

Precision

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Debtor-Lessor's Property
May Be Sold
"Free and Clear"
of Unexpired Lease

Industries

Part 1

A federal appellate court sent shock waves through the real estate industry last April with its decision in *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003). In a case of first impression, the Seventh Circuit was asked to reconcile two provisions of the Bankruptcy Code: Section 363(f), which allows the sale of a debtor's property "free and clear" of any "interest," and Section 365(h), which protects the rights of a lessee when a lessor-debtor rejects a lease. The court's determination—that Section 363(f) trumps Section 365(h)—presents potentially devastating ramifications for long-term leases and leasehold mortgages whenever a lessor files for bankruptcy. A careful analysis of the decision, however, suggests that there is still ample room for lessees to protect themselves. This article analyzes the court's reasoning in the *Precision Industries* case. A companion article describes some of the measures that practitioners can take to protect lessees and leasehold mortgagees. See *Precision Industries, Part 2: How Lessees and Leasehold Mortgagees Can Protect Themselves*, at page 16 of this issue.

The Conflict Between Sections 363(f) and 365(h)

Bankruptcy Code § 363(f) allows the bankruptcy trustee to sell property of the bankruptcy estate "free and clear of any interest in such property of an entity other than the estate[.]" 11 U.S.C. § 363(f). A "free and

clear" sale can occur, however, only in one of the following limited circumstances:

1. if applicable nonbankruptcy law permits such a sale;
2. the entity holding the interest consents;
3. the interest is a lien and the sale price is greater than the aggregate value of all liens against the property;
4. the interest is in bona fide dispute; or
5. such entity could be compelled to accept a money satisfaction of the interest.

Id. When the bankruptcy court has approved such a sale, Section 363(f) provides that the buyer acquires title unencumbered by any claims in bankruptcy, and the property may not be brought back into the estate absent fraud or collusion in the sale. See *In re Lemco Gypsum, Inc.*, 910 F.2d 784, 788 (11th Cir. 1990).

Precision Industries addressed the intersection between Section 363's sale provisions and Section 365(h), which protects the rights of the lessee when the debtor rejects an unexpired lease. Id. § 365(h). Section 365(a) gives a lessor the right to reject executory contracts or unexpired leases. Id. § 365(a). When a lessor has exercised this right, however, Section 365(h)(1)(A) permits lessees to either (1) treat the lease as terminated and vacate the space or (2) remain in possession for the balance of the lease term and any renewal or extension and retain its rights under the lease (including the amount and timing of the rent payments) that are "in or appurtenant to the real property[.]" As the Seventh Circuit recognized, the intent of this section is to balance the respective rights of the debtor-lessor and the lessee: "[T]he lessee retains the right to possess the prop-

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erty for the remainder of the term it bargained for, while the rejection frees the debtor-lessor of other burdensome obligations that it assumed under the lease (as, for example, the duty to provide services to the lessee)." *Precision Industries*, 327 F.3d at 546.

At issue in *Precision Industries* was how to reconcile these two provisions. As the district court recognized, the two provisions seemed to conflict with one another because "Section 365(h) appears to grant the tenant the right to retain the benefits



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of the lease, while Section 363(f) appears to allow the [debtor] to divest the tenant of its leasehold." *Precision Industries, Inc., v. Qualitech Steel SBQ, LLC*, No. IP-00-247-C-H/G, 2001 WL 699881, at *11 (S.D. Ind. Apr. 24, 2001). The Seventh Circuit, therefore, had to determine whether the district court correctly found for the lessee, holding that its right to remain in possession under Section 365(h) superseded the bankruptcy court's authority to order a sale "free and clear" of the leasehold interest.

The Precision Industries Case

The debtors (collectively, "Qualitech") owned and operated a steel mill in Indiana. Before filing

bankruptcy, Qualitech had entered into two agreements with the lessees (collectively, "Precision"). In the first of these agreements, executed in 1998, Precision agreed to construct a warehouse on the property for the sole purpose of providing on-site, integrated supply services to Qualitech for a 10-year period. The second agreement, executed in February 1999, was a 10-year lease of the property underlying the warehouse for a nominal rent of \$1 per year. If an early termination or default occurred under either agreement, Precision had the right to remove all improvements and fixtures from the property. Conversely, if the lease was not in default, Qualitech had the right to purchase the improvements and fixtures for \$1 at the end of the lease term.

Qualitech filed its Chapter 11 bankruptcy petition in March 1999 and three months later sold substantially all of its assets at auction to a group of pre-petition secured lenders for \$180 million. Although Precision

had proper notice of the sale, Precision did not object to the sale order, which directed that Qualitech convey the property "free and clear of all liens, claims, encumbrances, and interests" under Section 363(f). The sale order also provided that the purchaser retained the debtor's right to assume and assign executory contracts under Section 365.

The purchasers subsequently transferred their interests in the property to a new entity ("New Qualitech"), which assumed the rights of the purchaser under the sale order and took title to the property. The parties attempted to negotiate an assumption of the Precision lease, but the efforts were unsuccessful. The result, according to the Seventh

Circuit, was that "Precision's lease and supply agreement were *de facto* rejected." 327 F.2d at 541. By the end of the year, Precision had vacated and padlocked the warehouse on the property. New Qualitech, without Precision's knowledge or approval, changed the locks on the building.

Precision filed suit in the district court, claiming that under Section 365(h), its possessory interest in the leased property survived the bankruptcy sale. The case was referred to the bankruptcy court, which held that Precision's lease was an "interest" under the sale order, and, therefore, New Qualitech had obtained title to the property free and clear of Precision's leasehold. Precision appealed, and the district court reversed, ruling that the more specific terms of Section 365(h) prevailed over those of Section 363(f). In the district court's view, "[t]here is no statutory basis for allowing the debtor-lessor to terminate the lessee's possession by selling the property out from under the lessee, and thus limiting a lessee's post-rejection rights solely to cases where the debtor-lessor remains in possession of its property." *Precision Industries*, 2001 WL 699881, at *14.

The Seventh Circuit reversed the district court, noting as a threshold issue that Precision never objected to the sale order. The court stated that "[s]ale orders are final, appealable orders," and, therefore, once the appeal period has expired, "res judicata precludes a party to the sale proceeding from attacking the sale order by way of a new lawsuit." 327 F.2d at 543. The court found res judicata inapposite in this case, however, because the district court had referred the matter to the bankruptcy court; thus, the issue was decided by the bankruptcy judge who had issued the sale order.

The Seventh Circuit also noted that there was no dispute as to whether the debtor had complied with the conditions of Section 363(f). Although Section 363(f) permits a sale only in the five limited circumstances discussed earlier in this arti-

cle, the court assumed—from Precision’s failure to raise the issue—that one or more of the statutory criteria had been met.

Turning to the statutory construction issues in the case, the court first considered whether leaseholds fell within Section 363(f)’s language authorizing the sale of estate property “free and clear of any *interest* in such property of an entity other than the estate[.]” 11 U.S.C. § 363(f). The court noted that Congress had not defined the word “interest.” Based upon the word’s plain meaning, however, the court found the term expansive enough to cover a lessee’s possessory interest, which the court defined as “not simply a right that is connected to or arising from the property, . . . but a (limited) right to the property itself.” 327 F.3d at 545 (citations omitted).

The court then rejected the district court’s view that Section 365(h)’s protection of leasehold interests overrides a debtor-lessor’s ability to sell property free and clear of the leasehold under Section 363. In reaching this decision, the Seventh Circuit first observed that Section 363(f) does not contain any cross-reference subordinating its provisions to the lessee protections of Section 365(h), which suggests that Congress did not intend for Section 365(h) to limit Section 363(f). According to the court, “Congress authorized the sale of estate property free and clear of ‘any interest,’ not ‘any interest *except* a lessee’s possessory interest.’ ” *Id.* at 548 (alteration in original).

The court then held that Section 365(h), by its plain language, applies only when the trustee (or debtor in possession) actually *rejects* the lease. Therefore, the section was inapplicable in the present case, in which a statutory *sale* of the property (which was leased) had occurred. According to the court, “[t]he two statutory provisions thus apply to distinct sets of circumstances.” *Id.* at 547.

Finally, the court observed that the sale provision itself provides a statutory mechanism to protect lessees. More specifically, Section 363(e) pro-

vides that “on request of an entity that has an interest in property . . . proposed to be . . . sold . . . by the trustee, the court, with or without a hearing, shall prohibit or condition such . . . sale . . . as is necessary to provide adequate protection of such interest.” 11 U.S.C. § 363(e). The court stated that “[a]dequate 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—typically from the proceeds of the sale.” 327 F.3d at 548.

The divergence between the district court and appellate court opinions in *Precision Industries* demonstrates a major philosophical disagreement regarding the proper application of the relevant statutory provisions.

Based upon this reasoning, the court reconciled the two Code provisions in this way:

Where estate property under lease is to be sold, section 363 permits the sale to occur free and clear of a lessee’s possessory interest—provided that the lessee (upon request) is granted adequate protection for its interest. Where the property is not sold, and the debtor remains in possession thereof but chooses to reject the lease, section 365(h) comes into play and the lessee retains the right to possess the property.

Id. Through this construction, the court said, “both provisions may be given full effect without coming into conflict with one another and without disregarding the rights of lessees.” *Id.* The court also reasoned that its interpretation is “consistent with the process of marshaling the estate’s assets for the twin purposes of maximizing creditor recovery and rehabilitating the debtor, which are central to the Bankruptcy Code.” *Id.*

Analysis of the Court’s Ruling

The divergence between the district court and appellate court opinions in *Precision Industries* demonstrates a major philosophical disagreement regarding the proper application of the relevant statutory provisions. Indeed, as the district court noted, the case law has been sharply divided on the issue, with some courts taking the district court’s position that Section 365(h) trumps Section 363(f), and others agreeing with the Seventh Circuit’s view that Section 365(h)’s leasehold protections do not apply in the context of a Section



363(f) sale. Compare *In re Churchill Properties III, Limited Partnership*, 197 B.R. 283, 286 (Bankr. N.D. Ill. 1996) (interpreting § 365(h) as superseding § 363(f)), with *In re Downtown Athletic Club of New York City, Inc.*, No. M-47, 2000 WL 744126, at *4 (S.D.N.Y. June 9, 2000) (finding § 365(h) inapplicable when debtor-lessor sells property under § 363(f)).

As a policy matter, several bankruptcy courts have suggested that Section 365(h)’s protections would be toothless if a debtor-lessor could avoid its provisions through a Section 363(f) sale. As one bankruptcy court put it, “[s]ince Congress

decided that lessees have the option to remain in possession [under Section 365(h)], it would make little sense to permit a general provision, such as Section 363(f), to override its purpose." *In re Churchill Properties III*, 197 B.R. at 288; cf. *In re Taylor*, 198 B.R. 142, 165 (Bankr. D.S.C. 1996) (stating that to allow a sale free and clear of a leasehold interest under

bankruptcy court to "prohibit or condition such . . . sale . . . as is necessary to provide adequate protection of [the lessee or leasehold mortgagee's] interest." 11 U.S.C. § 363(e). The court then suggests that if the bankruptcy court proceeds with the sale, the lessee will be "compensated for the value of its leasehold—typically from the proceeds of the sale." 327 F.3d at 548.

Notwithstanding these criticisms, the *Precision Industries* opinion is perhaps not as devastating to lessees as it might appear.

§ 363(f) "would seem to be in direct contravention of the lessee protections specifically afforded by § 365").

The Seventh Circuit itself acknowledged that a Section 363 sale "might be understood as the equivalent of a repudiation of *Precision's* lease." 327 F.3d at 547. Nonetheless, the court found that

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. Section 365(h) instead focuses on a specific type of event—the rejection of an executory contract by the trustee or the debtor-in-possession. . . . It says nothing at all about sales of estate property, which are the province of section 363.

Id. This analysis—and the court's conclusion that "the two statutory provisions thus apply to distinct sets of circumstances"—suggests a distinction without a significant difference. The reasoning appears to be a somewhat disingenuous attempt by the Seventh Circuit to shoehorn the facts into the statutory interpretation the court desires in this case.

The court's suggestion that lessees can obtain "adequate protection" from a Section 363(f) order is also troublesome. The court correctly observes that Section 363(e) would permit the lessee (or leasehold mortgagee) to ask the



It is unclear, however, how effective this theory will prove to be in practice. Although the lessee would be able to assert a claim against the proceeds of the sale for the value of the leasehold estate, there are likely to be other competing claims. As a general rule, only creditors with secured claims can "credit bid" or receive the amounts owing on their claims directly from the sales proceeds. If there are other secured claims against the property (for example, a fee or leasehold mortgage or a judgment lien), what priority would the lessee's claim take against the sale proceeds for such competing interests? Should it make any difference whether or not the lease was recorded, for purposes of determining relative priorities? Questions are also likely to arise as to whether marshalling principles should be applied.

Notwithstanding these criticisms, the *Precision Industries* opinion is perhaps not as devastating to lessees as it might appear. Indeed, given the limit-

ed circumstances in which a Section 363(f) sale is allowed, *Precision Industries* seems to be an anomalous case. As noted above, bankruptcy estate property can be sold "free and clear" of a leasehold only in one of five situations, but it is unclear which of these circumstances was present in *Precision Industries*. It is possible that the lessee consented to the sale under Section 363(f)(2)—a horrible mistake by the lessee's attorneys, if true. The only other potentially applicable provision is Section 363(f)(5), which allows a sale "free and clear" of an entity's interest if the entity could be compelled to accept a money satisfaction of the interest. This theory depends, however, on whether a lessee could be forced to accept a money satisfaction, such as in a condemnation proceeding.

Under state law, a lessee generally cannot be forced to surrender the leased premises for a payment of money, absent a provision in the lease permitting such payment. See, e.g., *In re Independence Village, Inc.*, 52 B.R. 715, 733–34 (Bankr. E.D. Mich. 1985) (ruling that sale of a life care facility under Section 363(f) did not permit avoidance of interests of life-care residents and noting that if the interests held by residents were leases, then a sale would include either an assumption of leases or the leases could be rejected, which rejection would then trigger the lessees' rights under § 365(h)). But see *In re Rose*, 113 B.R. 534, 538–39 (Bankr. W.D. Mo. 1990) (permitting sale of real property free and clear of life estate interest under Section 363(f)(1) and (4) with value of life estate to attach to proceeds).

An earlier Seventh Circuit decision similarly suggests a strict interpretation of Section 363(f)(5). In *Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994), the court held that the bankruptcy trustee was not entitled to sell the debtor's land free of a restrictive, reciprocal covenant recorded on all the lots of a residential subdivision. The court was asked to rule whether Section 363(f)(5) applied to the subdivision landowners. The court concluded that the Chapter 7 trustee could not sell the debtor's

property free and clear of the covenant under Section 363(f)(5) because the covenant did not “compel” the landowners to accept monetary satisfaction of their interest; the covenant instead provided that enforcement “shall be by proceeding at law or in equity against any person or persons violating or attempting to violate any covenant either to restrain violation or recover damages.” *Id.* at 299. The objecting neighbors had requested equitable relief and had not sought damages. According to the court, “[s]ince the . . . landowners cannot be forced to accept money damages in lieu of equitable relief, we conclude that § 363(f)(5) is inapplicable to the case at bar.” *Id.* Although *Gouveia* did not involve a lease or the interplay between Section 363(f) and Section 365, it did address the threshold issue of the invocation of Section 363(f) in the first instance because of the applicability of one of the five alternative conditions stated therein authorizing the

sale free and clear of all other property interests. See also *In re 523 E. Fifth St. Housing Pres. Dev. Fund Corp.*, 79 B.R. 568, 576 (Bankr. S.D.N.Y. 1987) (finding restrictive covenant was not extinguished under Section 363(f)(5) because interest holder could seek equitable relief and, therefore, was not “compelled” to accept monetary satisfaction).

Conclusion

Attorneys for lessees (and leasehold mortgagees) are understandably concerned about the effect of the *Precision Industries* case on possessory rights of lessees when the lessor files for bankruptcy and attempts to sell or transfer its real property “free and clear” of the lessee’s interest in a Section 363 sale. The *Precision Industries* case, however, is not the end of Western civilization as we know it, as some commentators seem to believe. The facts in the *Precision Industries* case were somewhat unusual, and the lessee’s failure to

assert protective rights that were available to it (and that played a major role in the harsh ruling by the Seventh Circuit) is puzzling. Interestingly, the preliminary reaction from the major credit-rating agencies (Fitch, Moody’s, and Standard & Poor’s) is that they are not that concerned about the ruling in the *Precision Industries* case, and they do not plan any withdrawals, downgrades, or qualifications of existing credit ratings based on the possible risk of lease avoidance if the property is sold free and clear of all existing property interests in a bankruptcy proceeding under Section 363(f). Nonetheless, the case certainly serves as a cautionary tale, but it also provides a clear roadmap for steps that lessees (and leasehold mortgagees) can—and certainly should—take to prevent the result that occurred in *Precision Industries*. Those steps are discussed in *Precision Industries, Part 2: How Lessees and Leasehold Mortgagees Can Protect Themselves*, on the next page. ■