

When Leaseholds and Sales Collide in Bankruptcy

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Two sections of the Bankruptcy Code addressing leases sometimes work in tandem with each other, but some courts are creating a conflict.

Section 363 gives bankruptcy courts the power to approve the sale of the assets of a bankruptcy debtor, free and clear of any liens, claims or interests in the property, under certain conditions.

Section 365 gives bankruptcy courts the power to approve the termination of unexpired leases of real estate or to approve their assumption and assignment, also under certain conditions.

Lenders are well acquainted with both concepts, but what happens when Sections 363 and 365 collide? For leasehold mortgage financiers, the result can be a worrisome problem.

Most courts have held that Section 365 prevails, which they interpret as the more specific and controlling provision. That has led to courts to hold that a "free and clear" sale under Section 363 cannot transfer real estate free and clear of an existing lease.

A [recent court case](#) in the Ninth Circuit Court of Appeals concerning the former Spanish Peaks Resort in Montana, however, allowed a Section 363 sale of real estate but free of a lease, though it still reserved certain rights of a non-debtor lessee.

Why does this matter to lenders? The most important structural focus in a leasehold mortgage transaction is assuring that the underlying lease cannot be terminated without an opportunity for the lender to preserve the lease, which is its collateral. The majority of courts have not allowed the "stripping" of a lease in a Section 363 land sale. Other courts permit real property to be sold free and clear of a lease under Section 363 and the terms of Section 365 are relevant only if the lessee/debtor has sought to reject the lease, instead of selling the underlying real estate. In other words, the minority courts have held that a "sale" is not a "rejection".

Tenants and their lenders may take comfort from the appellate decision in the Atlantic City Revel Casino bankruptcy. It stayed the application of a sale order as to appellants (lessees) who were asserting rights under Section 365(h) and directed the district court to enter a stay order in conformity with the appellate order. The bankruptcy court sale order under Section 363(f) specifically stated that the sale was free and clear of all tenant possessory rights under Section 365(h). Ultimately, the sale order was stayed as to the lessees.

The decision in the Spanish Peaks case is a cautionary tale about the importance of complaining early and often in a bankruptcy case to protect one's rights. The court noted that the lessees under the lease failed to seek adequate protection before the court approved the Section 363 sale. Regardless of the jurisdiction, a lessee (or someone standing in the lessee's shoes) would be well-served by raising the adequate protection issue in a timely fashion.

In addition to aggressively seeking adequate protection, leasehold mortgagees should seek appropriate non-disturbance, consent and estoppel agreements from other holders of liens encumbering the fee estate when documenting loans secured by a leasehold mortgage. Lenders should also ensure their leasehold mortgage contains appropriate terms regarding the rights of the lender and leasehold mortgagee in the event that a bankruptcy case is filed. More specifically, the mortgage should include the right, under Section 363(e), to seek adequate protection while "standing in the shoes" of the tenant or lessee.

For more information on leasehold mortgages and bankruptcy matters, please contact [Timothy Dietrich](#) or [Joseph Schalk](#).

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