

Tenant's Rights Trump Sale "Free and Clear"

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In a new case of significance to New York real estate and bankruptcy lawyers, Judge Oetken of the Southern District of New York, effectively allowed the rights of a junior tenant to trump those of a senior mortgagee when a property was sold "free and clear" of interests pursuant to section 363 of the Bankruptcy Code. Here is a summary:

When a landlord files for bankruptcy and rejects a commercial tenant's lease, the Bankruptcy Code gives the tenant the right to retain possession for the lease term provided it continues to pay rent. However, the Code also permits a debtor to sell property "free and clear of any interest" in that property, which arguably permits a property to be sold free from the possessory right of any or all tenants. Courts have had trouble reconciling these two provisions, as shown by *Dishi & Sons v. Bay Condos LLC*, 2014 WL 2199819 (S.D.N.Y. 2014), in which the court affirmed that the power of the debtor or trustee to sell the property free and clear trumps the tenant's possessory rights, but also made it virtually impossible for the debtor or trustee to exercise that power over the tenant's objection.

The debtor owned two commercial condos that were leased to tenants, and also subject to more than \$13 million in mortgage debt. In the bankruptcy case, the court confirmed a plan proposed by the mortgagee under which the condos would be sold, pursuant to section 363 of the Code, free and clear of any leases "not assumed under the Plan." *Dishi & Sons* purchased the property at the sale for just over \$6 million, but one of the tenants asserted a right to continue in possession despite the sale and the rejection of its lease.

Rejection of a Lease

Section 365 of the Bankruptcy Code gives a debtor the power to reject or assume its executory contracts and leases. An assumed lease remains in full force and effect. Rejection of a lease is treated as a breach that frees the debtor from any obligation to provide services under the lease. If that breach would permit the tenant to terminate the lease under state law, it can do so after rejection, surrendering the property and filing a claim for damages in the bankruptcy case. If it prefers, however, section 365(h) provides that the tenant can remain in possession, and it can offset against its future rent any damages caused by the debtor/landlord's failure to perform its lease obligations.

Section 363 of the Code, however, potentially conflicts with the tenant's possessory right (under its lease or under section 365(h)) because it permits a debtor or trustee to sell estate property "free and clear of any interest in such property." To sell property free and clear of a given interest, the debtor or trustee must show that at least one of five conditions is met: (1) applicable nonbankruptcy law permits sale of the property free and clear of the interest; (2) the interest holder consents; (3) the interest is a lien and the sale price exceeds the value of all liens on the property; (4) the interest is in bona fide dispute; or (5) "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest." Even if one of these conditions is met, section 363(e) provides that the interest holder is entitled, upon request, to have the sale prohibited or conditioned "as is necessary to provide adequate protection" of its

interest.

Courts have split on how the protection of the tenant's possessory right under section 365(h) relates to the trustee's power to sell a property "free and clear of any interest in such property." The more common view is that these sections conflict, and the specific protections granted to the tenant in section 365(h) trump the trustee's general right to sell free and clear under section 363. However, the only Court of Appeals case on point, *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir.2003), held that there is no conflict: the tenant's protection under section 365(h) only applies upon rejection, and not upon sale under section 363. In a 363 sale, the tenant is limited to its right to demand "adequate protection" of its rights (which could be in form of cash compensation rather than possession).

No Conflict

The bankruptcy court had ruled for the tenant on two grounds. First, it agreed with most courts that the tenant retained the right to possession under section 365(h) even if the property was sold under section 363. Second, it held that the tenant was entitled to remain in possession as "adequate protection" of its rights.

District Court Judge Oetken affirmed the tenant's right to retain possession, but not the reasoning of the bankruptcy court. Rather, he sided with the Seventh Circuit, finding that there is no conflict between sections 365(h) and 363. If a property is sold under section 363, section 365(h) is simply not implicated, and a sale under section 363 can be free from a tenant's right to possession whether that right arises from its lease or from section 365(h) as long as the tenant receives adequate protection of its interest.

However, the decision continues, this is true only if at least one of the conditions for a sale free and clear have been met. The lender argued that the first and fifth conditions were met: First, applicable nonbankruptcy law permits sale of the property free and clear of the lease because the lease, which is subordinate to its mortgage, could be extinguished by a foreclosure sale, and second, the tenant could be compelled to accept a money satisfaction of its interest at a foreclosure or through eminent domain.

The tenant argued that these conditions were not met, because applicable nonbankruptcy law means the law that would apply outside of bankruptcy if the debtor or a trustee were to voluntarily sell the property. The court agreed, reasoning that foreclosure law is not the 'applicable' nonbankruptcy law because a sale under section 363 is analogous to a voluntary sale "because the owner of the asset (the trustee/estate) has discretion whether and in what manner to sell property and the goal is to maximize the benefit to the estate, not to a particular mortgagee." Using similar reasoning, it held that the fifth condition was not satisfied because the owner or trustee would have no power under nonbankruptcy law to compel the tenant to accept a monetary satisfaction of its possessory rights.

The court therefore held that section 363 did not, in this case, authorize a sale free and clear of the tenant's rights under section 365(h). It also affirmed the bankruptcy court's holding that the tenant was entitled to retain possession as adequate protection of its interest, finding no abuse of discretion in that determination.

Comments: Bankruptcy provides a collective forum for resolving the claims of the debtor and its various creditors, including lenders and tenants, but those claims are generally resolved in accordance with state law priorities. Through its ruling, the court essentially reversed the priority of the tenant and lender. Moreover, it is anomalous to hold that the powers of the debtor

or trustee under section 363 are less robust than those of a mortgagee, who could sell free and clear of these subordinate leases. This is particularly true here, where the sale was pursuant to plan of reorganization proposed by the mortgagee itself.