THROWING TENANTS OFF *SPANISH PEAKS*

By Michael St. James*

The only two Circuit Courts of Appeal to rule on the issue, the Seventh Circuit in *Qualitech*[1] and the Ninth Circuit in *Spanish Peaks*,[2] adopted a "minority" view, condoning sales of real property free and clear of a tenant's leasehold. The Circuit decisions explicitly stand only for a modest proposition which should be non-controversial: Bankruptcy Code sections 363(f) and 365(h) can co-exist, and neither trumps the other. Along the way, both Circuit decisions present three significant and problematic inferences: sales free and clear of leases can be readily approved; the tenant's substantive rights depend entirely on procedure and timing; and the tenant's right to possession is both inviolable and worthless, depending on the context. The critical question is whether the bankruptcy courts in future cases will blindly follow the Circuits' problematic inferences or analyze the actual circumstances before them instead.

The Circuit Courts' Decisions

The two Circuit decisions are strikingly similar, and similar in what they do not address. Each Circuit decision recites the same key facts:

A sale free and clear was conducted by auction, and the successful bid was a credit bid presented by the undersecured holder of the first mortgage.[3] Prior to the sale hearing, there was no clear notice to creditors or tenants about whether the sale would have an effect on the lease.[4] At the sale hearing, there was no ruling about whether the sale would have any effect on the lease.[5] In subsequent

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[1] Precision Indus. v. Qualitech Steel SBQ, LLC, 327 F.3d 537 (7th Cir. 2003) ("*Qualitech*").

[2] Pinnacle Res. at Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 862 F.3d 1148 (9th Cir. 2017) ("*Spanish Peaks*").

[3] *Spanish Peaks*, 862 F.3d at 1152; *Qualitech*, 327 F.3d at 540-1.

[4] *Spanish Peaks*, 862 F.3d at 1152; *Qualitech*, 327 F.3d at 541.

[5] *Spanish Peaks*, 862 F.3d at 1152; *Qualitech*, 327 F.3d at 541-2.

litigation, the bankruptcy court determined that the sale had been free and clear of the lease,[6] and so the tenant was no longer entitled to possession of the leasehold.

Both Circuit decisions recited that a sale free and clear of a lease must be authorized under one of the five subsections of section 363(f).[7] Both Circuit decisions recite that the bankruptcy court found that the sale had been free and clear of the lease under at least one of these subsections and that the litigants did not contest that,[8] seemingly rendering it unnecessary to explain why the lease could be the subject of one of those subsections. The Ninth Circuit nonetheless also presented an analysis of section 363(f)(1)[9] under which a sale free of the lease might have been authorized and which, if given general effect, would broadly change the law on sales free and clear of liens in that Circuit.

On the second issue, the impact of section 365(h), the Circuit decisions noted that the leases had not been rejected by the time of the sale. Since section 365(h) by its terms applies only to rejected leases, and the leases had not been rejected at the time of the sale, section 365(h) by its terms did not apply.[10] Finally, both Circuit decisions concluded that the tenant might have avoided its fate by seeking "adequate protection" prior to the sale hearing.[11]

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[6] *Spanish Peaks*, 862 F.3d at 1152-3; *Qualitech*, 327 F.3d at 541.

[7] *Spanish Peaks*, 862 F.3d at 1156 ("we emphasize that section 363(f) authorizes free-and-clear sales only in certain circumstances."); *Qualitech*, 327 F.3d at 546 ("[T]he statute conditions such a sale on satisfaction of one of five conditions . . . ").

[8] *Spanish Peaks*, 862 F.3d at 1156 ("The bankruptcy court did not specify which circumstance justified the sale in this case, stating only that Pinnacle and Opticom 'd[id] not dispute that at least one provision of § 363(f) was satisfied.'"); *Qualitech*, 327 F.3d at 546 ("Although the statute conditions such a sale on the satisfaction of one of five conditions, the parties before us do not dispute that at least one of those conditions was satisfied. On the contrary, both parties to the appeal proceed from the premise that section 363(f) standing alone permits the sale of estate property free and clear of a lessee's possessory interest.")

[9] *Spanish Peaks*, 862 F.3d at 1156-7.

[10] *Spanish Peaks*, 862 F.3d at 1156 ("the parties agree that the Pinnacle and Opticom leases were not 'rejected' prior to the sale. Under our interpretation, then, section 365 was not triggered."); *Qualitech*, 327 F.3d at 546. *But see* Dishi & Sons v. Bay Condos LLC, 510 B.R. 696, 704 (S.D.N.Y. 2014) ("Dishi") (criticizing decisions which consider "only the 'easy' case where § 365(h) is never triggered . . . .")

[11] *Spanish Peaks*, 862 F.3d at 1156 ("First, we note the mandatory language of section 363(e). A bankruptcy court *must* provide adequate protection for an interest that will be terminated by a sale if the holder of the interest requests it. Moreover, 'adequate protection' includes any relief . . . that will result in the realization by such entity of the indubitable equivalent of the terminated interest." Thus, "adequate protection [is] a powerful check on potential abuses of free-and-clear sales,"

Thus, on the issue most shocking to a majority of the courts which previously considered it—the ability to effect a sale free and clear of the rights of a tenant in possession—the Circuit decisions simply noted that the bankruptcy court and the litigants thought it had been accomplished and there was no reason for the Circuit Court to disagree.

This had the effect of skewing the Circuit Courts' analyses by allowing them to ignore one of the roots of lease law. Leases straddle real property law—an estate in real property for years—and contract law. As a matter of real property law, the landlord is obligated to protect the tenant's continuing right to possession. The landlord—and its general unsecured and judgment creditors—cannot disturb the tenant's possessory rights, which are inviolable under generally applicable non-bankruptcy law.[12] When the parties authorized the Circuit Courts to assume that a permissible sale free and clear of the tenants' possessory rights had occurred, they led the Circuit Courts to ignore real property law and look only to contract law to evaluate the tenants' rights. This appears to be at the root of the Circuit Courts' problematic inferences.

While the analyses presented by the Circuit Courts were straightforward, they provided little guidance on the key issues they created: when is it appropriate to sell free and clear of a lease, and how should a bankruptcy court respond to a tenant's request for adequate protection? Instead, the Circuit Courts offered three problematic inferences.

The Three Problematic Inferences

The Circuit decisions presented three inferences which are properly characterized as problematic but are likely to be the decisions' real legacies. Whether the bankruptcy courts adopt or scrutinize these inferences, and the manner in which they administer them in the cases in which they arise, are the critical questions for the future.

Sales Free and Clear of Leases Can Be Readily Approved

Both Circuit Courts were unsurprised that the bankruptcy courts thought they had effected sales free and clear of the leases and that the litigants before

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citing *Dishi* with approval for concluding that adequate protection should take the form of continued possession) (emphasis in original); *Qualitech*, 327 F.3d at 547-48 (lessees "have the right to seek protection under section 363(e), and upon request, the bankruptcy court is obligated to ensure that their interests are adequately protected.")

[12] *See infra* text accompanying notes 19-22.

them elected not to contest that issue. The assumption that sales free and clear of leases can readily occur is likely the most significant and enduring legacy of the Circuit decisions.[13]

As noted above, however, and with the exception of *dicta* in the Ninth Circuit's opinion discussed below, the Circuit decisions did not provide an analysis about how to effect a sale free and clear of a lease. Instead, they reaffirmed that the bankruptcy court must measure the facts against the five subsections of section 363(f) and only approve the sale free and clear of the lease if it satisfies one of those tests.[14] The Circuit decisions simply took the bankruptcy courts and the litigants at their word when they agreed the sales had satisfied one of those tests.

The Absence of Statutory Authorization

Of the five subsections of section 363(f), only three are potentially relevant to an attempt to sell real property free and clear of a lease where the tenant is in possession.[15] Of those three subsections, one, section 363(f)(4),

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[13] *Compare*, *In re* Churchill Props. III. Ltd. P'ship, 197 B.R. 283, 288 (Bankr. N.D. Ill. 1996) ("The lessee's interest in a leasehold cannot be modified or changed because of a pending bankruptcy"), *with* Upland/Euclid, Ltd. v. Grace Rest. Co. (*In re* Upland/Euclid, Ltd.), 56 B.R. 250, 253, (B.A.P. 9th Cir. 1985):

> Both subsections [365(h) and (i)] show a legislative intention that certain expectations of parties to real property transactions are to be protected although this protection does not benefit the bankruptcy estate. Any general goal of maximizing the bankruptcy estate is limited in recognition of these real property interests. *Collier* summarized this limitation as follows:
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> > The desire to effect a feasible plan of reorganization cannot override the vested rights of third persons who are not creditors of the debtor. Insofar as the lessee's leasehold is concerned he is as much a stranger to the reorganization as one who purchased, received and paid for goods of the debtor prior to reorganization.
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> 6 *Collier on Bankruptcy* para. 3.24, at 602-03 (14th ed. 1977).

See also In re Penn Centr. Transp. Co., 458 F. Supp. 1346, 1356 (S.D.N.Y. 1978) (denying trustee's proposed rejection and renegotiation of ground leases, explaining "The bankruptcy laws are intended as a shield, not as a sword. Their purpose is to minimize fiscal chaos and disruption, not to aggravate it . . . [So] disaffirmance of leases in which the Debtor is the lessor should not be permitted."); *In re* LHD Realty Corp., 20 B.R. 717 (Bankr. S.D. Ind. 1982) (Broadly rejecting the power of a bankruptcy court to modify the rights of a tenant in possession).

[14] *See supra* notes 7 and 8.

[15] Two of the subsections are not relevant to a non-consensual sale free of a lease: Section

authorizing a sale free and clear where the lease is in dispute, is readily understood and will occasionally be relevant. If the subject of an ordinary and modest interpretation, the other two, sections 363(f)(1) and (f)(5), will almost never be applicable to a tenancy; on the other hand, under a very aggressive interpretation—including the interpretation advocated in *Spanish Peaks*—they can provide authority to sell free and clear of almost anything.

Section 363(f)(4) authorizes a sale free and clear of an interest if that interest is in bona fide dispute. A number of cases have attempted to assert this as the basis for selling free and clear of a lease, but the disputes have generally been found to be pretextual.[16] One could imagine a long-term, low rent lease granted to an insider on the eve of bankruptcy satisfying this requirement. Indeed, that hypothetical is comparable to the findings of the bankruptcy court in *Spanish Peaks*, which seems to have established all of the predicates for a sale free and clear of the leases under section 363(f)(4).

The other two potentially relevant subsections raise the same analytical concern. Section 363(f)(1) permits sales free and clear of liens and interests if "applicable nonbankruptcy law permits sale of such property free and clear of" such lien or interest. Section 363(f)(5) authorizes a sale free and clear of an interest if the non-debtor party could have been "compelled, in a legal or equitable proceeding, to accept a money satisfaction" of its interest. In both cases, the debate has turned on whether the test looks to a law or proceeding the debtor or trustee could have invoked (under "applicable non-bankruptcy law" or that would "compel a money satisfaction"), or whether any hypothetical proceeding that could be invoked by a hypothetical entity will suffice.

363(f)(2) authorizes sales free and clear where the other party consents, and section 363(f)(3) refers only to liens.

[16] *In re* Taylor, 198 B.R. 142, 162 (Bankr. D.S.C. 1996) (concluding that a lease could be the subject of section 363(f)(4) as an abstract matter, but that the lease in question was not actually in bona fide dispute); *In re* Patriot Place, Ltd., 486 B.R. 773, 815 (Bankr. W.D. Tex. 2013) (declining to find an objective basis for a bona fide dispute about the lease); Revel AC, Inc. v. IDEA Boardwalk LLC, 802 F.3d 558 (3d Cir. 2015) (effort to sell free and clear of lease fails because no objective basis for bona fide dispute about lease validity); *but see In re* Bedford Square Assocs., L.P., 247 B.R. 140, 144, (Bankr. E.D. Pa. 2000) (since bona fide purchaser under state law could avoid restrictive covenant in unrecorded lease, trustee could sell free and clear of that covenant since it was in bona fide dispute); C.H.E.G., Inc. v. Millennium Bank, 99 Cal. App. 4th 505, 510-13; 121 Cal. Rptr. 2d 443, 446-48 (2002) (Sale free and clear terminated right to broker's commission contained in lease); *see also In re* Webber Lumber & Supply Co., 134 B.R. 76, 78 (Bankr. D. Mass. 1991) (where unrecorded lease was ineffective against bona fide purchaser under applicable state law, trustee could avoid lease by exercising section 544(a) powers).

The leading view is that *applicable* nonbankruptcy law is law that could be invoked by the trustee, exercising the rights of the debtor (via section 541) or of the debtor's unsecured creditors (via section 544).[17] For example, a commentator explained that this section "recognizes that there is no reason to limit preexisting rights and remedies . . ."[18]

Under generally applicable nonbankruptcy law, neither a landlord nor a landlord's judgment creditor may sell property free and clear of the lease of a tenant in possession. "A lease is partly the conveyance of an estate in land deemed fully executed once the tenant takes possession. Therefore, the weight of authority is that the conveyance aspect of a lease may not ordinarily be unilaterally disturbed by a debtor landlord or his trustee."[19] Indeed, the landlord may be under an affirmative duty to refrain from any action that would interrupt the tenant's occupancy.[20] The landlord's judgment creditor at an execution sale conveys no better title.[21]

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[17] *See, e.g.*, *In re* Jaussi, 488 B.R. 456, 458 (Bankr. D. Colo. 2013) ("§ 363(f)(1) should be interpreted narrowly . . . This section applies only to situations where the owner of the asset may, under nonbankruptcy law, sell an asset free and clear of an interest in such asset.")

[18] George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 AM. BANK. L. J. 235, 244 (2002).

[19] *Taylor*, 198 B.R. at 159; Anthony Asebedo, *The Sale of Real Property Free and Clear of a Lease: Making Sense of Section 363(f) and 365(h) of the Bankruptcy Code*, 24 AM. BANKR. L. REV. 279, 291-97 (Summer, 2016); *Id.* at 322 ("State law typically will not permit a landlord to terminate a lease unilaterally in order to sell real property free of the lease."); *see also* S. Motor Co. v. Carter-Pritchett-Hodges, Inc. (*In re* MMH Auto Group, LLC), 385 B.R. 347, 366 (Bankr. S.D. Fla. 2008) ("MMH's bankruptcy did not confer any greater legal rights on [the buyer] under the . . . lease or applicable non-bankruptcy law."). *See also infra* note 28.

[20] In every lease the landlord impliedly covenants that the tenant shall have quiet enjoyment and possession of the premises. In California this covenant is partially expressed in Civil Code section 1927, which guarantees the tenant against rightful assertion of a paramount title. Beyond the statutory covenant, the landlord is bound to refrain from action which interrupts the tenant's beneficial enjoyment.

Guntert v. City of Stockton, 55 Cal. App. 3d 131, 138, 126 Cal. Rptr. 690, 693 (Cal. App. 1976); *see also* Standard Livestock Co. v. Pentz, 204 Cal. 618, 269 P. 645 (Cal. 1928) (tenant entitled to recover damages from landlord after it was evicted by a foreclosing creditor of the landlord).

[21] *See* CAL. CIV. CODE section 3395 ("Whenever an obligation in respect to real property would be specifically enforced against a particular person, it may be in like manner enforced against any other person claiming under him by a title created subsequently to the obligation . . . "); CAL. CIV. CODE section 1217 ("An unrecorded instrument is valid as between the parties thereto and those who have notice thereof.") Under California law, possession of the premises will ordinarily provide constructive notice of the existence of the lease, thereby defeating efforts by a judgment

For many of the same reasons, the trustee—exercising the rights of the landlord or its judgment creditors—will not ordinarily be able to invoke a legal or equitable proceeding which would compel the tenant to accept a money satisfaction of its lease.[22] The only case which found that section applicable to a leasehold involved a contractual termination option exercisable by the landlord, which would clearly "compel" the lessee to accept a money satisfaction.[23]

The principal objection to limiting section 363(f)(1) and (f)(5) to non-bankruptcy law that the trustee could otherwise invoke is that it does not add much power for the trustee, and so those sections will only have limited application to sales free and clear. [24] For example, the debtor could generally terminate a month-to-month tenancy unilaterally, so it would be possible to sell free and clear of a month-to-month tenant under section 363(f)(1), but it would be equally possible to simply terminate the month-to-month tenancy prior to the sale.

The "hypothetical proceeding" view tends to have very broad consequences. For example, one court hypothesized that under eminent domain, almost anything can be converted into a money satisfaction, and so section 363(f)(5) could authorize a free and clear sale of almost anything; this approach has been pretty universally rejected. [25] Other authorities, including the Ninth Circuit in *Spanish Peaks*, have looked to a foreclosure sale as "applicable" non-

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creditor or a bankruptcy trustee to terminate the lease. *See In re* Probasco, 839 F.2d 1352, 1354 (9th Cir. 1988) ("Actual or constructive notice of a prior unrecorded transfer removes a subsequent purchaser from the protection of the recording acts. Clear and open possession of real property constitutes constructive notice of the rights of the party in possession to subsequent purchasers. Such a prospective purchaser must inquire into the possessor's claimed interests, whether equitable or legal.") *See also infra* note 54.

[22] Section 363(f)(5). *Patriot Place*, 486 BR. at 816 (rejecting an attempt to sell free and clear of a leasehold under section 363(f)(5)).

[23] *MMH*, 385 B.R. at 372.

[24] Asebedo, *supra* note 19, 24 AM. BANKR. L. REV. at 321 ("the scope of section 363(f)(1) is not particularly broad") and at 333 ("the application of section 363(f)(5) . . . will of course be more limited."); Clear Channel Outdoor, Inc. v. Knupfer (*In re* PW, LLC), 391 B.R. 25, 46, 43 (B.A.P. 9th Cir. 2008) (rejecting a bankruptcy cram-down as a proceeding that would compel a money satisfaction due to circularity, and acknowledging that its view "leads to a relatively small role for paragraph (5) . . . "); *but see In re* TWA, 322 F.3d 283, 291 (3d Cir. 2003) (approving a hypothetical chapter 7 case as one which would have compelled a monetary satisfaction of EEOC claims).

[25] *In re* Haskell L.P., 321 B.R. 1, 9 (Bankr. D. Mass. 2005) (rejecting eminent domain); Kuney, *supra* note 18, 76 AM BANKR. L. J, at 254-55 (noting that neither the leading commentator nor any published opinion approves construing section 363(f)(5) by reference to eminent domain powers).

bankruptcy law, noting that a foreclosure sale by a senior mortgage holder could sell free and clear of all junior encumbrances, including leases.

The problem is that this hypothetical sale swallows the rest of the section: since virtually everything is sold free and clear in a hypothetical eminent domain proceeding or foreclosure sale by the holder of the first mortgage, the authorization granted by section 363(f)(1) or (f)(5) on this interpretation renders the other four subsections superfluous.[26] If this analysis is adopted, it is hard to see a lien, claim or interest that would *not* be the subject of a free and clear sale, other than an undersecured first mortgage.[27]

An opportunistic desire to expand the scope of section 363(f)(1) is neither a policy nor an analysis. One of the most thorough analyses these issues concluded that section 363(f)(1) "refers not to foreclosure sales, but rather 'only to situations where the owner of the asset may, under nonbankruptcy law, sell an asset free and clear of an interest in such asset.'"[28]

In the case of both section 363(f)(1) and (f)(5), courts have generally rejected analyses based on the rights of hypothetical creditors and have concluded that "the statute requires that the trustee or the debtor be the party able to compel monetary satisfaction for the interest which is the subject of the sale."[29]

As long as the courts apply an ordinary and modest interpretation of sections 363(f)(1) and (f)(5) , looking to powers the debtor or trustee could otherwise invoke, those sections are unlikely to provide support for a sale free and clear of a lease. It is only by imbuing the trustee with the powers of a hypothetical super-creditor, such as an eminent domain taking or a foreclosure sale, that section 363(f)(1) or (f)(5) can become a powerful weapon.

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[26] *See* Kuney, *supra* note 18, 76 AM BANKR. L. J, at 251-255 (noting that treating eminent domain and foreclosure law as an available mechanism to compel money satisfaction would render section 363(f)(5) "The Standard That Could Have Swallowed the Others.")

[27] *See infra* note 35.

[28] *Dishi*, 510 B.R. at 709 (noting that applicable non-bankruptcy law respecting a landlord's voluntary sale of property "provides that the purchaser takes property subject to a lease if he had actual or constructive notice of its existence."); Scholey v. Steele, 59 Cal. App. 2d 402, 404-05, 138 P.2d 733, 734, Cal. App. 1943 ("The fact that appellant acquired the property after the inception of the tenancy is immaterial. He took it subject to the terms of the existing lease . . . ").

[29] *Haskell L.P.*, 321 B.R. at 9; Asebedo, *supra* note 19, 24 AM. BANKR. L. REV. at 333 (suggesting that "courts limit the application of section 363(f)(5) to proceedings of the debtor or trustee, not a third party . . . This is the most sensible approach, because it makes the subsection harmonious with the other subsections and prevents it from subsuming them.")

The *Spanish Peaks* Dicta

Although apparently acknowledging it to be *dicta*,[30] the Ninth Circuit did present an analysis of the ability to sell free and clear of a lease under section 363(f)(1) which, if given effect generally, would markedly expand the law on sales free and clear in that Circuit.

The Ninth Circuit noted that under applicable foreclosure law, a foreclosure sale would divest the tenants of all rights under their leases.[31] It concluded that "we see no reason to exclude the law governing foreclosure sales from the analogous language in section 363(f)(1)"; reasoning that the statute evinced a "clear intent to protect lessees' rights outside of bankruptcy, not an intent to enhance them."[32]

If foreclosure law is treated as "applicable" non-bankruptcy law, serious theoretical and practical problems arise. As a theoretical matter, it is a commonplace that the "trustee stood in the shoes of the bankrupt, [but also] in the overshoes of the [unsecured] creditors."[33] Allowing the trustee to stand in the secured creditor's ski boots as well seems inconsistent with practice and policy under the Bankruptcy Code and difficult to rationalize: there are no other circumstances in which the trustee is authorized to "borrow" or exercise the rights and powers of a consensually secured creditor.[34] As a practical matter, this

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[30] The Ninth Circuit preceded its analysis by noting that the application of section 363 was not in dispute, indicating that the analysis was *dicta*.:

> The bankruptcy court did not specify which circumstance justified the sale in this case, stating only that Pinnacle and Opticom "d[id] not dispute that at least one provision of § 363(f) was satisfied." We, on the other hand, focus on 11 U.S.C. § 363(f)(1), which authorizes a sale if "applicable nonbankruptcy law permits sale of such property free and clear of such interest." 11 U.S.C. § 363(f)(1).

Spanish Peaks, 862 F.3d at 1156.

[31] The claim may be overstated. Under California law, at least, a foreclosure would be unlikely to affect a tenant whose lease preceded the mortgage. *See supra* note 28, and *infra* note 55.

[32] *Spanish Peaks*, 862 F.3d at 1157.

[33] Schneider v. O'Neal, 243 F.2d 914, 918 (8th Cir. 1957); *see also In re* Agricultural Research and Technology Group, Inc., 916 F.3d 528, 534 (9th Cir. 1990) ("the trustee stands in the overshoes of the debtor corporation's unsecured creditors"). The "creditors' overshoes" are codified in section 544.

[34] *See* section 544; *but see* Bruce Grohsgal, *Colder Than a Landlord's Heart? Reconciling a Debtor's Authority to Sell Property Free and Clear of a Lease Under Bankruptcy Code Section 363(f) with the Tenant's Right to Remain in Possession on a Lease Rejection Under Bankruptcy*

interpretation would seem to swallow and render superfluous the balance of the subsections of section 363(f) and permit sales free and clear of almost all claims, liens and interests in every case.[35]

All of that said, it seems reasonably clear that the *Spanish Peaks* pronouncements about foreclosure sales being "otherwise applicable law" under section 363(f)(1) are non-binding *dicta*. Second Circuit Judge Leval explained that "If the court's judgment and the reasoning which supports it would remain unchanged, regardless of the proposition in question, that proposition . . . is superfluous to the decision and is *dictum*."[36] As a test, he proposed to substitute the questioned proposition with its opposite: if it "would not require a change in the court's judgment or the reasoning that supports it, then the proposition is dictum."[37]

Under this test, the *Spanish Peaks* pronouncements about section 363(f)(1) and reliance on foreclosure as "applicable nonbankruptcy law" is *dicta*. Since the availability of sale free and clear of the lease was uncontested, whether the Circuit stood mute as in *Qualitech* or volunteered an opinion on a possible basis for the

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Code Section 365(h), 100 MARQ. L. REV. 295 (2016) (arguing that bankruptcy courts sold free and clear of liens as though acting as foreclosure courts under the three Bankruptcy Acts which preceded the Bankruptcy Code); *e.g.*, *In re* Hotel Governor Clinton, Inc., 96 F.2d 50, 51 (2d Cir. 1938) ("The reorganization was carried out on the basis of the lien of the first mortgage bonds . . ." approving sale free and clear of a lease). It is submitted that the norms, objectives and practice of bankruptcy under the prior Acts and the Chandler Act were materially different than under the Bankruptcy Code of 1979; for example, equity receiverships and bondholder reorganizations, prevalent under the prior acts, are largely unknown under the Code.

[35] In a real estate case, the only exceptions would appear to be easements and CC&Rs recorded prior to the first mortgage and an undersecured first mortgage: everything else of record—and not of record—could be sold free and clear at a hypothetical foreclosure sale held to enforce the first deed of trust. Notably, section 363(h), permitting sales free and clear of a co-owner's interest, would become unnecessary in the ordinary case because a foreclosure could sell free and clear of a co-owner's interest, without the "burdensome" protections of that section. In a personal property case in which there was a typical blanket lien, the trustee could sell all assets, contract rights and other property or rights free and clear of claims, liens and interests, potentially except rights that are not assignable or transferable as a matter of contract or law. *In re* Catapult Entm't, Inc., 165 F.3d 747 (9th Cir. 1999) (holding that section 365(c)(1) barred the assumption or assignment of a non-exclusive patent license). On the other hand, just as the Circuit Courts concluded that section 365(h) was not implicated in a sale free and clear, arguably section 365(c)(1) would also not be implicated in a sale free and clear, thereby avoiding the *Catapult* result.

[36] Pierre Leval, *Judging Under the Constitution: Dicta About Dicta*, 81 N.Y.U. L. REV. 1249, 1256 (2006) ("Dicta").

[37] *Id.* at 1257.

sale was irrelevant to the opinion.[38] The Ninth Circuit's discussion of section 363(f)(1) and foreclosure sales was, in fact, non-binding *dicta.*

Whether the Ninth Circuit's analysis is treated as binding or *dicta* will be the key consideration going forward. At least within the Ninth Circuit, if it is viewed as *dicta* and an ordinary and modest interpretation of section 363(f) is applied by the courts going forward, it is likely to be the rare case in which there will be a sale free and clear of a lease where the tenant is in possession. On the other hand, if the *Spanish Peaks* assertion that foreclosure sales constitute "otherwise applicable law" is viewed as binding authority, the scope of sales free and clear of liens will expand to virtually every possible claim, lien or interest.[39]

The Tenant's Substantive Rights Depend Entirely on Procedure and Timing

As presented in both Circuit decisions, procedure and timing is dispositive. The sequence of the steps taken and whether and when procedural requests are made govern whether the tenant wins or loses everything.

If the lease is rejected first, the tenant's right to ongoing possession would be clearly established by the express provisions of section 365(h). Both Circuit decisions declined to address what might occur in a subsequent attempt to sell free and clear of the leasehold, but both strongly implied that after section 365(h) was formally invoked, the tenant's rights to continued possession would be protected. That said, when to make the decision to assume or reject a lease is left to the trustee's discretion and a tenant may face serious difficulties and obstacles attempting to force an "early" rejection.[40]

As presented in the Circuit decisions, the issue likely becomes a race between the trustee's motion to sell free and clear of the lease and the tenant's motion for adequate protection.[41] If the tenant's motion for adequate protection is heard at or before the time of the sale, the Circuit decisions presume that the

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[38] *See supra* note 8. As a consequence, one court held that *Qualitech* could not be viewed as authority for the power to sell free and clear of a leasehold. *Patriot Place,* 486 B.R. at 815.

[39] *See supra* note 35; as a practical matter, this seems to overrule the result in *Clear Channel.*

[40] *In re* Victoria Station Inc., 875 F.2d 1380, 1385 (9th Cir. 1989) (Approving multiple extensions of time to assume or reject leases; urging "a circumspect appraisal of the propriety of assumption or rejection" before a decision is made.)

[41] *But see Dishi,* 510 B.R. at 704 (rejecting as unreasonable the suggestion "that the procedural posture of a case—whether a trustee explicitly rejects a lease by the time of a sale—is critical.")

tenant's interest will be protected, likely through an order authorizing its ongoing possession of the premises.[42] On the other hand, if the property is sold free and clear of the lease before the tenant obtains "adequate protection," the Circuit decisions assume that upon approval of the sale, possession of the leasehold will be forfeited and the tenant will be left to whatever economic recovery it can obtain from the bankruptcy estate. (That was the outcome in the two cases addressed by the Circuit Courts, where the tenants lost all and recovered nothing.) It is hard to imagine another circumstance in which material legal rights in a bankruptcy case are won or lost based on such discretionary timing and procedure.

The Circuits' decisions raise the anomalous prospect that important substantive rights will be won or lost depending on procedure and discretionary timing issues. Apart from the gratitude likely felt by the tenant's bankruptcy bar over being hired to evaluate and attempt to guard against the risks posed by a landlord's bankruptcy filing, it is difficult to see the justification for this seemingly capricious "rule."[43]

The Tenant's Right to Possession Is Both Inviolable and Worthless, Depending on the Context

Both Circuit decisions uphold sales which effectively destroyed leases as worthless. If the leases were, in fact, worthless, this would not be problematic. If they had value, however, the bankruptcy court's conduct should be the subject of concern: typically, bankruptcy courts police the administration of cases to ensure that valuable rights are not lost capriciously or without notice. Were a bankruptcy court to permit creditors with high priority entitlements to lose them without justification, we should think that something was amiss.[44]

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[42] Both Circuit decisions strongly imply that this will be the result, *see supra* note 11; although, as discussed in the final section of this article, that is far from clear. The Ninth Circuit explains that "adequate protection" must "'result in the realization by such entity of the indubitable equivalent' of the terminated interest." *Spanish Peaks*, 862 F.3d at 1156. Clearly, there is only one "indubitable equivalent" of possession of a unique piece of real property – ongoing possession of *that* unique piece of real property. *But see infra* note 51; *see also Qualitech*, 327 F.3d at 548 ("'Adequate 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 . . . ")

[43] *See supra* note 41.

[44] Czyzewski v. Jevic Holding Corp., ___ U.S. ___, 137 S. Ct. 973, 979 (2017) (priority creditors could not be disenfranchised in favor of general unsecured creditors through procedural device of a structured dismissal of a Chapter 11 case).

But both Circuit decisions strongly implied that if the tenant sought "adequate protection" it would receive an order assuring it of ongoing occupancy; that is, that the lease would be treated as inviolable. Both Circuit decisions note that, if asked, the bankruptcy court *must* provide the lessee with "adequate protection" for its interests.[45] They both strongly imply that in the ordinary case adequate protection would include an order assuring the tenant of ongoing possession of the leasehold. Indeed, the Ninth Circuit favorably cites the appellate decision which most thoroughly analyzed these issues and affirmed the bankruptcy court's decision to provide the tenant ongoing possession of its leasehold as adequate protection for its interests.[46] All of this is consistent with bankruptcy policy in the twentieth century, which viewed the rights of a tenant in possession as inviolable[47] —neither the landlord nor its creditors had any right to disturb a tenant in possession.[48]

The problem here is that adequate protection is calibrated to the value and circumstances of the creditor's interest. In the case cited by the Ninth Circuit, the court found that the property could not be sold free and clear of the tenant's possessory interest in its leasehold, so that interest was inviolable and entitled to adequate protection in the form of continued occupancy.[49] If considered in terms of the rights of the landlord and the landlord's creditors, there is no ability to terminate the tenant's leasehold estate, and so adequate protection would necessarily include a right to continuing possession.[50]

Once one determines—or assumes, in the case of the two Circuit decisions—that the property can be sold free and clear of the tenant's possessory interest in the leasehold estate, it is difficult to rationalize ascribing any value to the tenant's "right" to continued possession—the "value" of mere possession is

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[45] *See supra* notes 11, 42.

[46] *Spanish Peaks,* 862 F.3d at 1155 (noting with approval that the District Court in *Dishi* "concluded that adequate protection could take the form of continued possession"); *see also supra* notes 11 and 42.

[47] *See supra* note 13.

[48] *See supra* notes 19-22, and accompanying text.

[49] Where it is improbable that the lessee will receive any compensation for its interest from proceeds of the sale, and it is difficult to value the lessee's unique property interest, courts have concluded that adequate protection can be achieved only through continued possession of the lease premises. *Dishi,* 510 B.R. at 711-12.

[50] *See Patriot Place,* 486 B.R. at 819 (sympathizing with courts which focus on the "practical impossibility of determining the amount and type of adequate protection that must be provided . . . to the displaced lessee-tenant" therefore requiring continued possession.).

presumptively zero—and a different metric must be used to calibrate appropriate adequate protection.

It is a commonplace that adequate protection is measured by the economic value of the creditor's interests in the property, and if "mere possession" is not worthy of protection, economic value is all that remains to be protected.[51] Where a junior creditor holds a lease or a lien that is completely "out of the money," it is likely entitled to little or nothing as adequate protection for that interest.[52] A leading commentary argues that this is the appropriate analysis for leases.[53] A lease can be recorded against title to the property and the priority of the tenant's rights will be measured by its priority in the chain of title. A lease which is superior to the mortgage remains enforceable notwithstanding a foreclosure; a lease which is inferior to the mortgage will be extinguished, but will entitled to a portion of the surplus proceeds from the foreclosure sale, if any, depending on the extent of intervening encumbrances.[54] An unrecorded lease still represents an

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[51] Steven R. Haydon & Nancy J. March, *Sale of Estate Property Free and Clear of Real Property Leasehold Interests Pursuant to §363(f): An Unwritten Limitation?*, 19-6 ABI J. 20 (2000) (Upon requesting adequate protection, "the lessee would receive the value of its leasehold interest from the sale proceeds. Section 363 does not require that a lessee receive his bargain 'in kind' when the debtor sells the underlying property, so long as the lessee's interest is adequately protected 'in value;'" the authors suggest that the tenant should enjoy a right to credit bid. *Id.*, note 5).

[52] *In re* 620 Church Street Bldg. Corp., 299 U.S. 24 (1936) (Lessee demanded "adequate protection," "[b]ut the adequate protection to which the statute refers is 'for the realization of the value of the interests, claims or liens' affected. Here the controlling finding is not only that there was no equity in the property above the first mortgage but that petitioners' claims were appraised by the court as having 'no value.' There was no value to be protected.")

[53] Grohsgal, *supra* note 34, 100 MARQ. L. REV. at 350 (Arguing that the value "of an out-of-the-money subordinated lien, leasehold, or other interest . . . is zero. Accordingly, it will be entitled to nothing as adequate protection."); *see Hotel Clinton*, 96 F.2d at 52 (noting that the "lien of the lease arises to no greater dignity than a[n underwater] second mortgage on the premises" and thus was properly the subject of a free and clear sale); *In re* Outrigger Club, Inc., 9 B.R. 152, 153 (Bankr. S.D. Fla. 1981) (Chapter X case; "a lease, junior to an undersecured mortgage and therefore valueless, can be eliminated in bankruptcy just as it could in foreclosure.")

[54] A California appellate court explained "traditional real property law" as follows:

> The law is clear that the [foreclosure] trustee's deed conveys to the purchaser the trustor's interest as of the date that the deed [of trust] was recorded. [cites omitted]
>
> A lease is generally deemed to be subordinate to a deed of trust if the lease was created after the deed of trust was recorded. [cites omitted] Also, there is no dispute that the general rule is that foreclosure of a senior encumbrance terminates subordinate liens, including leases. [cites omitted] ["A lease which is subordinate to the deed of trust is extinguished by the foreclosure sale. [Citations.]"].) Under traditional California law, "[a] foreclosure proceeding

entitlement superior to that of the owner,[55] but that entitlement will likely have economic value only if there is equity in the property.[56]

If a sale free and clear of a lease is ordinarily impermissible, the value of the tenant's possessory interest is high (or ordinarily inviolable) and adequate protection should require protecting the tenant's continuing right to possession. If instead one assumes, as the Circuit decisions did, that a sale free and clear is ordinarily available with respect to a lease, there is no rationale for ascribing value to the right to possession in itself (as opposed to the economic characteristics and lien priority of the lease). Neither section 363(f) nor section 365 call for weighing of the relative burden to the counter-party: the Court is only to look to maximizing the benefit to the estate. As a consequence, in the ordinary case there will be no justification for affording the tenant adequate protection or rights superior to the rights of any other counterparty to a rejected executory contract.[57] If sales free and clear of leases can be readily approved, it will be difficult to rationalize affording the tenant any meaningful adequate protection in the ordinary case.

> destroys a lease junior to the deed of trust, as well as the lessee's rights and obligations under the lease . . . ."
>
> "When a lease is executed and recorded prior to the recordation of the deed of trust, or if the beneficiary of the deed of trust had notice of a prior unrecorded lease at the time the trust deed was recorded, the lien of the trust deed is junior to the estate of the lessee and his or her right to occupy the premises. The title of the purchaser at a foreclosure sale of the junior lien is subject to the lessee's contract right to occupy the premises."

Nativi v. Deutsche Bank National Trust Co., 223 Cal. App. 4th 261, 272-73, 167 Cal. Rptr. 3d 173, 183-84 (2014).

[55] A lease will also be superior to a subsequent encumbrancer who had constructive notice of the lease due to the tenant's possession of the premises. *Nativi*, 223 Cal. App. 4th at 273 ("if the beneficiary of the deed of trust had notice of a prior unrecorded lease at the time the trust deed was recorded, the lien of the trust deed is junior to the estate of the lessee and his or her right to occupy the premises.")

[56] Except as noted in the preceding note, where the lease is not recorded, the lessee's entitlement—to the extent that it is not "entitled" to continuing possession—will be a general unsecured claim for rejection damages.

[57] *See infra* note 61. And to return to the beginning, it becomes virtually impossible to explain why the tenant whose lease is rejected should win all, assured of continuing possession by section 365(h), while the tenant whose lease is to be the subject of a free and clear sale should get nothing.

Conclusion

Much of the complexity of the law governing real property leases comes from its position straddling two bodies of law: real property and contract. On the one hand, a lease is a conveyance of an exclusive possessory estate in real property—a chattel real[58]—which the landlord is obligated to protect and defend. On the other hand, it is a complex bi-lateral contract which the landlord and tenant may perform or breach. At the core of this article are attempts to harmonize those two legal frameworks in the context of a bankrupt landlord.

Historically and through section 365(h), the tenant's right to retain its possessory leasehold estate was protected—ordinarily, inviolable—in a landlord's bankruptcy case.[59] That protection is not lost in a sale free and clear of liens, at least if the court applies a modest interpretation of sections 365(f)(1) and (f)(5) which looks only to proceedings that the debtor or trustee could invoke. If the trustee is limited to invoking his own powers, it will be the unusual case in which the tenant's possessory rights can be disturbed.

If one measures the power to sell free and clear by the rights of a hypothetical foreclosing creditor, however, the tenant's possessory right to its leasehold estate will rarely survive, and there will generally be no mechanism to justify treating the "right" to possession standing alone as valuable and worthy of adequate protection. When the right to possession of a leasehold estate is not treated as independently worthy of protection, all that remains is contract law and the calculation of rejection damages. Possessory rights were the only thing that had made the real property lease unique and different among executory contracts; when that drops out, the tenant is left with only a rejected contract and a general unsecured claim for damages.[60]

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[58] CAL. CIV. CODE §§ 761, 765.

[59] *See supra* note 13.

[60] This seems reminiscent of the *Lubrizol* problem. Lubrizol Enters. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1984). There, the debtor licensed intellectual property to Lubrizol pre-petition, but sought to reject the license post-petition so as to re-license it. The Fourth Circuit acknowledged that "allowing rejection of such contracts as executory imposes serious burdens upon contracting parties such as Lubrizol" but concluded that the only test for rejection is whether the debtor exercised "sound business judgment" in determining that rejection would be advantageous to the estate, "equitable considerations [about the harm to the licensee] may not be indulged by courts . . ." *Lubrizol*, 756 F.2d at 1048. (Ultimately, Congress enacted section 365(n) to "fix" the *Lubrizol* problem.) Here, one imagines the free and clear buyer negotiating a new lease with the pre-existing tenant, much as was contemplated by *Lubrizol* and as actually occurred in *Qualitech*, until the negotiations ceased and litigation over the termination of that lease began.

In prior real estate cycles, landlords complained that tenants enforced below-market leases and used bankruptcy to rid themselves of above-market leases. Perhaps turnabout is fair play: now landlords will enforce above-market leases and can try to use sales free and clear to rid themselves of below-market leases.