

## Alert

### Fifth Circuit Gives Commercial Lessees Likely Protection in Bankruptcy Court Free and Clear Asset Sales

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A bankruptcy court gave “unnecessary and unlikely incorrect” reasoning to support its “excessively broad proposition that sales free and clear under [Bankruptcy Code (“Code”)] Section 363 override, and essentially render nugatory, the critical lessee protections against a debtor-lessor under [Code] 365(h),” said the U.S. Court of Appeals for the Fifth Circuit on Feb. 16, 2022. *In re Royal Bistro, LLC*, 2022 WL 499938, \*1-\*2 (5th Cir. Feb. 16, 2022). The court still denied the lessees’ “motion for a writ of mandamus” to “compel the district court to stay pending appeal” from a bankruptcy court order authorizing the trustee’s sale of “the debtor’s real property... free and clear” of the lessees’ interests. *Id.* at \*1. In essence, the Fifth Circuit signaled that it would not approve in later cases a bankruptcy court asset sale of real property that summarily cuts off the rights of the debtor’s lessees.

The Court of Appeals stressed that the lower courts “made the mistake of relying on” the Seventh Circuit’s heavily criticized decision in *Precision Indus Inc. v. Qualitech Steel S.B. Q.*, 327 F.3d 537, 547 (7th Cir. 2003) (Section 365(h) lessee protections against a debtor-lessor do not supersede the free and clear sale terms of Section 363(f)). On the facts of the limited motion before it, the Fifth Circuit rejected the lower courts’ “overstatement of their reasoning,” based on their “serious misinterpretation of law or facts.” 2022 WL 499938, at \*2. Because the “essential state law rights of the tenants in this case [were] limited by the senior mortgagee’s prior lien on the” property being sold, however, “neither [Code] Section 363(e) nor 365(h)(A)(ii) offers [the lessee-appellants] protection.” *Id.* “[S]tate law [was] all that the bankruptcy court needed to decide this case” against the lessees. *Id.*

#### Relevance

The Third Circuit stressed in another similar case that a bankruptcy trustee or Chapter 11 debtor-in-possession cannot summarily use a free and clear sale under Code § 363(f) to sell property subject to a lease free and clear of the lease and thus extinguish a tenant’s possessory interest. *In re Revel AC, Inc.*, 802 F.3d 558, 564, 573 (3d Cir. 2015) (2-1) (lessee sought stay pending appeal from sale order that would “wipe out” the lessee’s interest; stay granted because, among other things, “success to it on the merits was assured”). It stressed that Code § 365(h) protects the lessee’s interest after the trustee’s rejection of the lease when the interest is not disputed in good faith. *Id.* Although the Fifth Circuit in *Royal Bistro* did not cite *Revel*, it noted the heavy criticism of *Qualitech* by other courts and commentators. *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 704 (S.D.N.Y. 2014) (criticizing *Qualitech*); *In re Samaritan Alliance LLC*, 2007 WL 4162918, \*4 (Bankr. E.D. Ky. Nov. 21, 2007); *In re Haskell L.P.*, 321 B.R. 1, 9 (Bankr. D. Mass. 2005); Michael S. Patrick Baxter, “Section 363 Sales Free and Clear of Interests: Why The Seventh Circuit Erred in *Qualitech*,” 59 Bus. Law. 475 (2004) (*Qualitech* had “the potential to profoundly impact the bankruptcy world”); Robert M. Zimman, “Precision in Statutory Drafting: The *Qualitech* Quagmire and the Sad History of § 365(h) of the Bankruptcy Code,” 38 John Marshall L. Rev. 97 (2004) (acknowledging turmoil created by *Qualitech*).

The Ninth Circuit followed *Qualitech*, though, in holding that a debtor's real property leased to a third party could be sold free of the lessee's interest, reasoning that a sale is not the rejection of the debtor's lease. *In re Spanish Peaks Holdings II, LLC*, 875 F.3d 892, 899, 900-01 (9th Cir. 2017) ("A sale... is not the same thing as... 'rejection' contemplated by Section 365"). According to the Ninth Circuit, Code § 365(h), which protects a real property lessee from the debtor-lessor's rejection of its lease, applies only when the debtor rejects the lease and remains in possession of the property. *Id.* ("Since the trustee did not reject the leases, section 365 was not implicated.") A lessee in that situation has a right to adequate protection under Code § 363(e) if the lessee asks for such relief, but had failed to do so in *Spanish Peaks. Id.*, at 900.

### **The Fifth Circuit's Nuanced Analysis**

The Fifth Circuit's *dicta* in *Royal Bistro* focused on the particular facts of the case before it. Two lessees of the debtor's property had objected to the sale of the property and alternatively sought "either adequate protection under Section 363(e) or rejection of the leases, all of which the bankruptcy court denied." 2022 WL 499938, at \*1. The lessees, "insiders of the debtor company," have leases "junior to the rights of the mortgagee" on the property. *Id.* "Had there been no bankruptcy," the mortgagee "could have foreclosed under state law and wiped out the junior interests." *Id.* The leases also had no "non-disturbance clauses that would have protected the lessees from" foreclosure. *Id.* For that reason, the bankruptcy court rejected the insider-lessees' objection to the sale. According to the Court of Appeals, "state law is all that the bankruptcy court needed to decide" the case. *Id.*

Both § 363(f)(1) and 365(h)(1)(A)(ii) limit the debtor's options, subject to applicable state law. First, under § 363(f) the debtor may sell free and clear if "applicable non-bankruptcy law permits," subject to providing "adequate protection" to the lessee under § 363(e). Because the lessees here had no residual value after the lender's prior mortgage debt was satisfied, the trustee had no "duty to provide adequate protection." *Id.*

The lessees may have had the further right to remain on the debtor's property for the term of their leases had the trustee rejected their leases "to the extent that such rights are enforceable under applicable non-bankruptcy law," according to § 365(h)(1)(A)(ii).

"Bankruptcy law, in other words, recognizes and defers to state law in these provisions." *Id.*, citing *Butner v. United States*, 440 U.S. 48, 54-57 (1979) (except when Code overrides state law, the Code enforces applicable state law property rights).

State law governed the bankruptcy court's first reason for denying relief to the insider lessees in *Royal Bistro*. Aside from the leases being subject to rights of the mortgagee, one of the lessees had "not paid any rent in many months... and was ... in default." 2022 WL 499938 at \*1. Because state law drove the result, there was thus no reason for the lower courts to rely on *Qualitech. Id.* In the Ninth Circuit's *Spanish Peaks* case, too, the leases "were legally subordinated to a senior mortgagee interest in the real property." *Id.*, at \*2.

### **Comment**

The lower courts overstated "their reasoning" in *Royal Bistro* but reached the right result. *Id.* According to the Fifth Circuit, courts "must be cautioned... against blithely accepting *Qualitech's* reasoning and

textual exegesis.” *Id.* State law thus remains relevant in federal bankruptcy cases. It must be read together with the Code, particularly when the Code explicitly refers to it.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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