

**IMPLICATIONS OF FEDERAL APPELLATE COURT DECISION
ALLOWING BANKRUPT COMPANY TO SELL REAL ESTATE
FREE AND CLEAR OF TENANT'S LEASE**

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On April 23, 2003, the Seventh Circuit issued an opinion, *Precision Industries, Inc. v. Qualitech Steel SBQ*, No. 01-2753 (7th Cir. 2003), in which it decided that a "free and clear" sale of property under Section 363(f) of the Bankruptcy Code extinguishes a lessee's right to remain a tenant on the property, even if the lessee is not in default.

Although the court strove to reconcile its ruling with Section 365(h) of the Bankruptcy Code, which allows a lessee whose lease has been rejected by a debtor-landlord to remain on the property for the duration of the lease as long as the lessee continues to abide by the terms of the lease, we believe this decision essentially vitiates the lessee protections of Section 365(h). The debtor can sell or threaten to sell the underlying property in a Section 363(f) action in order to extract better terms from the lessee or to realize the value of the assets free and clear of the lease.

The implications of this decision could conceivably stretch beyond lessees to include licensees of intellectual property as well, since the Bankruptcy Code has a parallel provision (Section 365(n)) that provides similar protections of licenses of intellectual property from a debtor. Nothing in the *Precision Industries* decision appears to limit the Seventh Circuit's reasoning to real property leases.

STATUTORY BACKGROUND

The Bankruptcy Code enables the debtor-in-possession (or its trustee) to sell its property "free and clear of any interest in such property" (§363(f)). Courts have generally construed the term "any interest in such property" very broadly. See *In re Trans World Airlines Inc.*, 322 F.3d 283 (3rd Cir. 2003) (includes any claim based on successor liability).

A debtor-in-possession (or its trustee) may also assume or reject unexpired leases. Section 365(h) of the Bankruptcy Code moderates this power where the debtor is the lessor. The

tenant's right to remain on the premises survives the debtor's rejection as long as the tenant abides by the terms of the lease. Protecting lessees in this way constrains the rejection power of the bankruptcy estate and provides businesses that depend on long-term occupancy of a particular space greater certainty in their affairs.

**FACTS OF THE CASE AND
ANALYSIS OF THE COURT**

Overturing a lower court decision, the Seventh Circuit held that a lessee did not have the right to occupy leased property when the property had been sold "free and clear" of its interest in the property pursuant to Section 363(f) of the Bankruptcy Code. Debtor, Qualitech, had leased a warehouse on its property to Precision Industries. During the hearing on the sale of the warehouse under Section 363(f), the lessee did not offer objection. When, after the Section 363 sale, the new owner changed the locks on the warehouse, barring lessee from the property, lessee sued, claiming trespass, conversion, breach of contract, and wrongful eviction. The bankruptcy court held that the lessee's possessory "interest" had been extinguished by the sale order. The district court reversed, deciding that the specific provisions of Section 365(h), which permit continued tenancy following debtor's rejection of a real estate lease, took precedence over the broader "free and clear" language of Section 363(f).

The Seventh Circuit reversed the district court on the following reasoning: (1) In the context of 363(f), "any interest" is defined extremely broadly and must include leases, which are interests in property. (2) A principle of statutory interpretation is to construe statutory provisions so that one does not supercede the other. In this case, the way to prevent either statute superceding the other is to construe Section 365(h) narrowly. (3) The language of Section 365(h) suggests that it is limited in scope; although the statute gives lessee a particular remedy if the lease is rejected by a debtor-landlord, "rejection" must mean a literal rejection of a lease, not simply a sale of the leased property, which may effectively "repudiate" a lease. (4) Section 363(e) allows for adequate protection of parties adversely affected by a Section 363(f) sale. Since a lessee holds an "interest" in the property, its rights can be protected by "adequate protection" under Section 363(e).¹ In the case decided, the lessee did not assert a Section 363(e) claim for adequate protection and therefore had no recourse against the debtor. Because the sale of the property "free and clear" had the effect of repudiating the lease, lessee never had a claim against the purchaser of the property. Therefore, the lessee lost its tenancy without compensation.

¹ The court did not specify what method of adequate protection would be appropriate in the circumstances. The specific methods laid out in Section 361 of the Bankruptcy Code – replacement liens and periodic cash payments – do not seem well tailored to the lessee's needs. Perhaps the court thought some portion of the sale proceeds could be paid to the tenant to compensate it for the loss of value in the leasehold and perhaps also for the actual out-of-pocket costs it would incur in moving its goods to a new location.

ANALYSIS

The result of this opinion is that, in the Seventh Circuit at least, lessees must object to “free and clear” sales of the premises they lease, and must also assert claims for adequate protection at the time of a Section 363(f) sale or they may lose their leasehold without any claim against the debtor or the sale proceeds. In the case where a secured creditor has a lien on the asset being sold, courts following this opinion will have to reconcile the lessee’s adequate protection with the secured creditor’s right to the sale proceeds. In any case, the use of adequate protection as a solution will require such courts to determine the value of the leasehold to be protected.

A licensee of patents or copyrights should also, in that Circuit at least, reach the prudent conclusion that it must also object to “free and clear” sales by its licensor of the patent or copyright, and couple that objection with a request for adequate protection.

IMPLICATIONS

The court’s resolution of the conflict between 363(f) and 365(h) leaves many questions unanswered.

First, would a rational, well-advised debtor ever choose to reject a lease and trigger a tenant’s 365(h) right to remain in possession, if instead it could sell the property free and clear of the lease? If the answer to the question is “no”, does the court’s ruling provide any practical comfort to tenants?

Second, assuming a debtor does reject a tenant’s lease before a sale, and the tenant elects to remain in possession under 365(h), can the debtor later sell the property free and clear of the tenant’s 365(h) interest? After all, 363(f) says “free and clear of *any* interest”, so why should a post-rejection tenancy under 365(h) be treated any differently from the pre-rejection tenancy eliminated in *Precision Industries*? If, however, courts were to rule that a debtor cannot sell the property free and clear of a 365(h) interest, then a rational, well-advised debtor would not be likely to reject a lease where it was the landlord, without first exhausting the sale possibilities, unless its time to assume or reject that lease were otherwise on the verge of expiration. In either case, the tenant’s Section 365(h) rights wind up having little practical value, despite the opinion’s effort to preserve a role for Section 365(h) in the bankruptcy laws.

Finally, what does the opinion mean for licensees of intellectual property? Section 365(n) of the Bankruptcy Code protects licensees of patents and copyrights in much the same fashion as tenants are protected by 365(h). If a debtor-owner of real property can sell that property “free and clear” of a leasehold under Section 365(f), can a debtor-owner of a patent or

copyright sell it “free and clear” of a license under Section 363(f)? Indeed, in another case it also decided last month, the same court ruled that a bankruptcy court’s “free and clear” sale order extinguished a licensee’s interest in the intellectual property sold. See *Futuresource LLC v. Reuters Ltd.*, 312 F.2d 281 (7th Cir. 2002), *cert. denied*, 2003 WL 1220239 (April 7, 2003). That decision was premised on the failure of the licensee to object to the “free and clear” nature of the sale and the court did not expressly analyze the conflict with 365(n).²

Beyond the questions it raises, the court’s opinion shows little recognition of its practical effect and commercial consequences. In the Seventh Circuit, tenants can be thrown out of the premises where they may be operating a vital portion of their business, even though they are performing under their leases, because of events in their landlord’s bankruptcy. It is difficult to imagine what would constitute adequate protection of such a devastating loss. Notwithstanding the court’s efforts to preserve Section 365(h), its decision imposes on tenants, as a practical matter, the exact same bankruptcy risk meant to be eliminated by Section 365(h).

If you have further questions about the *Precision Industries* decision, please contact one of the partners in our bankruptcy or real estate practices:

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² Cf. *Schlumberger Resource Management Services, Inc. v. CellNet Data Systems, Inc. (In re CellNet Data Systems, Inc.)*, No. 02- 2546 (3d Cir. April 30, 2003), *slip op.* at 11-12 (summarizing proceedings in lower court whereby a sale of intellectual property occurred, not “free and clear” of licenses of that property, as the purchaser desired, but subject to the licenses). This firm served as counsel for CellNet in that proceeding.