

Alert

Divided Third Circuit Partially Stays Sale of Casino Pending Commercial Tenant's Appeal

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A divided panel of the U.S. Court of Appeals for the Third Circuit stayed the part of a bankruptcy court's sale order that would have "stripped" a commercial tenant's lease from the casino property being sold to a third party. *In re Revel AC, Inc.*, 2015 WL 5711358 (3d Cir. Sept. 30, 2015) (2-1). Reversing the bankruptcy and district courts' denial of a limited stay pending the tenant'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 the tenant ("T"). Indeed, said the court, T's prevailing on the merits of its appeal was "all but assured." *Id.* at *14.

Facts

T had invested \$16 million in the debtor's casino and had obtained a lease for its nightclubs on the property. It had objected to the debtor's proposed sale only to the extent that it purported to extinguish its lease. Indeed, according to the declaratory judgment complaint filed by T, "its principal (and only) purpose was to invoke its rights under [Bankruptcy Code ("Code")] § 365(h) and 'clarify its appurtenant rights for,' among other things, 'a utility easement,' not litigate the nature of its interests." *Id.* at *13.

The debtor asked the bankruptcy court "to follow the Seventh Circuit's decision in *Precision Indus., Inc. v. Qualitech Steel SBO, LLC*, 327 F.3d 537 (7th Cir. 2003), which held that [Code] § 365(h) doesn't disable § 363(f)'s authority to sell property subject to a lease free and clear of that lease and instead triggers only when a debtor seeks to reject a lease under § 365." *Id.* at *3. According to the debtor, "it could satisfy one of § 363(f)'s five conditions — namely § 363(f)(4) — because a *bona fide* dispute exists with respect to the validity of [T's] lease." In essence, the debtor argued that, because its lease with T was based on a percentage of the revenue derived from T's operations, "it was not a 'true lease' ... entitled to benefit from the applicable protections" contained in Code Section 365(h). *Id.*

The bankruptcy court conceded that it could "not look at the result totally as to what the law requires" and agreed with the debtor that timing was essential. *Id.* at *3 (referring to "the need to push the sale through"). Accordingly, it held that T was "akin to" a partner of the debtor, not a mere tenant, and agreed with the debtor that there was "a *bona fide* issue in dispute" as to the validity of T's lease. It then approved the sale, allowing the debtor to sell its assets "free and clear of existing tenancies and/or possessory rights, irrespective of any rights a tenant may hold under [Code] § 365(h), including, but not limited to, all possessory rights." *Id.* T appealed and moved for a stay pending appeal, stressing, among other things, that if the "decision were not stayed, its appeal would [become] moot under [Code]

§ 363(m) once the sale closed.” The bankruptcy court denied the motion for a stay, as did the district court. *Id.* at *4.

Relevance

Revel is not merely a decision about stays pending appeal. Although Code Section 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,” 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* sheds light on the important issue of whether a trustee or DIP 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 Industries*, Code Section 365(h) limits a trustee or DIP’s right to sell free and clear of interests under Section 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 (Feb. 2004) (“a debtor’s right to sell free and clear of interests under § 363(f) is expressly limited by § 365 (h)”).

The Third Circuit, as shown below, had to address the merits of T’s objection to the sale order. Instead of finding any purported conflict between Code Sections 363(f) and 365(h), the court held that *Revel* had failed to satisfy the requirement of Code Section 363(f)(4) (“interest” must be “in *bona fide* dispute”). The likelihood of T’s prevailing “on the merits was all but assured because nothing in the record cast doubt on the validity of [T’s] lease with *Revel*, thus prohibiting the [DIP] from invoking § 363(f) and selling its assets free of [T’s] lease.” *Id.* at *14.

The Stay Pending Appeal

Revel is ostensibly a decision about the standards for a court’s granting or denying a stay pending appeal. The majority of the court conceded that it had thus far “provided little direction on how to balance the [applicable] four stay factors, mostly ‘[b]ecause this [C]ourt ordinarily grants or denies a stay pending appeal without opinion.’” *Id.* at *7, citing *Republic of Philippines v. Westinghouse Elec. Corp.*, 949 F.2d 653, 658 (3d Cir. 1991). In reversing the lower court’s denial of a stay pending appeal in *Revel*, the court took “the opportunity to provide guidance on how to conduct a balancing of the stay factors.” *Id.* Like the applicable requirements for a preliminary injunction, a party seeking a stay pending appeal must show the following: “it is likely to succeed on the merits; ... whether the applicant will be irreparably injured absent a stay; ... whether issuance of the stay will substantially injure the other parties” in interest; and “where the public interest lies.” *Id.*, quoting *Hilton v. Braunskill*, 481 U.S. 770, 776 (1987).

Appellate courts typically “balance” the four requirements and “consider the relative strength of the four factors.” *Id.*, citing *Brady v. National Football League*, 640 F.3d 785, 789 (8th Cir. 2011). Of course, explained the court, the “most critical factors” are whether the moving party has made “a strong showing of the likelihood of success and ... that it will suffer irreparable harm.” *Id.*

Irreparable Harm to T

First, T was merely seeking to confirm its “right of access to a power source so that it can begin running its business again.” *Id.* at *12. The court therefore deemed “unsupportable the suggestion of the District Court that, if [the proposed buyer] walked away, [T] would be left with ‘a possessory right in an empty and commercially-unproductive building.’” If no stay were granted, the Third Circuit found that T “will

lose not only its multi-million dollar investment, but also the opportunity to operate what was, until the Casino closed, a profitable business.” Accordingly, T had shown “sufficient irreparable injury to it absent a stay.” *Id.*

No Harm to Debtor

Nor did the Third Circuit accept the reasoning of the district court as to the purported harm to the debtor. “Absent some sort of declaration or other evidence in the record that a stay would cause substantial harm, the harm to Revel was at best speculative.” *Id.* According to the debtor’s counsel, “granting [T] a stay only to prevent its lease from being extinguished would ... spoil the entire sale.” *Id.* Although the Third Circuit had already granted a limited stay in February of 2015 before issuing its opinion on Sept. 30, it stressed that “a limited stay didn’t set off the consequences that *Revel* and [the buyer] said it would. Notwithstanding the limited stay we put into place on February 6, 2015, *Revel* and [the buyer] closed two months later on April 7.” *Id.* at n.11. Conversely, had T “lost its lease — a result a stay denial virtually guaranteed — its business at *Revel*’s site would be permanently shuttered,” causing “the balance-of-harms [to be] tilted ... in favor of [T].” *Id.* at *12.

Public Interest

Finally, the “public interest” requirement also had little weight in the court’s analysis. Although *Revel* justifiably sought to save jobs, “the public has a stake in protecting the rights of tenants in commercial properties,” and “public policy strongly favors the correct application of the Bankruptcy Code, especially where property rights are at stake.” *Id.* at *13.

The Merits

The court declined to resolve any purported conflict between Code Sections 363(f) and 365(h). It did not have to, for the debtor had failed to show that a “bona fide” dispute under Section 363(f)(4) existed “either in law or fact ... to cast doubt on the validity of [T’s] purported lease. *Id.* “[N]othing *Revel* said in response [to T’s complaint] created an objective legal dispute.” *Id.* at *14. “*Revel* failed to cite a single authority suggesting that a percentage-lease clause disqualifies a purported lease from being one,” and, moreover, the lease itself provided explicitly for a landlord-tenant relationship, nothing more. As the court stressed, “any dispute regarding the validity of [T] lease was fanciful, if not, disingenuous.” *Id.* Indeed, the bankruptcy court later held that *Revel* and T had a “true lease under New Jersey law,” thus protecting T’s “right to remain in possession.” *Id.* at n.12.

The Dissent

The dissenting judge accused the majority of creating a “new interpretation of the requirements for obtaining a stay.” *Id.* at *15. Rejecting the majority’s “sliding scale” approach, the dissent argued that a stay should not be granted “upon a particularly strong showing on just a single factor, apparently even if at least one factor weighs against the movant.” *Id.*

Comment

The majority’s sliding scale approach to the stay pending appeal analysis is sensible, pragmatic and consistent with that taken by other federal courts of appeals. *See, e.g., In re A&F Enterprises, Inc. II*, 742 F.3d 763, 766 (7th Cir. 2014) (“a ‘sliding scale’ approach applies; the greater the moving party’s likelihood of success on the merits, the less heavily the balance of harms must weigh in its favor”); *Brady*, 640 F. 3d at 789 (same).

The Third Circuit’s clear analysis of the merits offers guidance to buyers and sellers of assets in Chapter 11 reorganization cases. They cannot summarily demolish the rights of the debtor’s tenants and other interest holders.

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