Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred In *Precision Industries v. Qualitech Steel*

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INTRODUCTION

Rarely does a bankruptcy case have the potential to profoundly impact the non-bankruptcy world. The recent decision of the U.S. Court of Appeals for the Seventh Circuit in *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*,[1] is such a case. The Seventh Circuit's decision in *Precision Industries* will have profound implications not only on bankruptcy sales but on real estate leasing and real estate lease financing. Indeed, although *Precision Industries* deals with a real estate lease, the case has direct application to intellectual property licenses and, as such, may have substantial implications for the licensing of intellectual property.

Section 363(f) of the Bankruptcy Code allows a trustee or debtor to sell property of the estate "free and clear of any interest in such property" if at least one of five statutory conditions is satisfied.[2] A lease is almost certainly an "interest in such property."[3] Section 365(h) allows the lessee of a debtor to choose between the termination of its lease and the continuation of its leasehold if the trustee or

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1. 327 F.3d 537 (7th Cir. 2003) (Rovner, D. Wood, & Evans, JJ.).

2. 11 U.S.C. § 363(f) (2000). All section references in this Article are to the Bankruptcy Code.

3. *See*, *e.g.*, *Precision Indus.*, 327 F.3d at 545 (stating "interest" is sufficiently broad to include a lessee's possessory interest). There has been some controversy as to whether "interest" refers only to *in rem* interests, a broader category of interests in some way grounded in the property, or any right to demand money from the debtor-owner of the property. *See In re* Leckie Smokeless Coal Co., 99 F.3d 573, 581–82 (4th Cir. 1996). Some older cases interpret "interests" to mean *in rem* interests in property only, but "the trend seems to be toward a more expansive reading." *In re* Trans World Airlines, Inc., 322 F.3d 283, 288–89 (3rd Cir. 2003). Given that at least three circuits have now embraced a more expansive reading of "interest," and there appears to be no recent cases supporting a narrow reading of "interest," there is probably little merit in asserting that a leasehold is not an "interest" within the meaning of § 363(f).

debtor-in-possession rejects its unexpired lease of real property.[4] Can a trustee or debtor use a § 363(f) sale to extinguish a lessee's possessory interest, notwithstanding § 365(h)?

Until recently, no circuit court had addressed this issue. The reported lower court decisions, however, almost uniformly held that the protections afforded to lessees by § 365(h) prevail over the debtor's right to sell free and clear of interests under § 363(f). Two cases, decided by different bankruptcy courts, squarely addressed the issue.

In *In re Taylor*,[5] the debtor attempted to sell its nursing homes free and clear of leases pursuant to § 363(f)(3) and § 363(f)(4). The lessee objected to the proposed sale. The South Carolina bankruptcy court denied the free-and-clear sale on the grounds that § 363(f)(3) was not satisfied because the leases were not "liens" and § 363(f)(4) was not satisfied because of the absence of a *bona fide* dispute. The court also held that to authorize the sale free and clear of the leases would be in direct contravention of the protections expressly afforded to lessees by § 365(h) and Congressional intent.[6]

One month after *Taylor*, an Illinois bankruptcy court faced the same issue.[7] It, too, held that § 365(h) prevails over § 363(f).[8] In *In re Churchill Properties III, L.P.*, the debtor sold free and clear of interests certain real property that was subject to a lease. The debtor later rejected the lease. The lessee asserted its right to retain possession of the leased premises, but the purchaser contended that the lessee's possessory rights had been extinguished by the sale. The court held that the specific provisions of § 365(h) trumped the general provisions of § 363(f).[9] To rule otherwise, the court noted, would render § 365(h) "nugatory."[10] *Taylor* and *Churchill Properties* formed the basis for the prevailing view articulated by leading commentators that a debtor could not sell free and clear of a lessee's possessory interest.[11]

4. 11 U.S.C. § 365(h) (2000). Section 365(h)(1)(A)(ii) provides in relevant part as follows:

> If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and . . . if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.

5. 198 B.R. 142 (Bankr. D.S.C. 1996).
6. *Id.* at 165.
7. *In re* Churchill Props. III, L.P., 197 B.R. 283 (Bankr. N.D. Ill. 1996).
8. *Id.* at 288.
9. *Id.*
10. *Id.*
11. *See, e.g.*, 2 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW & PRACTICE 2D § 39:35, at 39-106 (1997) [hereinafter NORTON] ("A debtor lessor may not sell assets under Code § 363(f) free and clear of the interests of a tenant."); 3 LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY ¶ 365.10[1], at 365-79 to 365-80 (15th ed., rev. vol. 2003) [hereinafter COLLIER] ("The rights of the lessee are not subject to the general right of a trustee or debtor in possession to sell the property free and clear of all encumbrances.").

Enter the Seventh Circuit. In *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*,[12] the Seventh Circuit rejected the prevailing view of the relationship between § 363(f) and § 365(h).[13] The Seventh Circuit rendered a substantively flawed decision completely opposite to the existing precedents. *Precision Industries* eviscerates a lessee's § 365(h) rights. In addition, the case creates an incentive for debtors to try to accomplish a stealth rejection of leases in an attempt to extinguish unwanted leaseholds.

This Article examines the Seventh Circuit's decision in *Precision Industries* and its effect on the rights afforded to lessees by § 365(h). In Part I, the Article reviews the lower court decisions in *Precision Industries*. Part II examines the Seventh Circuit's decision, concluding that the case is wrongly decided. In particular, in an effort to avoid an inescapable conflict between § 363(f) and § 365(h) and to give effect to both provisions, the Seventh Circuit created an artificial distinction between the "rejection" of a lease (to which § 365(h) would apply) and the "repudiation" of a lease through the sale of the underlying property (to which § 365(h) would not apply).[14] The result effectively nullifies § 365(h). The potential impact of *Precision Industries* is not limited to § 365(h). As a result of the substantial similarity between § 365(h) and § 365(n), the case can be applied easily in § 363(f) sales to extinguish the rights of licensees of intellectual property under § 365(n).[15] An analysis of the relationship between § 363(f) and § 365(n), however, is beyond the scope of this Article. Part III of the Article discusses some of the practical problems created by *Precision Industries*. Finally, in Part IV, the Article suggests some strategies that can be employed to avoid the perils of *Precision Industries*.

Precision Industries v. Qualitech Steel

In *Precision Industries*, the debtor, Qualitech Steel Corp., owned a 138-acre tract of land on which it operated a steel mill. In 1998, Qualitech and Precision entered into a supply agreement, which provided that Precision would build a warehouse on Qualitech's land and operate it for ten years so as to provide on-site, integrated supply services to Qualitech. In February 1999, Qualitech entered into a ground lease with Precision pursuant to which Precision leased the one-acre parcel underlying the warehouse for ten years at a nominal rent of one dollar per year. "In accordance with the two agreements, Precision built and stocked a warehouse on the leased property and Qualitech began purchasing goods from Precision."[16] Under the terms of the lease, Qualitech was given the option to purchase the building constructed by Precision at the end of the lease term for one dollar. At the time the agreements were executed, the entire 138-acre tract was subject to two mortgages. Therefore, the mortgage liens were senior to the lease. Precision's

12. 327 F.3d 537 (7th Cir. 2003).
13. *Id*. at 546–47.
14. *Id*. at 547.
15. *See infra* notes 141, 145 and 156–57, and accompanying text.
16. *Precision Indus.*, 327 F.3d at 540.

lease was never recorded, and Precision did not obtain a nondisturbance agreement from the mortgagees.[17]

In March 1999, less than one month after entering into the lease, Qualitech filed for Chapter 11. On August 13, 1999, the bankruptcy court approved a sale of substantially all of Qualitech's assets free and clear of interests pursuant to § 363 and § 365 of the Bankruptcy Code to the debtor's senior prepetition lenders, which held the first mortgage on the property. These lenders, who were owed approximately $264 million, submitted a successful credit bid of $180 million.[18] The lenders formed a new company, referred to herein as "New Qualitech," to assume the rights of the purchaser under the sale order and to take title to the property. Neither the motion nor the sale order specifically referred to Precision's lease. Precision received notice of the sale hearing but did not file an objection to the sale.[19] The sale order gave the purchaser the right to designate which executory contracts and unexpired leases would be assumed by the debtor and assigned to the purchaser at the sale closing. The sale closed on or about August 26, 1999. The period for the assumption and assignment of Precision's supply agreement and lease was extended four times by agreement. New Qualitech and Precision continued to negotiate over Precision's lease until December 3, 1999, when the final extension was allowed to expire, and the supply agreement and lease were rejected.[20]

Shortly after the last extension expired, New Qualitech moved to take possession of the warehouse by changing the locks without Precision's consent or knowledge. Precision filed a complaint for trespass in the U.S. District Court. New Qualitech responded with a motion in the bankruptcy court to enforce the sale order as having extinguished Precision's possessory rights. Precision's district court complaint was referred by the district court to the bankruptcy court.[21] The debtor was not a party to the litigation. The bankruptcy court, adopting verbatim the findings of fact and conclusions of law proposed by New Qualitech,[22]

17. *See In re* Qualitech Steel Corp., No. 99-03364, Order Granting Purchaser's Request to Enforce, in part, Sale Order Dated August 13, 1999, ¶ 15, at 9 (Bankr. S.D. Ind. Jan. 20, 2000) (on file with *The Business Lawyer*) [hereinafter *Qualitech* Order dated January 20, 2000]. Precision's failure to obtain a nondisturbance agreement meant that its leasehold interest could be eliminated in a foreclosure sale by the senior mortgagees. It is precisely because of this consequence that ground lessees—particularly those who intend to make substantial investment in their ground lease by building on the land—typically obtain nondisturbance agreements from all senior mortgagees. This ensures that the mortgagees will respect the leasehold interests of the ground lessees in the event that the ground lessor (the mortgagor) defaults on the mortgage and the land is sold in a foreclosure sale by the mortgagees.

18. *Id.* ¶ 12, at 3. There was a second mortgage on the property, junior to the senior lenders' mortgage, in the amount of approximately $86 million. *Id.* ¶ 11, at 3.

19. *Precision Indus.*, 327 F.3d at 541.

20. The parties and the courts agreed that Precision's lease was rejected by the failure of the debtor to assume and assign the lease to New Qualitech within the period fixed by the bankruptcy court. It should be noted, however, that the lease would not be deemed to be rejected as a matter of law sixty days from the date of bankruptcy pursuant to § 365(d)(4) because that section applies only to nonresidential leases under which the debtor is the lessee not the lessor. Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, No. IP00-0247-C-H/G, 2001 WL 699881, at *9 & n.8 (S.D. Ind. Apr. 24, 2001), *rev'd*, 327 F.3d 537 (7th Cir. 2003). *See* COLLIER, *supra* note 11, ¶ 365.04[6], at 365–43.

21. *Precision Indus.*, 2001 WL 699881, at *4.

22. *Id.* at *5.

concluded that Precision's possessory rights had been extinguished by the sale order, and that Precision's failure to object to the sale order precluded any further challenge to its terms.[23]

The bankruptcy court held that Precision's possessory interest under § 365(h) would survive the sale only to the extent provided by applicable nonbankruptcy law.[24] The court stated that, in this case, the applicable nonbankruptcy law was the state's foreclosure laws, and found that Precision's lease, which was junior to the existing mortgages, would not survive a foreclosure sale.[25] The bankruptcy court reasoned that, because the lease would not survive a foreclosure sale under applicable nonbankruptcy law, Precision's possessory interest was not protected by § 365(h).[26] The court found that to hold otherwise would grant Precision greater rights than it had under state law.[27]

In addition, the bankruptcy court found that Precision's lease was unenforceable against the buyer, New Qualitech, under the Indiana priority statute because the sale order expressly conferred upon New Qualitech the status of a "good faith purchaser."[28] Under the Indiana priority statute, an unrecorded lease for a term of more than three years is void and unenforceable against a "good faith purchaser."[29] Finally, the bankruptcy court found that Precision failed to take available steps to protect its interests, namely, to obtain a subordination agreement from the senior lenders, to record the lease, or to object to the sale.[30] As a result, the bankruptcy court held that Precision had lost all rights to its leasehold interest in the property.[31]

On appeal by Precision, the district court reversed.[32] At the district court, the primary issue was whether § 365(h) preserved Precision's possessory interest notwithstanding the sale order and the purchaser's decision not to assume Precision's lease.[33] The district court rejected New Qualitech's argument that "applicable nonbankruptcy law" in § 363(f)(1) and § 365(h) referred to Indiana's foreclosure law.[34] The district court found that it referred instead to the law governing

23. *Qualitech* Order dated January 20, 2000, *supra* note 17, ¶ 11, at 7–8, ¶ 16, at 9.
24. *Id*. ¶ 7, at 5.
25. *Id*.
26. *Id*. This is a misreading of § 365(h)(1)(A)(ii), which provides that the lessee retains its rights under the lease "to the extent that such rights are enforceable under applicable nonbankruptcy law." 11 U.S.C. § 365(h)(1)(A)(ii) (2000). Under § 365(h)(1)(A)(ii), the question is not whether applicable nonbankruptcy law provides protection for lessees against the debtor's senior creditors, but whether, under applicable nonbankruptcy law, the lease is valid and enforceable against the debtor. Under Indiana law, the applicable nonbankruptcy law, Precision's lease was indeed valid and enforceable against the debtor. *Precision Indus.*, 2001 WL 699881, at *15.
27. *Qualitech* Order dated January 20, 2000, *supra* note 17, ¶ 7, at 5.
28. *Id*. ¶ 5, at 4–5.
29. *Precision Indus.*, 2001 WL 699881, at *15; *see also* IND. CODE ANN. §§ 32-1-2-11 and 32-1-2-16 (Michie 1995).
30. *Qualitech* Order dated January 20, 2000, *supra* note 17, ¶ 15, at 9.
31. *Id*.
32. *Precision Indus.*, 2001 WL 699881, at *21.
33. *Id*. at *1. Precision also argued that the bankruptcy court lacked jurisdiction to issue the enforcement order. The district court rejected this argument holding that the bankruptcy court retained jurisdiction to interpret and enforce its own order. *Id*. at *6.
34. *Id*. at *15.

voluntary sales.[35] In other words, the debtor's power to sell free and clear under § 363(f)(1) if permitted by applicable nonbankruptcy law referred to a debtor's power to sell under applicable nonbankruptcy law, not to a senior mortgagee's power to sell. The district court held that the specific provisions of § 365(h) override the general provisions of § 363(f) when they conflict, as in this case.[36] New Qualitech argued, *inter alia*, that Precision's failure to record its lease rendered the lease void and unenforceable against New Qualitech as a good-faith purchaser without notice of the unrecorded lease. The district court agreed, but held that the conferral of "good faith" status by the sale order was not equivalent to qualification as a "good faith purchaser" under the Indiana priority statute.[37] It remanded the case to the bankruptcy court to determine whether New Qualitech had notice of Precision's lease prior to the purchase.[38]

New Qualitech appealed to the Seventh Circuit, arguing that § 365(h) does not impose a limitation on § 363(f) sales.[39] The Seventh Circuit agreed with New Qualitech and reversed the district court.[40] The Seventh Circuit held that § 365(h) does not supersede § 363(f).[41] The court based its holding on three grounds. "First, the statutory provisions themselves do not suggest that one supersedes or limits the other."[42] The absence in either § 363(f) or § 365(h) of a "cross-reference indicating that the broad right to sell estate property free of 'any interest' is subordinate to the protections that section 365(h) accords to lessees" suggests that Congress did not intend for § 365(h) to limit § 363(f).[43] Second, the plain language of § 365(h) suggests that it has limited scope, applying only when the debtor "rejects" an unexpired lease.[44] The Seventh Circuit reasoned that a sale—even one equivalent to the repudiation of a lease—was different from a "rejection" and, therefore, a § 363(f) sale does not trigger consideration of § 365(h).[45] Finally, lessees, like Precision, have the ability to protect their interests in the event of a sale free and clear of their interests by requesting adequate protection under § 363(e).[46]

35. *Id.* at *16.
36. *Id.* at *14.
37. *Id.* at *16.
38. *Id.* at *21. Under Indiana law, an unrecorded lease with a term of more than three years is void and unenforceable against a "good faith purchaser" unless the purchaser has either actual or constructive notice of the unrecorded lease. IND. CODE ANN. §§ 32-1-2-11 and 32-1-2-16 (Michie 1995). If New Qualitech did not have notice of Precision's lease, the lease, under Indiana law, would be void and unenforceable against New Qualitech. *Precision Indus.*, 2001 WL 699881, at *15.
39. To expedite its appeal to the Seventh Circuit, New Qualitech waived the remand hearing and conceded that Precision's possession of the leased premises was sufficient to impute knowledge of the unrecorded lease to New Qualitech. *See In re* Qualitech Steel Corp., No. IP 99-3364-AJM, Waiver of Remand Hearing and Request to Expedite Appeal, Document No. 893 (July 19, 2001) (on file with *The Business Lawyer*). As in the courts below, the debtor was not a party to the litigation.
40. Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 548 (7th Cir. 2003) (decision by Rovner, J.).
41. *Id.* at 547.
42. *Id.*
43. *Id.*
44. *Id.*
45. *Id.*
46. *Id.*

The Seventh Circuit dismissed the district court's opinion as merely "following the lead of other lower courts."[47] The Seventh Circuit failed to specifically address the lower court precedents that the district court found persuasive. Instead, the Seventh Circuit adopted a novel approach to § 363(f) and § 365(h), motivated by a desire to avoid a construction of the two provisions that would bring them into conflict.

What's Wrong with the Seventh Circuit's Opinion?

In reaching its conclusion that the provisions of § 365(h) did not supersede those of § 363(f), the Seventh Circuit relied on three basic arguments. Each will be examined in turn.

No Statutory Evidence of Primacy

As a threshold matter, the Seventh Circuit found that the power to sell free and clear under § 363(f) is a "broad right" that should not be limited without some clear statutory authority.[48] A debtor's right to sell free and clear of interests, however, is not actually a broad right, but a narrowly circumscribed one. This right is specifically limited by § 363(f) to five carefully described conditions.[49] At least one of the five conditions must be satisfied to permit a sale free and clear of interests. If none of these conditions is satisfied, the debtor cannot sell free and clear of interests. If the debtor's right to sell free and clear of interests were a broad one, "§ 363(f) could be vastly simplified by retaining just the first twenty-two of its one hundred or so words, leaving it to read 'The trustee may sell property under subsection (b) and (c) of this section free and clear of any interest in such property.'"[50] Congress, however, did not enact merely the first twenty-two

47. *Id*. at 546–47. Contrary to the Seventh Circuit's assertion, the district court's opinion was a thoughtful analysis of the case law on the subject and the legislative history of the provisions. The district court reached its conclusion only after considering the competing bankruptcy policies at stake, the contrary position held by the district court in *In re Downtown Athletic Club*, No. M-47 (JSM), 2000 WL 744126 (S.D.N.Y. June 9, 2000), and the analyses of the *Taylor* and *Churchill Properties* courts. Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 2001 WL 699881 (S.D. Ind. April 24, 2001).

48. *Precision Indus.*, 327 F.3d at 547.

49. Section 363(f) provides as follows:

> The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if —
> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
> (2) such entity consents;
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
> (4) such 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.

11 U.S.C. § 363(f) (2000).

50. George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 Am. Bankr. L.J. 235, 255–56 (2002) (citation omitted) [hereinafter Kuney].

words of the section.[51] Therefore, any analysis of the relationship between § 363(f) and § 365(h) must proceed, not from the premise that the debtor has a "broad right" to sell free and clear of interests, but from the premise that the debtor's right to sell free and clear is in fact quite limited. Although the "interests" of which the debtor has the right to sell free and clear are broad,[52] the "right" to sell free and clear of interests is not.[53]

The Seventh Circuit found that there was no evidence in either § 363(f) or § 365(h) that one trumps the other. The court noted that, although § 363 and § 365 both contain cross-references indicating that certain of their provisions are subject to other statutory provisions, there is no such similar reference in either § 363(f) or § 365(h).[54] This omission, the Seventh Circuit concluded, was evidence that Congress did not intend for § 365(h) to limit § 363(f).[55]

The problem with this argument is that, when § 363 is read as a whole, it becomes clear that § 363(f) is indeed subject to the provisions of § 365. Admittedly, neither § 363(f) nor § 365(h) contains any cross-reference to the other that would indicate that one supersedes or is subordinate to the other. Nonetheless, § 363(f) is expressly limited by § 365—although the limitation does not appear in either § 363(f) or § 365(h).

Two basic types of sales are permitted under § 363: sales outside the ordinary course of business under § 363(b), and sales in the ordinary course of business under § 363(c). Free-and-clear sales under § 363(f) are a subset or category of these sales. Thus, a free-and-clear sale under § 363(f) also must be a sale under

51. *Id.* at 256.

52. *See supra* note 3.

53. It is doubtful that there was any basis under § 363(f) for the sale free and clear of Precision's lease. The Seventh Circuit recognized this weakness but assumed that a basis existed because the parties did not dispute that at least one of the conditions of § 363(f) was satisfied. *Precision Indus.*, 327 F.3d at 546 n.3. No one can fault the Seventh Circuit for proceeding as it did. It seems entirely possible, however, that there was, in fact, no basis under § 363(f) to sell free and clear of Precision's lease because of the failure to satisfy any of the conditions thereunder. Of the grounds under § 363(f), only § 363(f)(1) (applicable nonbankruptcy law permits a sale free and clear) and § 363(f)(4) (the interest is in *bona fide* dispute) appear to be relevant. Section 363(f)(4) was not applicable because the lease was not disputed by the debtor. Section 363(f)(1) was also not applicable because the property could not have been sold free and clear of the lease under applicable nonbankruptcy law; the Indiana priority statute does not permit such a sale if the purchaser had notice of the lease. New Qualitech conceded that it had notice of the lease. *See supra* note 39.

The bankruptcy court's sale order stated that (i) the holders of interests in the assets have either consented to the sale, or such interests are liens and the purchase price of the assets exceeds the value of such liens, or (ii) such interests or liens are subordinate to the liens held by the prepetition senior lenders and accordingly are of no value. *See In re* Qualitech Steel Corp., No. IP 99-3364-AJM, Order Approving the Sale of Substantially All of the Debtors' Assets Free and Clear of All Liens, Claims Encumbrances and Interests Pursuant to 11 U.S.C. § 363 and the Assumption and Assignments of Executory Contracts and Unexpired Leases Pursuant to 11 U.S.C. § 365, Document No. 492, ¶ L, at 5–6 (Bankr. S.D. Ind. Aug. 13, 1999) (on file with *The Business Lawyer*) [hereinafter *Qualitech* Order dated August 13, 1999]. Contrary to the findings in the sale order, it seems clear that Precision did not consent to a sale free and clear of its lease because a decision on the assumption and assignment of executory contracts and unexpired leases was deferred until the closing of the sale and any objection to assumption and assignments was expressly preserved until such time. *See id.* ¶ 9, at 9. In addition, it is clear that Precision's lease was not a "lien." *See infra* note 135.

54. *Precision Indus.*, 327 F.3d at 547.

55. *Id.*

either § 363(b) or § 363(c). Therefore, any limitation on sales under § 363(b) or § 363(c) is also a limitation on free-and-clear sales under § 363(f). Sales under §§ 363(b) and (c) are limited by §§ 363(d), (e), and (l). Section 363(l) provides that sales in or outside the ordinary course of business are "[s]*ubject to the provisions of section 365* . . . notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor."[56] As a result, sales in or outside the ordinary course of business—including free-and-clear sales under § 363(f)—are expressly subject to the provisions of § 365, in its entirety, by virtue of § 363(l). In other words, a free-and-clear sale under § 363(f) is subject to the provisions of § 365, and, therefore, is also subject to § 365(h).

One could argue that the reference in § 365(l) to "section 365" refers only to § 365(e)(2) and not to any other provision of § 365, including § 365(h).[57] Put differently, one may argue that § 363(l) applies only when an *ipso facto* clause exists to authorize a sale despite the presence of such a clause; therefore, if there is no *ipso facto* clause, § 363(l) has no application. This argument, however, fails for two reasons. First, a review of the legislative history of § 363(l) reveals a clear Congressional intent to subordinate § 363 sales to the provisions of § 365 in its entirety. Section 363(l) was amended in 1984 to make clear that all § 363 sales are subject to the provisions of § 365.[58] In the 1984 amendment, Congress added the proviso "[s]ubject to the provisions of section 365" to § 363(l).[59] The addition of this proviso is compelling evidence of Congressional intent to subordinate § 363 sales to § 365, including the lessee protections of § 365(h). Second, a review of the other subsections of § 363 demonstrates that, when Congress wanted to limit the scope of a statutory cross-reference, it refers to a specific subsection, not to an entire section.[60] As the Seventh Circuit correctly noted, "it is generally presumed that Congress acts intentionally and purposely when it includes par-

56. 11 U.S.C. § 363(l) (2000) (emphasis added). Section 363(l) in its entirety provides as follows:

> Subject to the provisions of section 365, the trustee may use, sell, or lease property under subsection (b) or (c) of this section, or a plan under chapter 11, 12 or 13 of this title may provide for the use, sale, or lease of property, notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title concerning the debtor, or on the appointment of or the taking possession by a trustee in a case under this title or a custodian, and that effects, or gives an option to effect, a forfeiture, modification, or termination of the debtor's interest in such property.

57. Section 365(e) deals with *ipso facto* or bankruptcy clauses and renders them unenforceable except in certain limited circumstances described in § 365(e)(2).

58. *See* COLLIER, *supra* note 11, ¶ 363.LH[3][a], at 363-87 ("Subsection (l) was amended to make clear that the trustee is subject to section 365 with the substitution of 'Subject to the provisions of section 365, the trustee' for 'The trustee.'").

59. Pub. L. No. 98-353, 98 Stat. 372 § 442(h) (1984) (codified as amended at 11 U.S.C. § 363(l) (2000)).

60. *See*, *e.g.*, 11 U.S.C. § 363(d). In addition, the other uses of "notwithstanding" in § 363 are not limiting. For example, §§ 363(g) and (h) both begin "[n]otwithstanding subsection (f)" but apply whether or not subsection (f) is applicable. This undermines the argument that § 363(l) is only meant to apply to situations where an *ipso facto* clause is present.

ticular language in one section of a statute but omits it in another."[61] If the proviso ("subject to section 365") were intended to be applicable only with respect to *ipso facto* or bankruptcy clauses, the proviso would have referred specifically to § 365(e)(2) rather than to § 365 generally. Therefore, the reference in § 363(l) to "section 365" without any subsection specifically identified suggests that *all* sales involving executory contracts or unexpired leases under § 363(b) and (c)—including free-and-clear sales under § 363(f)—are subject to the entire provisions of § 365.

Contrary to the finding of the Seventh Circuit in *Precision Industries*, the statute, namely § 363(l), does in fact expressly provide that all § 363 sales, including free-and-clear sales, are subject to the provisions of § 365, including the lessee-protection provisions of § 365(h). This argument does not appear to have been made to the Seventh Circuit.

Moreover, the legislative history of § 365(h) reveals that Congress has consistently sought to strengthen lessee rights when they were threatened by narrow court interpretations.[62] When Congress first enacted § 365(h) to replace the lessee-protection language in the Bankruptcy Act, it intended to avoid the narrow construction of "estate" which some courts had applied to limit lessee rights.[63] The legislative history of the original § 365(h) declared unequivocally that "the tenant will not be deprived of his estate for the term for which he bargained."[64]

In 1984, Congress amended § 365(h), giving the lessee not only the right to "remain in possession," but also the right to "remain in possession of the leasehold . . . interest."[65] This amendment was intended to clarify that all the lessee's rights

61. Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 547 (7th Cir. 2003) (internal quotations omitted) (citation omitted).

62. Robert M. Zinman, *Landlord's Lease Rejection and the 1984 Amendments to § 365(h)*, 16 AM. BANKR. INST. J. 31(1994) [hereinafter Zinman].

63. *Id.* at 32 n.3.

64. H.R. REP. NO. 95-595, at 349 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6306; *see* COLLIER, *supra* note 11, App. Pt. 4(d)(i), at 4-1484. The 1978 version of section 365(h)(1) was as follows:

> If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, the lessee under such lease may treat the lease as terminated by such rejection, or, in the alternative, may remain in possession for the balance of the term of such lease and any renewal or extension of such term that is enforceable by such lessee under applicable nonbankruptcy law.

11 U.S.C. § 365(h) (Supp. II 1979).

65. 11 U.S.C. § 365(h)(1) (Supp. II 1985). The 1984 version of section 365(h)(1) in relevant part was as follows:

> If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, . . . the lessee . . . under such lease . . . may treat such lease . . . as terminated by such rejection, where the disaffirmance by the trustee amounts to such a breach as would entitle the lessee . . . to treat such lease as terminated by virtue of its own terms, applicable nonbankruptcy law, or other agreements the lessee . . . has made with other parties; or, in the alternative, the lessee . . . may remain in possession of the leasehold . . . under any lease . . . the term of which has commenced for the balance of such term and for any renewal or extension of such term that is enforceable by such lessee . . . under applicable nonbankruptcy law.

Id. (omitting separate references to timeshares).

under the lease survive rejection, at least for the purpose of determining the extent of the lessee's right of offset.[66] In 1994, the provision was amended to make clear that physical possession by the lessee was not necessary if the term of the lease had commenced, and again to clarify that the lessee retained its rights under the lease.[67] This is the version that exists today.

In view of Congress' unequivocal declaration that § 365(h) will preserve the tenant's estate "for the term for which he bargained" and its consistent amendment of the section in favor of lessee rights, it seems unlikely that Congress intended to allow circumvention of the specific provisions of § 365(h) through the general provisions of § 363(f).

Proponents of the application of § 363(f) to extinguish a lessee's possessory rights contend that, when Congress amended § 365(h) in 1994 to strengthen the lessee protections, it failed to expressly subordinate §§ 363(b), (c) or (f) to § 365(h).[68] Therefore, they argue, Congress did not intend such a subordination.[69] As previously discussed, however, this argument fails.[70] By the time of the 1994 amendments, § 363(l) already expressly subordinated §§ 363(b), (c) and (f) to § 365.[71] Therefore, further Congressional action was unnecessary.

A Sale that Effects a Repudiation is Different from "Rejection"

In an effort to avoid the conflict between § 363(f) and § 365(h) that the district court found (as did the courts in *Taylor* and *Churchill Properties*), the Seventh Circuit drew a distinction between the rejection of a lease, on the one hand, and a sale that effects the repudiation of the lease, on the other. The Seventh Circuit stated that "rejection" is not implicated in a sale:

> By its own terms, . . . subsection [365(h)] applies "[i]f the trustee [or debtor-in-possession] *rejects* an unexpired lease of real property . . . ." Here what occurred in the first instance was a sale of the property that Precision was leasing rather than a rejection of its lease. Granted, if the Sale Order operated to extinguish Precision's right to possess the property—as we conclude it did—then the effect of the sale might be understood as the equivalent of a repudiation of Precision's lease.[72]

66. Zinman, *supra* note 62, at 32. After the rejection, the debtor is not required to perform the covenants under the lease, but the lessee is entitled to offset the damages caused by nonperformance against rent. 11 U.S.C. § 365(h)(1)(B).

67. 11 U.S.C. § 365(h)(1)(A)(ii) (2000). *See generally* Thomas C. Homburger et al., *Conflict Resolved: Bankruptcy Code § 365(h) and the Contradictory Cases Requiring its Amendment*, 29 Real Prop. Prob. & Tr. J. 869 (1995) (analyzing the cases and policy justifications that led to the 1994 amendments of § 365(h)).

68. Steven R. Haydon & Nancy J. March, *Sale of Estate Property Free and Clear of Real Property Leasehold Interests Pursuant to §363(f): An Unwritten Limitation?* 19 Am. Bankr. Inst. J. 20, 21 (2000) [hereinafter Haydon & March].

69. *Id*.

70. *See supra* notes 56–61 and accompanying text.

71. *See supra* notes 56–61 and accompanying text.

72. Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 547 (7th Cir. 2003).

The Seventh Circuit reasoned that, because the "rejection" of a lease is different from a sale that effects the repudiation of the lease, a free-and-clear sale under § 363(f) does not trigger or implicate § 365(h).[73] As a result, the court stated, "both provisions may be given full effect without coming into conflict with one another and without disregarding the rights of lessees."[74] This fails analysis.

If we accept, for the sake of argument, that the free-and-clear sale did not constitute "rejection" so as to trigger § 365(h), what happens when the lease is rejected? Is § 365(h) triggered upon the subsequent rejection, thereby giving rise to Precision's § 365(h) possessory rights?

It is clear that Precision's lease was rejected sometime after the sale.[75] If the sale did not effect rejection so as to trigger Precision's § 365(h) rights, surely the subsequent rejection of the lease did. Moreover, if the Seventh Circuit is correct that its interpretation of § 363(f) and § 365(h) allows "both provisions [to] be given full effect without coming into conflict with one another and without disregarding the rights of lessees,"[76] Precision must necessarily have been entitled to exercise its § 365(h) possessory rights at the time of rejection. At rejection, however, Precision was deprived of its § 365(h) rights. The underlying property had already been sold free and clear. There was simply no way that Precision's § 365(h) rights could have been given effect. The sale was tantamount to rejection. The problem with the Seventh Circuit's conclusion that a sale equivalent to the repudiation of the lease does not constitute "rejection" is that its effect is to nullify § 365(h)—the very thing the court sought to avoid.

The Seventh Circuit reasoned that § 365(h) "focuses on a specific type of event—the rejection of an executory contract by the trustee," and, "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."[77] It elevates form over substance, however, to draw a distinction between the "event" of rejection and circumstances that accomplish the same result as rejection. The plain meaning of "reject" in § 365 should include a sale free and clear of the leasehold interest if the effect of the sale is to repudiate the lease. Admittedly, assumption and rejection are subject to court approval under § 365(a). Court approval of a sale free and clear of interests, including leases, however, implies and effectively accomplishes a court-approved rejection of such leases.[78] The plain language of § 365(h) does not manifest an intent to exclude deemed or implied rejections, and there is no compelling reason why this artificial distinction should be made.

Section 365(h) begins with the phrase, "[i]f the trustee rejects an unexpired lease,"[79] because the special protections for lessees are inapplicable if the lease is

73. *Id.* at 548.
74. *Id.*
75. *Id.* at 541 ("Precision's lease and supply agreement were *de facto* rejected.") (citation omitted).
76. *Id.* at 548.
77. *Id.* at 547.
78. *Cf.* Chbat v. Tleel (*In re* Tleel), 876 F.2d 769, 770–71 (9th Cir. 1989) (stating that the bankruptcy court's order permitting the sale of property was effectively a court-authorized assumption of an executory contract despite that the contract was never formally assumed).
79. 11 U.S.C. § 365(h)(1)(A) (2000).

assumed, not because, as the Seventh Circuit found, rejection is an "event" with special significance.[80] In other words, the key to rejection is whether the lease will be performed. If the circumstances are such that performance is rendered impossible, there must be rejection. Whether § 365(h) protects lessees from "any and all events that threaten [their] possessory rights" is simply a red herring.[81]

In support of its strained interpretation of "rejects," the Seventh Circuit cited two cases as holding that § 365(h) is not implicated by § 363 sales.[82] The court quotes *In re Stein*[83] as stating, "'[t]he trustee is not seeking to assume or reject the lease for the [debtor's] apartment; he is attempting to sell the property of the estate under §363(b). Thus, the effect of a theoretical rejection is immaterial.'"[84] This quotation, however, is out of context. The "property" in question in *Stein* was an occupancy right of the debtor derived from a non-eviction condominium conversion plan, not an unexpired lease.[85] The debtor was the lessee, not the lessor. Therefore, § 365(h) was clearly not applicable. Indeed, the full text of the paragraph in *Stein* demonstrates that the case does not support the conclusion drawn by the Seventh Circuit:

> Section 365(h) is inapplicable. To begin with, *the lease has terminated*, and the trustee is not seeking to assume or reject the lease for the Apartment; he is attempting to sell property of the estate under § 363(b). Thus, the effect of a theoretical rejection is immaterial. *More important, the debtor is the tenant, not the landlord, and § 365(h) would not apply in any case*.[86]

The other case cited by the Seventh Circuit, *In re Downtown Athletic Club*,[87] is more problematic. *Downtown Athletic Club* held that "when [a] debtor-lessor sells property subject to a lease free and clear of that lease pursuant to Section 363(f), the Court will not apply Section 365(h)."[88] The court in *Downtown Athletic Club* in a footnote declined to follow *Taylor*.[89] Conspicuously absent from the opinion is any discussion or analysis of why the court declined to follow *Taylor*. Even more notable is the court's failure to address the conflict in the application of § 363(f) and § 365(h). To better appreciate the import of *Downtown Athletic Club*, it is helpful to review the decisions in *Taylor*, which the court rejected, and *Churchill Properties*,[90] which was decided almost contemporaneously with *Taylor*.

80. *Precision Indus.*, 327 F.3d at 547.
81. *Id*.
82. *Id*.
83. 281 B.R. 845 (Bankr. S.D.N.Y. 2002).
84. *Precision Indus.*, 327 F.3d at 547 (quoting *Stein*, 281 B.R. at 851).
85. New York law requires that when apartments are converted into condominiums, a conversion plan must be adopted that provides, *inter alia*, that non-purchasing tenants cannot be evicted for refusing to purchase. *Stein*, 281 B.R. at 848.
86. *Id*. at 851 (emphasis added). The *Stein* court in its decision did not refer to either *Taylor* or *Churchill Properties*.
87. No. M-47 (JSM), 2000 WL 744126 (S.D.N.Y. June 9, 2000).
88. *Id*. at *4.
89. *Id*. at *5 n.5.
90. 197 B.R. 283 (Bankr. N.D. Ill. 1996).

In *In re Taylor*,[91] the debtor sought to sell its nursing homes free and clear of interests under § 363(f)(3) and § 363(f)(4). The lessees under the unexpired leases in the properties objected to the sale arguing, *inter alia*, that the debtor's sole remedy as lessor of the properties was under § 365. The bankruptcy court held that the sale could not occur under § 363(f)(3) because "the leases do not amount to liens under South Carolina law for purposes of § 363(f)(3)."[92] The court also found that the debtor had failed to meet his burden that there was a *bona fide* dispute within the meaning of § 363(f)(4).[93] In addressing the relationship between § 363(f) and § 365(h), the court acknowledged "the rule of statutory construction that specific legislation governs general legislation"[94] and noted that § 365(h) was specific legislation and § 363(f) was general legislation.[95] The court observed that the legislative history of § 365(h) "evinces a clear intent on the part of Congress to protect a tenant's estate when the landlord files [for] bankruptcy."[96] The court concluded that to allow a sale free and clear of leases under § 363(f) would circumvent the provisions of § 365 and would be in direct contravention both of the lessee protections specifically afforded by § 365(h) and Congressional intent.[97] The court held that the provisions of § 365(h) were applicable to restrict the ability of the debtor to sell free and clear under § 363(f).[98]

A month after *Taylor* came the bankruptcy court decision *In re Churchill Properties III, L.P.*[99] In *Churchill Properties*, an Illinois bankruptcy court faced the same issue as the Seventh Circuit in *Precision Industries*: "whether a Section 363(f) sale overrides the rights and remedies of a lessee under Section 365(h) when the lease in question was rejected after the Section 363(f) sale."[100] In *Churchill Properties*, the debtor owned and operated an apartment complex. The laundry concession at the property was under a long-term, recorded lease. The property was subject to two mortgages. The debtor obtained authority to sell the property free and clear of interests subject only to the first mortgage. The debtor also sought authority to reject the laundry concession lease. The bank, which held the second mortgage on the property, submitted a successful credit bid for the property. The lessee, though not formally noticed of the sale, was represented by counsel at the sale hearing.[101] No objection was made to the sale. The bankruptcy court approved the sale free and clear of interests. Four months later, the bankruptcy court approved the debtor's rejection of the laundry concession lease.[102] The lessee sought

91. 198 B.R. 142 (Bankr. D.S.C. 1996).
92. *Id.* at 160.
93. *Id.* at 163.
94. *Id.* at 164.
95. *See id.* at 165.
96. *Id.*
97. *Id.* at 165–66.
98. *Id.* at 167.
99. 197 B.R. 283 (Bankr. N.D. Ill. 1996). *Churchill Properties* was decided on June 6, 1996; *Taylor* was decided approximately a month earlier on May 3, 1996.
100. *Id.* at 286.
101. *Id.* at 285 n.5.
102. Although both the sale motion and the rejection motion were set for the same hearing date, the rejection motion was continued to a later date because it was not properly noticed. *Id.* at 284.

to enforce its § 365(h) rights. The bank argued that the sale was free and clear of the lease.

At the outset, it should be noted that § 363(f)(1) appeared to be the basis for the sale as the bank contended that Illinois judicial foreclosure procedure law permits a sale of property free and clear of leasehold interests.[103] As in *Precision Industries*, too little attention appears to have been paid to the legal basis for a § 363(f) sale in the absence of objections. It is far from clear whether § 363(f)(1) provided a basis for the sale. To come under § 363(f)(1), applicable nonbankruptcy law must permit the sale *by the debtor* of the property free and clear of leaseholds. The reference to "applicable nonbankruptcy law" in § 363(f)(1) is to a sale by the debtor. It does not refer to foreclosure sales by a lienholder or to sales by a person other than the debtor.[104] An inquiry as to whether a foreclosure sale by a lienholder would extinguish the lessee's possessory rights, therefore, is misdirected. The Illinois judicial foreclosure procedure was not applicable because the debtor's sale was under § 363(f), not under the Illinois judicial foreclosure procedure law. Thus, it is questionable whether a valid basis under § 363(f) existed for the sale.[105]

The *Churchill Properties* court found that the provisions of § 363(f) and § 365(h) were in conflict. "The difficulty arises when the two provisions must be applied together because each provision seems to provide an exclusive right that when invoked would override the interest of the other."[106] After reviewing the legislative history, the court concluded that "Congress sought to protect both the rights of the lessor and the lessee so as to preserve expectations in real estate transactions."[107] Applying a well-accepted principle of statutory interpretation, the court held that the provisions of § 365(h) trump those of § 363(f):

> Section 365(h) is clear and specific in providing for certain rights and remedies available to the lessee after rejection of its lease. Since Congress decided that lessees have the option to remain in possession, it would make little sense to permit a general provision, such as Section 363(f), to override its purpose. The Code is not intended to be read in a vacuum. Here, if the Court were to adopt the Bank's application of Section 363(f), the application of Section 365(h)(1)(A)(ii) as it relates to non-debtor lessees would be nugatory.[108]

The opinion in *Taylor* (and that in *Churchill Properties*) is persuasive despite rejection by the court in *Downtown Athletic Club*. The failure of the latter court to specifically address the issues and analysis presented in *Taylor*, and its summary

103. *Id*. at 286.
104. *See* Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, No. IP00-0247-C-H/G, 2001 WL 699881, at *15 (S.D. Ind. April 24, 2001).
105. *See id*. *See also supra* note 53.
106. 197 B.R. at 286.
107. *Id*. at 288 (citation omitted).
108. *Id*.

dismissal of *Taylor*, casts a cloud over the precedential value of *Downtown Athletic Club* and undermines its persuasiveness.[109]

LESSEES ARE PROTECTED BY § 363(E)

After holding that § 365(h) is inapplicable to free-and-clear sales, the Seventh Circuit offered reassurance to lessees that they are not without recourse in the event of a sale free and clear of their interests because they have the right to seek adequate protection under § 363(e):

> Because a leasehold qualifies as an "interest" in property for purposes of section 363(f), a lessee of property being sold pursuant to subsection (f) would have the right to insist that its interest be protected. . . . Lessees like Precision . . . have the right to seek protection under section 363(e), and upon request, the bankruptcy court is obligated to ensure that their interests are adequately protected.[110]

This is particularly significant in Precision's case because the amount of the mortgage liens on the property substantially exceeded the value of the property.[111] Providing adequate protection to Precision, therefore, effectively would have rendered the lease senior to the mortgage liens, when the lease was in fact junior to them.[112]

109. *Taylor* and *Churchill Properties* were criticized in a recent article, which argued that the two cases essentially have rewritten § 363(f), failed to apply well-established rules of statutory construction and did not consider the safeguards already built into § 363 to protect lessees. Haydon & March, *supra* note 68, at 20. This argument, although persuasive to the Seventh Circuit in *Precision Industries*, fails analysis for the same reasons this Article contends the Seventh Circuit erred in *Precision Industries*. *See supra* notes 48–108 and accompanying text, and *infra* notes 110–40 and accompanying text.

110. Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 547–48 (7th Cir. 2003). Section 363(e) requires the bankruptcy court, upon the request of an entity that has an interest in property, to prohibit or condition the sale of such property as is necessary to provide adequate protection of such interest.

Section 363(e) in its entirety provides as follows:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. This subsection also applies to property that is subject to any unexpired lease of personal property (to the exclusion of such property being subject to an order to grant relief from the stay under section 362).

11 U.S.C. § 363(e) (2000).

111. *See supra* note 18 and accompanying text.

112. If the Seventh Circuit did not intend to alter priorities, the court's assurance of adequate protection will be cold comfort to lessees if there are senior liens that exhaust the sale proceeds. In such circumstances, the value of the lessee's "interest" will be zero, and the lessee will not be entitled to adequate protection. Indeed, the situation may be capable of manipulation by the debtor. A debtor and a mortgagee who desire to extinguish a lease may allow the secured claim to accumulate to exceed the value of the property. If the value of the property is less than the amount of the secured claim, it can be argued that the lessee is not entitled to adequate protection. Moreover, the sale need not disrupt the debtor's business. The debtor may sell the property free and clear of the unwanted lease, and then lease back the property from the new owner, as was done in *Downtown Athletic Club*. *See In re* Downtown Athletic Club, No. M-47 (JSM), 2000 WL 744126, at *1 (S.D.N.Y. June 9, 2000).

At the outset, it must be noted that adequate protection under § 363(e) applies only if the debtor has the right to sell the property under § 363. As discussed later, it will be rare for the debtor to have the right to sell free and clear of a lease.[113] Therefore, adequate protection will almost never be applicable. A lessee, moreover, is not subject to cramdown. The requirements for a cramdown are expressly made subject to the provisions of § 365 by § 1123(b)(2).[114] This means that a lessee must be afforded its § 365(h) rights. To convert a lessee's § 365(h) rights to cash compensation in the form of adequate protection under § 363(e), as suggested by the Seventh Circuit, would be tantamount to an impermissible cramdown of the lessee.

In *Precision Industries*, the Seventh Circuit assumed that the debtor had the right to sell free and clear of Precision's lease. As a result, the court found that Precision was entitled to adequate protection of its leasehold interest under § 363(e). The Seventh Circuit seemed of the view that the "interest" that must be "adequately protected" is the economic value of possession to the leaseholder: "'Adequate 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."[115]

Assuming, *arguendo*, that adequate protection applies, the "interest" that must be adequately protected in § 363 sales is usually the economic value that could be obtained if the property were sold or liquidated, not the value of the interest from the perspective of the creditor.[116] Moreover, valuation may present serious difficulties. There does not appear to be any reported case valuing a lessee's § 365(h) possessory rights. Doubtless, this is because, under the prevailing view of § 365(h), there was never a need to value the lessee's possessory rights because the lessee was entitled to possession—not the cash equivalent of possession.[117] Short of allowing the lessee to retain possession of the leased premises, there are obvious difficulties with trying to adequately protect the value of the lessee's possessory rights. Should the lessee be compensated, for example, for the value of its improvements to the leased premises? If the premises are unique, how can the interest be adequately protected? How do you value and adequately protect the cost to the lessee of the disruption to its business, the loss of goodwill associated with the loss of the leased premises, and any loss of profits associated with

113. *See infra* notes 133–37 and accompanying text.

114. *See infra* note 136.

115. *Precision Indus.*, 327 F.3d at 548 (citation omitted). The Seventh Circuit did not have to consider precisely what protection § 363(e) would give to the lessee because Precision failed to object to the sale or request adequate protection, precluding a subsequent remedy under that section.

116. *See* La Jolla Mortgage Fund v. Rancho El Cajon Assoc., 18 B.R. 283, 286 (Bankr. S.D. Cal. 1982) ("The creditor's right to adequate protection is limited to the lesser of the value of the collateral or the amount of the secured claim.").

117. Under § 365(h), the lessee either elects to retain possession, in which case valuation is unnecessary, or to treat the lease as terminated and claim damages, in which case the lease would need to be valued. 11 U.S.C. § 365(h)(1)(A). The lease-rejection claim would be an unsecured claim in the bankruptcy case and would not be entitled to adequate protection. *See*, *e.g.*, Chestnut Ridge Plaza Assocs., L.P. v. Fox Grocery Co. (*In re* Chestnut Ridge Plaza Assocs., L.P.), 156 B.R. 477, 483 (Bankr. W.D. Pa. 1993); MARTIN J. BIENENSTOCK, BANKRUPTCY REORGANIZATION 449–50 (1987).

relocation?[118] In some circumstances, the failure to adequately protect a lessee against these losses may result in the subsequent failure and bankruptcy of the lessee.

Regardless of whether "adequate protection" under § 363(e) would be, in fact, adequate, it is not an appropriate substitute for the right to remain in possession under § 365(h). Section 363(e) was added in the Bankruptcy Reform Act of 1978 to give secured creditors protections they did not previously have.[119] The secured creditors' bargain is for the right to look to specific assets of the debtor for repayment of their obligations ahead of other creditors, and to require protection to prevent the current value of their collateral from being further diminished.[120] In addition, secured creditors are subject to cramdown.[121]

Lessees, on the other hand, are in a much different position than secured creditors and have rights and interests of a different nature that require a different kind of protection. The lessees' bargain is for possession of the leased premises. In addition, lessees are not subject to cramdown.[122] Section 365(h) was added specifically to protect the possessory rights of lessees. It seems self-evident that Congress intended lessees to be protected under § 365(h) and secured creditors under § 363(e). Admittedly, § 363(e) uses the broader term "entity that has an interest in property" rather than "secured creditor," which likely includes more than just secured creditors.[123] This is no reason, however, to deprive lessees of the specific protection Congress granted to them and to relegate them to protection better suited to secured creditors.

Proponents of the view that § 365(h) is inapplicable to sales contend that to allow § 365(h) to trump § 363(f) would elevate the rights of lessees above other creditors in violation of the general bankruptcy policy of equality of distribution.[124] Proponents argue that "favoring a tenant over the prior mortgagee 'discriminates unfairly' against the mortgagee and the general unsecured creditors,"[125] allows the lessee to "effectively wield veto power over the sale of the debtor's property,"[126] and allows the lessee to "leapfrog . . . prior liens on the Debtor's

118. It may be argued that the measure of adequate protection for the loss of a leasehold interest is different from the measure of damages resulting from the rejection of the lease. It seems unlikely a court would interpret "adequate protection" to require full compensation of the lessee for its losses. *But see La Jolla*, 18 B.R. at 286 & n.2 (finding that "adequate protection" must be "completely compensatory" but noting that does not mean the interest holder will be put in the same position as when the transaction was initially negotiated).

119. H.R. REP. NO. 95-595, at 182–83 (1977) ("Under present law, . . . [t]he protection of the secured creditor is left entirely to the judge. . . . This [new provision] is protection that secured creditors do not have today. The bill as written is a significant boon to secured lenders.").

120. J. Bradley Johnston, *The Bankruptcy Bargain*, 65 AM. BANKR. L.J. 213, 225 (1991). *See generally* Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989).

121. *See* 11 U.S.C. § 1129(b)(2)(A) (2000).

122. *See infra* note 136.

123. 11 U.S.C. § 363(e).

124. *See* Peter A. Alces, *Unexpired Leases in Bankruptcy: Rights of the Affected Mortgagee*, 35 U. FLA. L. REV. 656, 674–75 (1983).

125. *Id.* at 675.

126. Haydon & March, *supra* note 68, at 43.

property."[127] In some cases, the debtor's inability to extinguish a lease may reduce the value of the underlying property, and thereby reduce the assets available for distribution to creditors. If, however, that is what the Bankruptcy Code provides and what Congress intended, it should not be overruled by judicial fiat.[128]

The Seventh Circuit's decision, moreover, exacerbates rather than avoids this apparent alteration of priorities. According to the Seventh Circuit, a lessee whose leasehold interest is extinguished by a free-and-clear sale is entitled to be "compensated for the value of its leasehold—typically from the proceeds of the sale."[129] This means that the value of the leasehold would be effectively treated as a secured claim that would come ahead of unsecured claims.[130] Indeed, according to the Seventh Circuit, this claim would prime senior liens in the property.[131] This is neither what Congress intended nor what § 365(h) provides. Section 365(h) gives special treatment to a lessee's possessory rights but it does not convert the cash equivalent of the lessee's leasehold interest into a secured or priority claim. Indeed, it is clear from § 365 that, if the lessee elects to treat the lease as rejected, the lessee is only entitled to a prepetition, unsecured claim for rejection damages.[132] The Bankruptcy Code does not afford special treatment of the lessee's rejection-damage claim. This is recognition of the fact that it is the lessee's possessory rights that Congress intended to protect and accord special treatment.

Although there may be circumstances in which the debtor's inability to extinguish a leasehold may reduce the value of the underlying asset or impair the ability of the debtor to reorganize, it should not be assumed that the debtor would have the right to sell the underlying property free and clear of the lease in the first place. The fact is that the debtor's right to sell free and clear is narrowly circumscribed by § 363(f). The debtor can only sell free and clear if at least one of the five requirements of § 363(f) is satisfied. In the context of sales free and clear of leases, the only requirement that is usually satisfied is § 363(f)(4), where the lease is in *bona fide* dispute. This is because applicable nonbankruptcy law rarely, if ever, permits a sale free and clear of leasehold interests, as required by § 363(f)(1).[133] The lessee seldom consents, as required by

127. Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, No. IP00-0247-C-H/G, 2001 WL 699881, at *10 (S.D. Ind. April 24, 2001).

128. *Id*. at *14 ("[W]hether [this] . . . is the most sensible [result] . . . matters little if Congress intended that result.").

129. Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 548 (7th Cir. 2003) (citations omitted).

130. *See supra* notes 110–11 and accompanying text.

131. *See supra* notes 110–11 and accompanying text.

132. *See* 11 U.S.C. §§ 365(g), 365(h)(1)(A)(i), 502(g) (2000). Section 365(h)(1)(A)(i) gives the lessee the alternative option to treat the rejection as a termination of the lease. Section 365(g) provides that a rejection-damage claim is be treated as a prepetition unsecured claim. *See In re* Chestnut Ridge Plaza Assocs. v. Fox Grocery Co. (*In re* Chestnut Plaza Assocs., LP), 156 B.R. 477, 483 (Bankr. W.D. Pa. 1993); *see also* NORTON, *supra* note 11, § 39:24, at 39-80 to 39-83; COLLIER, *supra* note 11, ¶ 365.09[1], at 365-73; BIENENSTOCK, *supra* note 117, at 449–50.

133. The reference to "applicable nonbankruptcy law" in § 363(f)(1) is to a sale by the debtor. It does not refer to foreclosure sales by a lienholder or a person other than the debtor. Therefore, an inquiry as to whether a foreclosure sale by a lienholder would extinguish the lessee's possessory rights

§ 363(f)(2).[134] A leasehold interest is not a "lien," as required by § 363(f)(3).[135] Additionally, a lessee cannot be compelled to accept a money satisfaction of its leasehold interest, as required by § 363(f)(5).[136] Therefore, the only circumstance in which a debtor usually will be able to sell free and clear of leasehold interests is where the existence or validity of the lease is in *bona fide* dispute.[137] As a result, subordinating the sale power under § 363(f) to the provisions of § 365(h) will not usually frustrate bankruptcy policies as argued by some.[138] In any event, the fact that in certain circumstances § 363(h) may give a lessee leverage over a debtor's reorganization is not a valid basis for disregarding otherwise applicable provisions of the Bankruptcy Code in an effort to promote reorganization. The statutory rights of lessees should not be sacrificed on the altar of reorganization.

What of the argument that the Seventh Circuit only allowed the buyer to do what it was permitted under applicable state law to do anyway as the first mortgagee, namely, to cut out a lease that was junior to its lien?[139] Whatever rights the

is misdirected. Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, No. IP00-0247-C-H/G, 2001 WL 699881, at *15 (S.D. Ind. April 24, 2001).

134. If the lessee consents, there is obviously no issue. The court should not, however, construe the lessee's failure to object as consent unless the circumstances are such that it is reasonably clear that the debtor intends to sell free and clear of the lessee's lease. In *Precision Industries*, not only was it unclear that the debtor intended to sell free and clear of Precision's lease, but, from both the sale motion and the sale order, it appeared that the issue on the lease was deferred to the closing, at which time the buyer would identify the executory contracts and unexpired leases to be assumed by the debtor and assigned to the buyer. *See Qualitech* Order dated August 13, 1999, *supra* note 53, ¶ 9, at 9.

What about the argument that Qualitech could sell free and clear of the lease because the mortgagee, whose claim was senior to the lease, consented to the sale? In other words, because the mortgagee could have extinguished the lease in a foreclosure sale, and the mortgagee consented to a sale free and clear of its mortgage lien, Qualitech, therefore, was able to sell free and clear of the lease. This argument fails because the "consent" required under § 363(f)(2) to sell free and clear of the lease is the consent of the lessee, not the mortgagee.

135. "Lien" is defined in the Bankruptcy Code to mean "charge against or interest in property to secure payment of a debt or performance of an obligation." 11 U.S.C. § 101(37) (2000). *See In re* Taylor, 198 B.R. 142, 160 (Bankr. D.S.C. 1996) (stating that true leases are not liens for the purposes of § 363(f)(3)); *see also* Folger Adam Sec., Inc. v. DeMatteis/MacGregor JV, 209 F.3d 252, 259–60 (3rd Cir. 2000).

136. Section 363(f)(5) has been interpreted in two ways: (i) the debtor must pay the full amount of the interest unless equitable considerations justify extinguishment for less than the full amount; and (ii) the sale may be authorized if the interest holder can be "crammed down" pursuant to § 1129(b)(2). *In re* Trans World Airlines, 322 F.3d 283, 291 (3rd Cir. 2003); Scherer v. Federal Nat'l Mortgage Ass'n (*In re* Terrace Chalet Apartments, Ltd.), 159 B.R. 821, 829 (N.D. Ill. 1993); NORTON, *supra* note 11, § 37:22, at 37-58; COLLIER, *supra* note 11, ¶ 363.06[6], at 363-51 to 363-52. The contents of reorganization plans, including the requirements for cramdowns, are subject to the provisions of § 365. 11 U.S.C. § 1123(b)(2) (2000). Therefore, any attempt to cram down a lessee would be subject to the lessee's section 365(h) rights. *See* Solon Automated Servs., Inc. v. Georgetown of Kettering, Ltd., 22 B.R. 312, 316 (Bankr. S.D. Ohio 1982). The only other authority in the Bankruptcy Code to reduce a leasehold interest to a monetary claim would be § 363(f) itself, which would require § 363(f)(5) to be nonsensically self-referential. The judicial interpretation of § 363(f)(5), however, is unsettled. *See generally* Kuney, *supra* note 50, at 254–55.

137. The standard for determining whether a "*bona fide* dispute" exists is whether there is an objective basis for either a factual or legal dispute as to the validity of the asserted interest. *Taylor*, 198 B.R. at 162. *See infra* notes 158–59 and accompanying text.

138. Haydon & March, *supra* note 68, at 43.

139. It is also possible that Precision's lease may have been avoided by the debtor (as opposed to the purchaser) under § 544(a)(3) because of the failure to record the lease in accordance with the Indiana priority statute. *See* Webber Lumber & Supply Co. v. Trucklease Corp. (*In re* Webber Lumber

buyer may have had under state law, it elected to proceed by way of a § 363(f) sale. Presumably, the buyer determined that § 363(f) offered greater benefits or better protection than obtaining relief from the automatic stay and proceeding by way of foreclosure under state law. Having elected to proceed under § 363(f), it is not open to the buyer to argue that it could have accomplished the same result by foreclosure. By electing to proceed under § 363(f), "the buyer must take the bitter with the sweet."[140] Section 363(f) was neither intended nor does it enable a debtor to deprive a lessee of its § 365(h) rights. It is irrelevant that a foreclosure sale would have accomplished this result, if § 363(f) could not. Moreover, the Seventh Circuit in *Precision Industries* did not limit its holding to circumstances in which the buyer is also a lienholder capable of extinguishing the lessee's unrecorded leasehold interest in a foreclosure sale. (Indeed, the Seventh Circuit did not even limit its holding to circumstances in which the property is subject to senior liens capable of extinguishing the lease in a foreclosure sale.) In many cases, the buyer at a § 363(f) sale is not the mortgagee, and, as such, would not have the right to extinguish a leasehold through a foreclosure sale. *Precision Industries* could be used in those circumstances to dispossess a lessee despite that the buyer was not capable of extinguishing the lessee's leasehold interest.

Practical Problems Created by *Precision Industries*

If *Precision Industries* is followed by other courts, it will have profound consequences for lessees, in particular, and real estate lease financings, in general. In addition, the case may have similar consequences for licensees of intellectual property if the debtor-licensor attempts to sell the underlying intellectual property free and clear of interests.[141]

& Supply Co., Inc.), 134 B.R. 76, 80 (Bankr. D. Mass. 1991) (holding unrecorded lease avoided by trustee under 544(a)); NORTON, *supra* note 11, § 39:35, at 39-108. But the debtor, Qualitech, did not seek to avoid the lease. The case before the Seventh Circuit, as in the courts below, was prosecuted by the purchaser, New Qualitech, not by the debtor. *See supra* note 39. An examination of the relationship between § 544 and § 365(h) is beyond the scope of this Article.

140. Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, No. IP00-0247-C-H/G, 2001 WL 699881, at *15 (S.D. Ind. April 24, 2001). In full, the court stated:

> By purchasing assets rather than going through a foreclosure, the buyer obtained a going business and some important benefits, including the right to have the debtor assume any *favorable* contracts or leases and assign those to the buyer. Having chosen that form of transaction, the buyer must take the bitter with the sweet.

Id.

141. Section 365(n) protects the rights of licensees of intellectual property in much the same way that § 365(h) protects the possessory rights of lessees. Section 365(n) provides, in relevant part, as follows:

> If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee, under such contract may elect— . . . to retain its rights . . . under such contract . . . to such intellectual property, . . . as such rights existed immediately before the case commenced, for—(i) the duration of such contract; and (ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.

11 U.S.C. § 365(n)(1) (2000).

First, the Seventh Circuit's decision has effectively nullified § 365(h) and stripped lessees of the statutory protection afforded to them by Congress. The Seventh Circuit has endorsed the use of § 363(f) to circumvent the specific provisions of § 365(h), despite that the statute on its face clearly indicates that all § 363 sales are subject to the provisions of § 365.[142] Moreover, the court has given license to stealth rejections, that is, the *de facto* rejection of a lease without the procedural and substantive protections afforded by § 365.[143] The Seventh Circuit recognized that the effect of the free-and-clear sale was "the equivalent of a repudiation of Precision's lease."[144] Yet the court chose to ignore the consequence of repudiation by drawing an artificial distinction between "repudiation" and "rejection."

If repudiation is not rejection, it cannot be disputed that the debtor, ultimately, would have to reject the lease, as indeed did occur. If the Seventh Circuit did what it said it was doing, namely, construing the two statutory provisions to avoid a conflict and thereby allowing each provision to function, should § 365(h) not be triggered upon the subsequent rejection of Precision's lease? The answer must be yes. As a result of the free-and-clear sale, it was impossible for Precision to exercise its § 365(h) rights upon rejection. Therefore, the effect of the Seventh Circuit's decision is to render § 365(h) a practical nullity. The decision will encourage debtors to attempt stealth rejections of leases to circumvent the requirements of § 365(h).[145] Debtors will be motivated to accomplish indirectly what they could not directly. The consequences may be devastating to lessees and real estate lease financiers who rely on the ability of lessees to retain possession of their leasehold interests in the event of the bankruptcy of the lessor.

Take the not uncommon situation where a person enters into a long-term, $10-million ground lease and constructs a $500-million building on the land. Not only has the lessee made substantial improvements on the land in reliance on its ability to retain the leasehold in the event of the bankruptcy of the lessor, but the lenders who have financed the construction have advanced money and taken a security interest in the leasehold in the same reliance. In the event of the lessor's bankruptcy, can the debtor-lessor sell the property free and clear of the ground lease? As a threshold matter, there ordinarily would not be any basis for a free-and-clear sale under § 363(f). Therefore, the debtor could not sell the land free of the lease.[146] Assuming there was a basis for a free-and-clear sale, however, the sale should be still subject to the lessee's § 365(h) rights for the reasons discussed in this Article. But if *Precision Industries* is followed, the debtor would be able to

If a sale free and clear of interests is not "rejection" under § 365(h), then it very likely would not be "rejection" under § 365(n). As a result, § 365(n) would not be triggered, and the licensee would be deprived of its statutory rights to the intellectual property. An examination of these issues is outside the scope of this Article.

142. *See* Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 548 (7th Cir. 2003).

143. *See id*.

144. *Id*. at 547.

145. Licensees of intellectual property rights from a debtor face the same risk. *See supra* note 141 and *infra* notes 156–57 and accompanying text.

146. *See supra* notes 133–37 and accompanying text.

extinguish the leasehold, completely circumvent § 365(h), and deprive the lessee of its § 365(h) rights and the lease financier of its collateral. Indeed, if *Precision Industries* is followed, the debtor will be given a power by the court that it was denied by Congress, namely the power to cramdown a lessee by converting the lessee's possessory rights to merely an adequate protection payment.

The potentially devastating consequences of this cannot be overstated. A debtor who desires to reject a lease but otherwise would have been subject to the lessee's § 365(h) rights, now, will try simply to effect a § 363(f) sale to extinguish the lease. As a result, and according to the Seventh Circuit, the debtor will merely incur the liability for an adequate protection payment to the dispossessed lessee. But this, in fact, is an advantage to the debtor because the debtor will have succeeded in a cramdown of the lessee—something it could not have accomplished in a plan of reorganization.[147] Indeed, the § 363(f) sale may be simply a prelude to a plan of reorganization or perhaps even incorporated into the plan. The result, however, is clear: a judicial repeal of § 365(h).

Second, *Precision Industries* allows a debtor to effect a free-and-clear sale that covertly extinguishes a lessee's possessory rights under circumstances in which the lessee may not have a reasonable basis to know that the sale was intended to be free and clear of its lease. In *Precision Industries*, the debtor did not clearly indicate in its § 363 motion that it was seeking to sell free and clear of Precision's lease.[148] The debtor avoided any reference in the sale motion or the sale order to selling free and clear of Precision's lease, instead including broad free-and-clear language that could be interpreted to include the lease. This fact, by itself, is not problematic. The problem is that the motion expressly sought, and the sale order expressly granted, authority for the later assumption and assignment of unexpired leases.[149] The effect was to lull Precision into a false sense of security that any issue regarding its lease would be resolved at a later time. Worse yet, the parties, following the sale order, entered into several agreements to extend the time in which to assume and assign Precision's lease, and continued to negotiate over the ultimate disposition of the lease. This course of conduct doubtless worked to confirm Precision's belief that its lease was unaffected by the sale and would be addressed at a later time.[150] But when New Qualitech failed to come to terms with

147. *See supra* note 136.

148. Indeed, the sale motion sought authority for the debtor to assume and assign executory contracts and unexpired leases to the purchaser. The sale order provided that, prior to closing, the purchaser shall designate those "executory contracts and unexpired leases of the Debtors that shall be assumed and assigned to the Purchaser at the Closing." *Qualitech* Order dated August 13, 1999, *supra* note 53, ¶ O, at 6. In addition, the sale order authorized the assumption and assignment, at the closing, of executory contracts and unexpired leases designated by the purchaser. *Id.* ¶ 9, at 9. All objections to assumption and assignment were "preserved until such time." *Id.* Therefore, it was perfectly reasonable for Precision to assume that any issues regarding its lease would be dealt with, not at the sale hearing, but at the closing.

149. *Id.*

150. It could not have been a surprise to Precision that the debtor wanted to reject its one dollar-a-year lease unless the rent terms were altered. The surprise was that the sale, unbeknownst to Precision, was free and clear of its leasehold. Precision believed that the issue with its lease was reserved to be dealt with later. *See supra* note 148.

Precision months after the sale, it was, for the first time, asserted that Precision's leasehold had been extinguished earlier by the § 363(f) sale.

Even if grounds existed for a § 363(f) sale free and clear of the lease (and it is doubtful that they did),[151] the bankruptcy court should not have permitted the debtor to sell free and clear of Precision's lease without requiring the debtor to raise the issue squarely and unambiguously before the court to put Precision on notice.[152] To sell free and clear of Precision's lease under the ambiguous, if not misleading, circumstances of the case was manifestly unfair. The Seventh Circuit's decision will feed the paranoia of many bankruptcy lawyers that it is necessary to object to all motions that can even arguably affect their clients' interests. *Precision Industries* puts bankruptcy lawyers on notice that, as a matter of prudence, they must object to every free-and-clear sale to avoid Precision's fate. Surely, neither debtors nor creditors nor the bankruptcy court is well served by reflexive objections designed to protect rights that do not appear to be challenged.

Third, even if § 363(f) allows a sale free and clear of leases, and, as the Seventh Circuit has assured, the lessee is entitled to adequate protection under § 363(e), to what kind of adequate protection is the lessee entitled? According to the Seventh Circuit, "'[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."[153] Therefore, upon a request for adequate protection, the lessee is entitled to either possession or, alternatively, cash compensation from the sale proceeds. At the outset, it should be recognized that converting the lessee's possessory rights to an adequate protection claim is effectively an impermissible cramdown of the lessee.[154] But assuming *arguendo* that adequate protection is applicable, what happens when the sale proceeds are insufficient to cover any liens on the property subject to the lease? Is the lessee out of luck, or is the lessee entitled to adequate protection ahead of the lien holders? The Seventh Circuit, by approving the conversion of the lessee's possessory rights to cash in the form of an adequate protection payment, may be creating a new priority that did not previously exist. On the other hand, if the lessee is only entitled to adequate protection in the event that the sale proceeds are greater than the liens, the adequate protection rights articulated by the Seventh Circuit will be illusory in circumstances in which the liens exceed the sale proceeds.

Finally, *Precision Industries* may be used as judicial support of the debtor's broad right to sell free and clear under § 363(f), when in fact a debtor's right to sell free and clear of interests is limited, and the circumstances in which a debtor may sell free and clear of leases are rare.[155] *Precision Industries* will encourage debtors to

151. *See supra* note 53.

152. *See* Folger Adam Sec., Inc. v. DeMatteis/MacGregor JV, 209 F.3d 252, 265 (3rd Cir. 2000) (noting notice of sale did not provide a creditor with sufficient information to put it on notice that its interest would be extinguished by the proposed sale if it did not file an objection). An examination of the "due process" issues is beyond the scope of this Article.

153. Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 548 (7th Cir. 2003).

154. *See supra note* 136.

155. *Supra* notes 133–37 and accompanying text.

effect § 363(f) sales free and clear of anything and everything without a considered judicial determination that the conditions of § 363(f) are in fact satisfied.

AFTER *PRECISION INDUSTRIES V. QUALITECH STEEL*

Contrary to the decision of the Seventh Circuit, a free-and-clear sale under § 363(f) is indeed subject to the lessee-protection provisions of § 365(h). Therefore, a debtor, in a sale free and clear of interests, cannot extinguish a lessee's possessory rights protected by § 365(h). Nonetheless, life after *Precision Industries* must be different or else lessees run the substantial risk of losing both their leaseholds and their § 365(h) rights in free-and-clear sales. In addition, and as previously discussed, licensees of intellectual property also risk the loss of their rights to intellectual property under § 365(n) in the event of a free-and-clear sale by the debtor of the underlying intellectual property.[156] The following strategies should be employed to protect leasehold interests in the event of a free-and-clear sale. These strategies can and should be employed simultaneously. Similar strategies can be employed by licensees of intellectual property to protect their § 365(n) rights in a free-and-clear sale by the debtor of the underlying intellectual property.[157]

First, in jurisdictions outside the Seventh Circuit, it should be argued that *Precision Industries* is wrongly decided and should not be followed. Indeed, should the matter again reach the Seventh Circuit, it should be argued that *Precision Industries* should be reversed.

Second, a lessee should object to a § 363(f) sale unless the proposed sale is expressly made subject to its lease. The objection should be based on the failure of the debtor to satisfy the requirements of § 363(f) to effect such a sale. This will bring the issue squarely before the bankruptcy court and avoid a situation in which it is assumed that there is a statutory basis for the sale, where none may exist. In the event that the lease is subject to a *bona fide* dispute, the lessee should argue that § 365(h) requires that the dispute be resolved before the sale or, at least, that both the sale and the dispute be heard and decided contemporaneously.[158] There is authority that the bankruptcy court is not required to resolve the dispute before the sale.[159] The lessee, however, should argue that the sale should not be free and clear of its leasehold interest until the underlying dispute is resolved by the court. In most sales under § 363(f)(4), where the basis for the sale is that the interest is in *bona fide* dispute, there is no express statutory provision protecting the interest that the debtor seeks to sell free and clear of, so there is usually no compelling statutory reason why the bankruptcy court should delay the sale to resolve the underlying dispute. Such is not the case, however,

156. *See supra* notes 141, 145, and *infra* note 157 and accompanying text. An examination of the relationship between § 363(f) and § 365(n) is beyond the scope of this Article.

157. *See supra* notes 141, 145, 156 and accompanying text.

158. *See supra* note 137.

159. *See*, *e.g.*, *In re* Taylor, 198 B.R. 142, 161 (Bankr. D.S.C. 1996); *In re* Clark, 266 B.R. 163, 171 (9th Cir. BAP 2001) (stating the purpose of § 363(f)(4) is to allow estate assets to be sold free and clear of disputed interests without the delay of the resolutions of such disputes).

in a sale free and clear of leases. Because § 365(h) expressly protects the possessory rights of lessees, the bankruptcy court should not approve a sale free and clear of a lease without a prior resolution of the underlying dispute that forms the basis for the § 363(f)(4) sale.

Third, the lessee should move to compel the debtor's assumption or rejection of the lease and give notice of the lessee's exercise of its § 365(h) rights in the event of rejection. This will force the issue that the Seventh Circuit tried to avoid. In the face of a motion to sell the underlying property free and clear that will effectively repudiate the lease, the debtor will be compelled to concede that the lease must be rejected as a result of the sale. The lessee should seek to have rejection dealt with at the same time as the sale hearing. By doing so, the lessee can then assert its § 365(h) rights, which will produce an inescapable conflict between § 363(f) and § 365(h). In the face of such a conflict, the well-accepted rule of statutory construction, namely, that specific legislation takes priority over general legislation, should be applied, resulting in the primacy of § 365(h) over § 363(f).

Fourth, the lessee should request adequate protection of its leasehold interest in the property. The lessee should argue that adequate protection and § 365(h) demand that it retain possession of the leased premises. This is the only way in which the lessee can be adequately protected and avoid an impermissible cram-down, if the court approves a sale free and clear of its lease. If the case is in the Seventh Circuit, the lessee should argue, in the alternative and without conceding that anything less than possession is adequate, that adequate protection requires that it receive in cash the value of its leasehold interest, regardless of existing liens, plus any costs of improvements or tenant build-out, relocation and resulting loss of profits.

It is key to these strategies to employ them simultaneously and to seek a resolution of these issues contemporaneously with the sale hearing. The lessee must avoid a bifurcation of the sale from the lease rejection. Only by so doing can the lessee best avoid Precision's fate.

Unfortunately, these strategies are all defensive in nature. There does not appear to be any prophylactic strategy that can be adopted. Although lessees should continue to require nondisturbance and subordination agreements from all senior mortgagees to avoid dispossession in the event of foreclosure by the mortgagees, these agreements will not protect the leasehold in the event of a § 363(f) free-and-clear sale to a person other than the mortgagees.[160]

Conclusion

The Seventh Circuit's decision in *Precision Industries v. Qualitech Steel* is wrongly decided and should not be followed. The decision is based on two fundamental

160. This is because the basis for the enforcement of nondisturbance and subordination agreements is contract law. Unless the purchaser at the § 363(f) sale is the mortgagee, or unless the purchaser acquires its rights to the property through the mortgagee, there will be no privity of contract between the lessee and the purchaser to enable the lessee's enforcement against the purchaser of the non-disturbance and subordination agreement.

flaws. First, it is based on the erroneous premise that a debtor has a broad right to sell free and clear of interests. Although the "interests" of which a debtor can sell free and clear are broad, the debtor's "right" to sell free and clear is limited. Second, the court held incorrectly that there was no evidence in either § 363(f) or § 365(h) that one was to trump the other. The court, however, overlooked § 363(l), which clearly subordinates all sales under §§ 363(b) and (c) to the provisions of § 365. Contrary to the holding of the Seventh Circuit, a debtor's right to sell free and clear of interests under § 363(f) is expressly limited by § 365(h).

The Seventh Circuit, in an effort to avoid a conflict between § 363(f) and § 365(h), and thus to give effect to both provisions, ignored the reality that a sale effecting the repudiation of a lease is tantamount to rejection. In so doing, the court failed to see that, upon the event of rejection, § 365(h) would be rendered "a practical nullity and a theoretical absurdity"[161] because the prior sale made it impossible for the lessee to exercise its § 365(h) rights. Ironically, the Seventh Circuit, in the end, did the very thing it sought to avoid.

161. United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 375 (1988).