequate protection could include permitting the lessee to remain in possession of the property. The lessees in Spanish Peaks did not demand adequate protection until the appeal (i.e., after the sale).

Implications of the Court's Decision:

The court's decision could have major implications for lessees and debtor landlords in the Ninth Circuit (and elsewhere, as other circuit courts may choose to follow the Seventh and the Ninth Circuits).

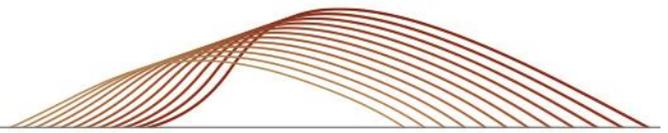
Lessees:

Lessees will need to ensure that, in the event of a landlord's bankruptcy filing, they are prepared to take immediate and necessary actions to protect themselves. The primary form of protection for the lessee likely will be to file an objection to the debtor's motion to approve the "free and clear" sale, through which the lessee will demand adequate protection of its interests. What constitutes adequate protection for the lessee will be determined on a case-by-case basis by the bankruptcy court, but may include allowing the lessee to remain in possession of the leased property. Lessees will also want to act promptly. Because section 363 sales can be completed on an expedited basis (e.g., in as little as 30 to 60 days), lessees may have little time to weigh options and develop a plan of action.

Debtor Landlords:

Debtor landlords, on the other hand, should evaluate their existing leases and take advantage where appropriate of their ability to make real property sales free and clear of undesirable leases. Where the ability to make these free and clear sales is material to a debtor, it should keep these new developments in mind while evaluating the appropriate venue for filing.

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¹ Title 11 of the United States Code, §§ 101, et seq.

² Section 363 sales are a method of selling financially distressed assets through which a debtor can sell its assets significantly faster than a full chapter 11 reorganization and can also sell those assets “free and clear” of preexisting liens and interests.

³ States in the Seventh Circuit are Illinois, Indiana, and Wisconsin. States in the Ninth Circuit are Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington, and the territories of Guam and the Northern Mariana Islands.

⁴ Section 363(f) of the Bankruptcy Code provides a debtor may sell property under section 363 free and clear of any interest in such property of an entity other than the estate, only if—

- (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.

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