

In A Landlord Bankruptcy Sale, What Happens To The Lease?

By **Michael Cook** (December 14, 2018, 3:08 PM EST)

The U.S. Court of Appeals for the Third Circuit held on Nov. 30, 2018, that “Section 365(h) of the Bankruptcy 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 [l]ease,” in *In re Revel AC Inc.*[1] 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.”[2]

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 Section 363(f). The asset buyer here 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.[3]

Code Section 363(f) allows a trustee or a debtor in possession 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 Section 365(h) allows the debtor’s tenant to choose between the termination of its lease and the continuation of its leasehold when the debtor in possession, for example, rejects its unexpired real property lease. At bottom, *Revel* clarifies the important issue of whether a bankruptcy trustee or debtor in possession can use a Section 363(f) sale to extinguish a tenant’s possessory interest when Code Section 365(h) protects that interest. Despite the often-criticized holding of the Seventh Circuit in *Precision Industry Inc. v. Qualitech Steel SBQ LLC*,[4] (Section 365(h) doesn’t disable Section 363(f)’s authority to sell leased property free and clear of the lease; Section 365(h) triggered only when debtor in possession rejects lease under Section 365), Code Section 365(h) does limit a trustee or debtor in possession’s right to sell free and clear of interests under Section 363(f).)[5]

Facts

The debtor owned an Atlantic City, New Jersey, casino. It had entered into a complex commercial 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.”[6] During the bankruptcy case, the tenant sued the debtor to protect its rights under the lease. The asset buyer 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 the buyer 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 the nightclub operator "for an administrative expense claim up to a specified maximum amount." [7] Buyer also would agree to "acquire certain legal claims [the debtor] may have against [nightclub operator] with respect to the [l]ease [including] any rent payments that [club operator] may still owe under the [l]ease." [8]

Sale Order

The sale order authorized buyer's purchase "free and clear of all liens," consistent with Code Section 363(f). But the sale order expressly preserved certain rights relating to [club operator's] continued use of the casino premises under the lease: "[a]ny rights (including rights of setoff and recoupment), claims and defenses of [club operator] ... with respect to [operator's] adversary proceeding against [the debtor]"; plus "any rights elected to be retained by [club operator] pursuant to" Code Section 365(h) after the debtor rejected the lease. [9] This "carve-out of ... tenant rights" "set the stage for further litigation between [club operator and buyer] under the terms of the lease." [10] After the debtor rejected the lease, club operator filed a notice electing to "retain its rights as a tenant under Section 365(h) ... as expressly allowed by the sale order." [11]

Litigation

The parties then litigated whether club operator was "permitted to deduct from its outstanding rent obligations certain 'recoupment' amounts owing to [operator] under the lease." The bankruptcy court granted nightclub operator's summary judgment motion to the extent of permitting operator "to offset" against future rent "any damages caused, after rejection, by [buyer's] nonperformance" under the lease and enabling operator to "apply and set off the recoupment amount, as defined in the lease." [12] On appeal, buyer challenged the amount of its obligations subject to recoupment.

Capital Contributions

The lease contemplated that both the debtor and club operator "would make capital contributions to 'build out' [operator'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. [13]

Rent Obligations

"The lease contemplated that [operator] 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 club operator 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 [club operator] the amount necessary to cause [operator] to break even for that period.”[14]

The Lower Courts

The bankruptcy court and district court ruled that club operators had “a right to reduce its rent obligations to [buyer] by the amount of [buyer’s] recoupment obligations under the lease.”[15]

Nightclub operator had retained certain rights when it made its election under Code Section 365(h) to remain in possession, which included its “right to reduce its rent obligations by the recoupment amounts.” Also, operator “would be permitted to reduce its rent obligations under the doctrine of equitable recoupment.”[16]

The Third Circuit

Code Section 365(h) Election

Section 365(h) “protects a tenant whose landlord files for bankruptcy and then rejects the tenant’s lease.”[17] The sale order expressly preserved “any rights elected to be retained by [club operator]” under Code Section 365(h). Nightclub operator also preserved its rights when it made its Section 365(h) election after the bankruptcy court had granted the debtor’s motion to reject the lease. A “tenant who makes an election under [Section 365(h)] is ‘entitled to remain under the same rental terms as set forth in the lease.’”[18]

The “rental terms” under which nightclub operator leased property from the debtor included “the right to receive recoupment payments under the lease.”[19] Because operator 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.”[20]

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.”[21] “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.’”[22]

The Third Circuit agreed that “the doctrine of equitable recoupment requires reducing [club operator’s] existing rent obligations by [buyer’s] recoupment obligations.”[23] Because the “recoupment provisions of the lease performed a periodic downward adjustment to [operator’s] rent obligations under the lease,” the parties’ opposing claims arose from the same transaction. Thus, it would be unfair to require club operator “to pay the full amount of its rental obligations without applying the countervailing downward adjustments contemplated by the recoupment provisions.”[24]

The sale order also preserved operator’s setoff and recoupment rights, thereby eliminating any argument that buyer could make under Code Section 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.”[25]

No Affirmative Recovery Authorized

Finally, the Third Circuit stressed that club operator was not “entitled to recover affirmatively any recoupment amount from [buyer].”[26] It limited its holding “to giving [operator] the right to reduce its rent obligations to [buyer].”[27]

Comment

The Third Circuit, as noted, had previously rescued nightclub operator from buyer. In 2015, it stayed part of a bankruptcy court sale order that would have “stripped” club operator’s lease from the casino property being sold to buyer.[28] Reversing the lower courts’ denial of a limited stay pending club operator’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 club operator.[29]

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[1] In re Revel AC Inc., 2018 WL 6259316, *6 (3d Cir. Nov. 30, 2018).

[2] Id.

[3] See In re Revel AC Inc., 802 F.3d 558, 575 (3d Cir. 2015).

[4] Precision Industry Inc. v. Qualitech Steel SBQ LLC, 327 F.3d 537 (7th Cir. 2003).

[5] 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).”

[6] Id.

[7] Id. at *1.

[8] Id.

[9] Id.

[10] Id. at *2.

[11] Id.

[12] Id. at *2.

[13] Id.

[14] Id. at *3.

[15] Id.

[16] Id.

[17] Id.

[18] Id., quoting *In re Flagstaff Realty Assocs.*, 60 F.3d 1031, 1034 (3d Cir. 1995).

[19] Id. at *4.

[20] Id.

[21] Id. at *4, quoting *Flagstaff*, 60 F.3d at 1035, and *In re Anes*, 195 F.3d 177, 181-82 (3d Cir. 1999).

[22] Id. at *5, quoting *In re Univ. Med. Ctr.*, 973 F.2d 1065, 1079 (3d Cir. 1992).

[23] Id.

[24] Id., citing *Flagstaff*, 60 F.3d at 1035.

[25] 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.”).

[26] Id., n.6.

[27] Id.

[28] *In re Revel AC Inc.*, 802 F.3d 558 (3d Cir. 2015).

[29] Id. at 575.