

Alert

Third Circuit Protects Commercial Tenant with Rejected Lease from Bankruptcy Sale Purchaser

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“Section 365(h) of the Bankruptcy Code [(“Code”)] and the doctrine of equitable recoupment entitled [a commercial tenant] to continue paying [reduced] rent ... even after its landlord filed for bankruptcy and rejected the Lease,” held the U.S. Court of Appeals for the Third Circuit on Nov. 30, 2018. *In re Revel AC Inc.*, 2018 WL 6259316, *6 (3d Cir. Nov. 30, 2018). Affirming the lower courts, the Third Circuit sensibly explained that “[n]othing in the agreements or court orders governing [a third party’s] purchase of the [debtor’s] casino in bankruptcy changes this result.” *Id.*

Relevance

Few cases address a landlord debtor’s bankruptcy and its effect upon tenants. This case deals not only with the landlord debtor issue but also with the effect of a bankruptcy court’s asset sale order permitting the sale to be “free and clear of all liens, claims, encumbrances and other interests of any kind” under Code § 363(f). The asset buyer here (“P”) had “first tried to purchase [the debtor’s] assets under a sale order that would have extinguished [the tenant’s] possessory rights under the Lease,” but the Third Circuit, “in a prior decision,” stayed that proposed sale order. See *In re Revel AC Inc.*, 802 F.3d 558, 575 (3d Cir. 2015).

Code § 363(f) allows a trustee or a debtor in possession (“DIP”) to sell property of the estate “free and clear of any interest in such property,” and a lease is an “interest in such property.” But Code § 365(h) allows the debtor’s tenant to choose between the termination of its lease and the continuation of its leasehold when the DIP, for example, rejects its unexpired real property lease. At bottom, *Revel* clarifies the important issue of whether a bankruptcy trustee or DIP can use a § 363(f) sale to extinguish a tenant’s possessory interest when Code § 365(h) protects that interest. Despite the often-criticized holding of the Seventh Circuit in *Precision Industry Inc. v. Qualitech Steel SBO LLC*, 327 F.3d 537 (7th Cir. 2003) (§ 365(h) doesn’t disable § 363(f)’s authority to sell leased property free and clear of the lease; § 365(h) triggered only when DIP rejects lease under § 365), Code § 365(h) does limit a trustee or DIP’s right to sell free and clear of interests under § 363(f). See Michael S. Baxter, “Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in *Precision Industries v. Qualitech Steel*,” 59 Bus. Law 1, 27 (February 2004) (“a debtor’s right to sell free and clear of interests under § 363(f) is expressly limited by § 365 (h)”).

Facts

The debtor owned an Atlantic City, New Jersey, casino. It had entered into a complex commercial lease (“Lease”) with a nightclub operator (“T”) long before it entered Chapter 11 in 2014. According to the Third Circuit, the “almost impenetrable” lease “is long and neither simple nor direct.” *Id.* During the bankruptcy case, the tenant sued the debtor to protect its rights under the lease. P later bought the debtor’s assets, including the casino, under purchase agreements that the bankruptcy court had approved in a “Sale Order.”

Purchase Agreement. The purchase agreement provided that P would purchase the debtor's assets "free and clear of all liabilities except for those listed in the" purchase agreement including a potential liability to T "for an administrative expense claim up to a specified maximum amount." *Id.* at *1. P also would agree to "acquire certain legal claims [the debtor] may have against [T] with respect to the Lease [including] any rent payments that [T] may still owe under the Lease." *Id.*

Sale Order. The Sale Order authorized P's purchase "free and clear of all liens," etc., consistent with Code § 363(f). But the Sale Order ... expressly preserved certain rights relating to [T's] continued use of the casino premises under the Lease ... : "[a]ny rights (including rights of setoff and recoupment), claims and defenses of [T] ... with respect to [T's] adversary proceeding against [the debtor]"; plus "any rights elected to be retained by [T] pursuant to" Code § 365(h) after the debtor rejected the Lease. *Id.* This "carve-out of ... tenant rights" "set the stage for further litigation between [T and P] under the terms of the Lease" *Id.* at *2. After the debtor rejected the Lease, T filed a notice electing to "retain its rights as a tenant under § 365(h), ... as expressly allowed by the Sale Order." *Id.*

Litigation. The parties then litigated whether T was "permitted to deduct from its outstanding rent obligations certain 'recoupment' amounts owing to [T] under the Lease." The bankruptcy court granted T's summary judgment motion to the extent of permitting T "to offset" against future rent "any damages caused, after rejection, by [P's] nonperformance" under the Lease and enabling T to "apply and set off the Recoupment Amount, as defined in the Lease" *Id.* at *2. On appeal, P challenged the amount of its obligations subject to recoupment.

Capital Contributions. The Lease contemplated that both the debtor and T "would make capital contributions to 'build out' [T's] venues before opening them." The "relative proportions of capital contributed by" the parties were the basis for the Lease's rent and recoupment obligations. *Id.*

Rent Obligations. "The Lease contemplated that [T] would pay rent to [the debtor] each month on a venue-by-venue basis," apportioning each party's capital contribution among the three leased venues. The parties would use the "distributable cash flow from" each venue to determine the share of their required capital contributions.

Recoupment Obligations. The Lease required the debtor to make certain "recoupment" payments to T during the first four years of the Lease if one of the leased venues met the "applicable gross-sales threshold but did not have a positive return to capital net of depreciation." In that case, the debtor "would refund to [T] the amount necessary to cause [T] to break even for that period." *Id.* at *3.

The Lower Courts

The bankruptcy court and district court ruled that T had "a right to reduce its rent obligations to [P] by the amount of [P's] recoupment obligations under the Lease." *Id.*

T had retained certain rights when it made its election under Code § 365(h) to remain in possession, which included its "right to reduce its rent obligations by the recoupment amounts." Also, T "would be permitted to reduce its rent obligations under the doctrine of equitable recoupment." *Id.*

The Third Circuit

Code § 365(h) Election. Section 365(h) "protects a tenant whose landlord files for bankruptcy and then rejects the tenant's lease." *Id.* The Sale Order expressly preserved "any rights elected to be retained by

[T]” under Code § 365(h). T also preserved its rights when it made its § 365(h) election after the bankruptcy court had granted the debtor’s motion to reject the Lease. A “tenant who makes an election under [§ 365(h)] is ‘entitled to remain under the same rental terms as set forth in the lease.’” *Id.*, quoting *in re Flagstaff Realty Assocs.*, 60 F.3d 1031, 1034 (3d Cir. 1995).

The “rental terms” under which T leased property from the debtor included “the right to receive recoupment payments under the Lease.” *Id.* at *4. Because T had a “statutory right to remain in possession of the premises under the same rental terms,” it was “permitted to reduce its rent obligations by the recoupment amounts applicable under the Lease for the balance of the term of the Lease after the date of rejection.” *Id.*

Equitable Recoupment. According to Third Circuit precedent, “[w]hen a claim against a debtor qualifies for equitable recoupment, the claim ‘avoids the usual bankruptcy channels,’ in that it receives full value in the netting of obligations between a creditor and the debtor without regard to the bankruptcy priority of the claim — ‘thus, in essence, [the claim] is given priority over other creditors’ claims.” *Id.* at *4, quoting *Flagstaff*, 60 F.3d at 1035, and *In re Anes*, 195 F.3d 177, 181-82 (3d Cir. 1999). “Recoupment means ‘the setting up of a demand arising from the same transaction as the plaintiff’s claim or cause of action, strictly for the purpose of abatement or reduction of such claim.’” *Id.* at *5, quoting *In re Univ. Med. Ctr.*, 973 F.2d 1065, 1079 (3d Cir. 1992).

The Third Circuit agreed that “the doctrine of equitable recoupment requires reducing [T’s] existing rent obligations by [P’s] recoupment obligations.” *Id.* Because the “recoupment provisions of the Lease performed a periodic downward adjustment to [T’s] rent obligations under the Lease,” the parties’ opposing claims arose from the same transaction. Thus, it would be unfair to require T “to pay the full amount of its rental obligations without applying the countervailing downward adjustments contemplated by the recoupment provisions.” *Id.*, citing *Flagstaff*, 60 F.3d at 1035.

The Sale Order also preserved T’s setoff and recoupment rights, thereby eliminating any argument that P could make under Code § 363(f) (sale “free and clear of all liens, claims, encumbrances and other interests of any kind”). In any event, the Third Circuit stressed that because “equitable recoupment is an affirmative defense,” any asset sale “free and clear” of liens, encumbrances and interests “does not include defenses to claims.” *Id.*, citing *Folger Adam Sec. Inc. v. DeMatteis/MacGregor, JV*, 209 F.3d 252, 257, 258-64 (3d Cir. 2000) and *In re Trans World Airlines Inc.*, 322 F.3d 283, 289 (3d Cir. 2003) (“[A] right of recoupment is a defense and not an interest and therefore is not extinguished by a § 363(f) sale.”).

No Affirmative Recovery Authorized. Finally, the Third Circuit stressed that T was not “entitled to recover affirmatively any recoupment amount from [P].” *Id.*, n.6. It limited its holding “to giving [T] the right to reduce its rent obligations to [P].” *Id.*

Comment

The Third Circuit, as noted, had previously rescued T from P. In 2015, it stayed part of a bankruptcy court sale order that would have “stripped” T’s lease from the casino property being sold to P. *In re Revel AC Inc.*, 802 F.3d 558 (3d Cir. 2015). Reversing the lower courts’ denial of a limited stay pending T’s appeal from the sale order, the Third Circuit not only recognized the public interest in protecting commercial tenants’ rights, but also held that the debtor had shown no “objective basis — either in law or fact — to cast doubt on the validity of” the debtor’s lease with T. *Id.* at 575.

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