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November 15, 2007

The Honorable Charles Schumer  
Chairman  
Senate Judiciary Subcommittee on  
Administrative Oversight and the Courts  
Washington, D.C. 20510

The Honorable Linda Sanchez  
Chair  
House Judiciary Subcommittee on  
Commercial and Administrative Law  
Washington, D.C. 20515

The Honorable Jeff Sessions  
Ranking Member  
Senate Judiciary Subcommittee on  
Administrative Oversight and the Courts  
Washington, D.C. 20510

The Honorable Chris Cannon  
Ranking Member  
House Judiciary Subcommittee on  
Commercial and Administrative Law  
Washington, D.C. 20515

Re: Proposed Technical Amendment to Bankruptcy Code Regarding Certain Sales of  
Real Property

Dear Senators Schumer and Sessions and Representatives Sanchez and Cannon:

As your subcommittees continue their work on draft technical corrections legislation relating to the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," P.L. 109-8 (BAPCPA), the American Bar Association (ABA) respectfully urges you to support amending Section 363(f) of the Federal Bankruptcy Code, 11 U.S.C. § 363(f), to clarify that a sale of real property free and clear of an unexpired lease under which the debtor is the lessor can be accomplished only if the non-debtor lessee is granted the same rights afforded to non-debtor lessees when their leases are rejected.<sup>1</sup> If this Code amendment is adopted by Congress, the leasehold interest held by a nondebtor would survive the sale, thereby permitting the nondebtor lessee to remain in possession during the term of the lease notwithstanding the concurrent or subsequent rejection of the lease in the debtor's bankruptcy case.

This amendment, if enacted by Congress, would overrule the 2003 decision by the Seventh Circuit Court of Appeals in *Precision Industries, Inc. v. Qualitech Steel SBQ*,

<sup>1</sup> The technical amendment recommended by the ABA in this correspondence is in addition to the more substantive changes to the Bankruptcy Code that the ABA recommended in its May 1, 2007 letter to the House Judiciary Subcommittee on Commercial and Administrative Law in connection with the subcommittee's hearing on the second anniversary of BAPCPA. In that earlier statement, available at [http://www.abanet.org/poladv/letters/bankruptcy/2007may01\\_BAPCPAh\\_1.pdf](http://www.abanet.org/poladv/letters/bankruptcy/2007may01_BAPCPAh_1.pdf), the ABA urged Congress to repeal the three "bankruptcy attorney liability" provisions created by BAPCPA and to add a new section to the Code dealing with partnerships in bankruptcy. The ABA continues to strongly support these bankruptcy reforms in addition to the more technical amendment addressed in this letter.

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*LLC (In re Qualitech Steel Corporation)*, 327 F. 3d 537 (7<sup>th</sup> Cir. 2003). In that decision, the Seventh Circuit held that real estate owned by a debtor could be sold free and clear of an unexpired lease under Section 363(f) of the Code. The *Qualitech* decision contradicts the intention of the drafters of Section 365(h) and is problematic. While some believe that the court's reading of the statute was technically correct, others believe that the court misconstrued the statute. Therefore, to ensure that other courts do not adopt the reasoning and holding of the Seventh Circuit in *Qualitech* and eviscerate the special provisions of Section 365(h), Congress should amend Section 363(f) of the Federal Bankruptcy Code.

The ABA also recommends that any such amendment be narrowly drawn to grant non-debtor lessees the same rights afforded to them by 11 U.S.C. § 365(h) upon rejection of leases in bankruptcy cases. In order to avoid any impact on sales of other types of property, any such amendment should provide that neither the adoption of the amendment with regard to sales of real property nor the failure to adopt a comparable amendment with regard to sales of other types of property shall be construed to modify, impair, supersede or otherwise affect, directly or by implication, existing authority concerning the impact of sales of property other than real property on the interests of non-debtor parties in such property.

This proposed technical amendment to the Bankruptcy Code was approved overwhelmingly by the ABA House of Delegates in August 2007 upon a motion made by the ABA Real Property, Trust and Estate Law Section. A copy of the ABA's policy and a detailed background report that explains the issue and the various legal and policy reasons for amending Section 363(f) of the Bankruptcy Code are attached as Appendix A.

Thank you for considering the views of the ABA on this important bankruptcy matter. If you would like more information regarding the ABA's position on this issue, your staff may contact our senior legislative counsel for bankruptcy law issues, Larson Frisby, at (202) 662-1098.

Sincerely,



Denise A. Cardman  
Acting Director

Attachment

cc: The Honorable Patrick J. Leahy  
The Honorable Arlen Specter  
The Honorable John Conyers, Jr.  
The Honorable Lamar S. Smith

**APPENDIX A****RESOLUTION ADOPTED BY THE  
HOUSE OF DELEGATES  
OF THE  
AMERICAN BAR ASSOCIATION  
AUGUST 13-14, 2007\***

RESOLVED, that the American Bar Association urges Congress to amend Section 363(f) of the Federal Bankruptcy Code, 11 U.S.C. § 363(f) to clarify that a sale of real property free and clear of an unexpired lease under which the debtor is the lessor can be accomplished only if the non-debtor lessee is granted the same rights afforded to non-debtor lessees when their leases are rejected. Any such amendment should provide that neither the adoption of the amendment with regard to sales of real property nor the failure to adopt a comparable amendment with regard to sales of other types of property shall be construed to modify, impair, supersede or otherwise affect, directly or by implication, existing authority concerning the impact of sales of property other than real property on the interests of non-debtor parties in such property.

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\*Note: The Resolution, but not the attached background Report, constitutes official ABA policy.

## REPORT

The American Bar Association (ABA) urges Congress to amend the Federal Bankruptcy Code, 11 U.S.C. §§ 101, *et seq.* (the “Code”) to prohibit the sale of real property by a bankruptcy trustee or debtor in possession free and clear of any existing leasehold interest in that property unless the non-debtor holder of the leasehold interest is granted the same rights afforded to non-debtor lessees when their leases are rejected. If this Code amendment is adopted by Congress, the leasehold interest held by a nondebtor would survive the sale, thereby permitting the non-debtor lessee to remain in possession during the term of the lease notwithstanding the concurrent or subsequent rejection of the lease in the debtor’s bankruptcy case. The ABA desires that any such amendment be narrowly drawn to grant to non-debtor lessees the same rights afforded to them by 11 U.S.C. § 365(h) upon rejection of leases in bankruptcy cases. In order to avoid any impact on sales of other types of property, any such amendment should provide that neither the adoption of the amendment with regard to sales of real property nor the failure to adopt a comparable amendment with regard to sales of other types property shall be construed to modify, impair, supersede or otherwise affect, directly or by implication, existing authority concerning the impact of sales of property other than real property on the interests of non-debtor parties in such property.

### A. The Statutory Framework

#### 1. Sales of Estate Property

In 1978, Congress enacted the Bankruptcy Reform Act which became effective on October 1, 1979. Section 363(b) of the Code permits a trustee appointed in a debtor’s bankruptcy case or a debtor in possession to sell “property of the estate”<sup>1</sup> outside the ordinary course of a debtor’s business. This property may be sold by a bankruptcy trustee or debtor in possession “free and clear of any interest in such property [held by] an entity other than the estate” if one of the following conditions is met:

- (a) “applicable nonbankruptcy law permits sale of such property free and clear of such interest”;
- (b) the nondebtor entity holding the interest consents to the sale;
- (c) the interest is a lien and the sale price of the property subject to that interest “is greater than the aggregate value of all liens” on that property;
- (d) the interest in the property to be sold “is in bona fide dispute”; or
- (e) the holder of the interest “could be compelled, in a legal or equitable proceeding to accept a monetary satisfaction” of that interest.

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<sup>1</sup> Section 541 of the Code defines very broadly the term, “property of the estate.” With respect to an individual debtor, “property of the estate” does not include property subject to a debtor’s claimed exemptions. Debtors that are artificial persons, e.g. corporations, and not entitled to exemptions in bankruptcy cases.

11 U.S.C. § 363(f).

In addition, section 363(e) of the Code requires a trustee or a debtor in possession proposing to sell property of the estate to provide “adequate protection” to the holder of an “interest” in the subject property provided that the holder of the interest requests adequate protection. The term, “adequate protection,” is not a defined term in section 101 of the Code. However, section 361 of the Bankruptcy Code lists three nonexclusive examples of adequate protection of an interest in property of the estate:

- (i) the provision of a cash payment or periodic cash payments to the interest holder to the extent that the sale of property “results in a decrease in the value of such entity’s interest in such property”;
- (ii) the grant of an additional or replacement lien on other estate property to compensate the interest holder for a decrease in the value of its interest as a result of the sale; or
- (iii) the grant of other relief that will award the interest holder the “indubitable equivalent” of that interest in property to be sold.

**B. Rejection of Real Estate Leases**

Section 365 of the Code contains a series of provisions relating to unexpired leases of real property between a debtor and a nondebtor. A debtor that is a party to a real estate lease, either as a landlord or a tenant, may either assume or reject the lease. If the debtor is the lessor and rejects the lease, section 365(h) of the Code permits the non-debtor tenant either (i) to treat the lease as terminated, or (ii) to retain the lessee’s rights under the lease that are appurtenant to the realty for the balance of the lease term and any renewals or extensions of the term enforceable under nonbankruptcy law. 11 U.S.C. § 365(h)(1)(A). If the second option is selected by the lessee, the lessee may offset against rent reserved under the lease certain damages arising from the rejection. 11 U.S.C. § 365(h)(1)(B). Congress amended this Code provision in 1994 to protect the rights of leasehold mortgagees that, as a result of certain bankruptcy court decisions construing a prior version of this provision, ceased making loans to tenants secured by mortgages in their leaseholds. *See, e.g., R. Zinman, Precision in Statutory Drafting: The Qualitech Quagmire and the Sad History of Section 365(h) of the Bankruptcy Code*, 38 J. Marshall L. Rev. 97, 114-19 (2004), T. Homburger, B. Gallagher and K. Rubel, Conflict Resolved: Bankruptcy Code Section 365(h) and the Contradictory Cases Requiring Its Amendment, 29 Real Prop. Prob. & T. J. 869 (1995).

**C. The Interplay of Section 363(f) and 365(h) of the Code.**

The plain language of sections 363 and 365 of the Code do not address the situation where real estate subject to an unexpired lease is proposed to be sold by a bankruptcy trustee or debtor in possession. As previously described, section 363 is silent on this matter and section 365(h) addresses only the situation where an unexpired lease of real property is rejected by the trustee or debtor in possession. However, after the 1994 Amendments to the Code, which broadened the protections afforded to nonbankrupt leases and leasehold mortgages, two cases were decided by bankruptcy courts holding that leases may not be annulled by means of a sale

free and clear of interests because of the broad protections granted to lessees under section 365(h) of the code. *In re Churchill Properties II, Ltd. Partnership*, 197 B.R. 283 (Bankr. N.D. Ill. 1996); *In re Taylor*, 198 B.R. 142 (Bankr. D.S.C. 1996).

Nevertheless, in 2003, the Seventh Circuit Court of Appeals issued its *Qualitech* decision, *Precision Industries, Inc. v. Qualitech SBQ, LLC*, 327 F.3d 537 (7<sup>th</sup> Cir. 2003), (provide full name and citation), holding that real estate owned by a debtor could be sold free and clear of an unexpired lease under section 363(f) of the Code. In its decision, the Seventh Circuit pointed out that sections 363(f) and 365(h) addressed two different events in a bankruptcy case of a real property lessor and that the protections afforded lessees in section 365(h) of the Code did not apply to bankruptcy sales free and clear of interests. Rather, the Court indicated that the lessee should have objected to the sale on the ground that the debtor in possession offered no adequate protection for the lessee's leasehold interest.

Since *Qualitech* was decided, there has been only one reported decision addressing this same issue. *In re Haskell, L.P.*, 321 B.R. 1 (Bankr. D. Mass. 2005). In *Haskell*, Bankruptcy Judge Joan Feeney parted ways with the Seventh Circuit, holding that the debtor in possession was unable to invoke section 363(f) of the Code to annul a lessee's interest in the real estate to be sold in the absence of the protections afforded by section 365(h). One of the reasons advanced by Judge Feeney in support of her decision was that, because the debtor's liquidating Chapter 11 plan rejected the lease, not to grant the lessee the protections of section 365(h) would eviscerate that Code provision and the debtor would "be doing indirectly what it could not do directly, namely, disposing [of the tenant]." *Id.* at p. 9.

#### D. Conclusion

The *Qualitech* decision contradicts the intention of the drafters of section 365(h) but may nevertheless be a correct technical reading of section 363(f). Therefore, to ensure that other courts do not adopt the reasoning and holding of the Seventh Circuit in *Qualitech*, and eviscerate the special provisions of section 365(h) Congress should amend Section 363(f) of the Federal Bankruptcy Code. In order to avoid any impact on sales of other types of property, any such amendment should provide that neither the adoption of the amendment with regard to sales of real property nor the failure to adopt a comparable amendment with regard to sales of other types property shall be construed to modify, impair, supersede or otherwise affect, directly or by implication, existing authority concerning the impact of sales of property other than real property on the interests of non-debtor parties in such property.