ALERTS

Third Circuit Permits Reopening of Reorganization Case to Enforce Debtor's Purchase Option in Real Estate Lease

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The U.S. Court of Appeals for the Third Circuit held on July 30, 2013, that a reorganized Chapter 11 debtor could reopen its closed case, enabling the debtor assignee to enforce a purchase option in a real property lease despite the lease's "anti-assignment provisions." *In re Lazy Days' RV Center Inc.*,2013 WL 3886735, *5 (3d Cir. July 30, 2013). Agreeing with the Delaware bankruptcy court, but reversing the district court, the Court of Appeals held that "the anti-assignment provision [in the lease] was unenforceable [under Bankruptcy Code § 365 (f)(3)] and that [the landlord's] refusal to honor the purchase option violated" a separate court-approved "Settlement Agreement" between the parties. *Id.*

Relevance

The court confirmed the vitality of Code § 365(f)(3), which makes contractual "anti-assignment clauses … unenforceable in bankruptcy." *Id.* The case also shows the many procedural obstacles that a party can raise over a two-year period in a 2009 Chapter 11 case that had been successfully closed in 2010, and reopened in 2011 only to be followed by a 2012 district court reversal. Among the legal issues resolved by the Third Circuit were the following: (a) the meaning of a settlement agreement; (b) when a bankruptcy court should abstain from ruling; (c) when a bankruptcy court has subject matter jurisdiction to reopen a closed case; (d) what constitutes an improper advisory opinion by a court; (e) what constitutes an improper taking under the U.S. Constitution's Fifth

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Amendment; and (f) when is a party deprived of "due process" right to "present [a] case in a meaningful way." *Id.*, at *6.

Facts

One of the debtors in this case leased a parcel of land in Florida with an option to purchase the property. *Id.*, at *1. The Lease prohibited the debtor from assigning or transferring the Lease without the landlord's "prior written consent," except to affiliated entities. *Id.* By 2008, the debtor tenant had failed to pay rent, informing the landlord of its intention to file a Chapter 11 petition, assume the Lease, and then assign the Lease to its affiliate, which would also file a Chapter 11 petition. Before filing their petitions, the debtors negotiated with the landlord and reached a "Settlement Agreement" under which the landlord consented to the assignment of the lease to the affiliate. The tenant debtor agreed not to "argue against the Bankruptcy Court abstaining from consideration of lease interpretation issues … except to the extent necessary in connection with the assumption and assignment of the Lease as contemplated herein." *Id.* The parties also agreed that they had "no intent, nor is the Lease modified in any respect and the lease and all terms and conditions thereof remain in full force and effect." *Id.* The parties made no mention of the purchase option in the Lease.

The bankruptcy court confirmed a reorganization plan, which incorporated the Settlement Agreement, for both the original tenant and the debtor assignee in December 2009, and closed the case in 2010. The tenant debtor thereafter assigned the Lease to its debtor affiliate.

The assignee debtor attempted to exercise the purchase option in 2011, but the landlord refused to honor it, forcing the parties to litigate in the Florida state courts. Both reorganized debtors simultaneously moved in the bankruptcy court for a ruling that "the lease's anti-assignment provision was unenforceable" under Code § 365(f)(3), which renders unenforceable any "provision in an … unexpired lease of the debtor … that terminates or modifies … a right … under such … lease on account of an assignment of the lease." *Id.* Appeals to the district court and court of appeals followed the bankruptcy court's holding the "anti-assignment provision [to be] unenforceable and that [the landlord's] refusal to honor the purchase option violated the Settlement Agreement." The bankruptcy court thus ordered the landlord "to honor the option." *Id.*

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District Court

The district court reversed and vacated the bankruptcy court's opinion. In its view, the bankruptcy judge had rendered an improper advisory opinion directed at the Florida state court litigation.

Substantive Merits

The court of appeals easily dealt with the substantive merits of the appeal after it disposed of the procedural obstacles generated by the landlord. First, nothing in the parties' Settlement Agreement eliminated the purchase option at issue. In fact, not only did the Settlement Agreement provide that the parties would "remain liable for all obligations under the Lease, after assignment," but it also went on to provide that the parties had no intention to modify "in any respect … the Lease…." *Id.* at *5. If anything, the court stressed that the assignee debtor affiliate had stepped into the tenant debtor's "shoes and acquire[d] all the rights and obligations that [the original debtor tenant] had, notwithstanding any anti-assignment provisions." *Id.* In short, the Settlement Agreement merely provided for the landlord's waiver of the debtor tenant's prior defaults and consent to the "contemplated assignment of the Lease" as part of the tenant debtor's Chapter 11 reorganization. The affiliated debtor assignee thus had "the same rights in the Lease that [debtor tenant] had, including the purchase option." *Id.*

Most important, the Settlement Agreement provided no waiver of Code § 365(f)(3), enabling the court to invalidate the anti-assignment clause in the lease and enforce the purchase option. Nor had the reorganized debtors waited too long to reopen their case as the landlord argued. The reorganized debtors "could have reasonably read the purchase option to survive the Settlement Agreement," and thus had no reason "to sue to enforce" it until the landlord "actually decided not to honor it." *Id.* at *6. Moreover, the bankruptcy court "did not modify the Settlement Agreement, but only clarified that it did not void the purchase option." *Id.*

No Advisory Opinion by Bankruptcy Court

The Third Circuit quickly rejected the district court's holding that the bankruptcy court had rendered an advisory opinion. In its view, the bankruptcy court issued a "two-page decree, declaring the anti-assignment clause invalid and ordering [the landlord] to honor the

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purchase option. Because this decree actually invalidated the anti-assignment clause and ordered the parties to do something, it 'affect[ed] the rights of litigants,' … and was not an advisory opinion." *Id.* at *2, quoting *In re McDonald*, 205 F.3d 606, 609 (3d Cir. 2000) (bankruptcy court opinion not advisory when it "resolved the litigation"). Regardless of whether the reorganized debtors "sought to impact the [Florida litigation]," the bankruptcy court effectively voided "the anti-assignment clause." *Id.*

Reopening of Case Proper

The court further confirmed the broad discretion given bankruptcy courts under Code § 350(b) to reopen cases after they have been administered. *Id.* at *3. Despite the landlord's argument that the court had lacked "statutory subject matter jurisdiction over the motion to reopen," the bankruptcy court here "was asked to reopen proceedings to resolve a dispute regarding the Settlement Agreement it had previously confirmed." *Id.* at *4. Relying on ample precedent, the court easily disposed of this argument: "the Bankruptcy Court plainly had jurisdiction to interpret and enforce its own prior orders." *Id.*, quoting *Travelers Indem. Co. v. Bailey*, 557 U.S. 137, 151 (2009).

Jurisdiction

The court also rejected the landlord's argument that the bankruptcy court had unconstitutionally "asserted subject matter jurisdiction over a private rights dispute" that belonged in the Florida state courts. *Id.*, citing *Stern v. Marshall*, 131 S.Ct. 2594 (2011). The Third Circuit found that *Stern* and its precedents, however, dealt only with the question of whether a bankruptcy court "may constitutionally exercise jurisdiction over common law claims." *Id.* The bankruptcy court here was not ruling on a state law issue, "but rather … whether, in light of [Code] § 365(f)(3), an anti-assignment clause survived the settlement agreement it had confirmed as part of a Chapter 11 bankruptcy." *Id.* Because the relief requested by the reorganized debtors turned on a "federal bankruptcy law provision with no common law analogue," the landlord's constitutional challenge easily fell.

Abstention

The landlord argued that the bankruptcy court was also required to abstain under 28 U.S.C. § 1334(c)(2) (abstention required from "proceeding

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based upon a State law claim or State law cause of action, related to a case under title 11 but not arising under title 11 or arising in a case under title 11"). Although this litigation may "have been provoked by state court actions," the court of appeals found that the motion to reopen the bankruptcy case "was founded upon a quintessentially federal claim, *viz.*, whether the anti-assignment clause was invalid under [Code] § 365(f)(3)." *Id.* Moreover, the dispute arose in the bankruptcy case because the debtors had asked the court to "interpret and enforce" its own order. *Id.* Although the debtors had agreed in the Settlement Agreement that they would not argue against abstention "except to the extent necessary in connection with the assumption and assignment of the Lease," this particular litigation was, in fact, brought "in connection with the … assignment of the Lease." *Id.*, at 5.

Improper Taking

The court also rejected the landlord's argument that the bankruptcy court's order reopening the case "was a taking under the Fifth Amendment." *Id.* at *6. As the Court of Appeals found, the bankruptcy court's order took none of the landlord's "established property rights, but rather adjudicated the parties' bona fide dispute regarding their rights under the Settlement Agreement." *Id.* An "adjudication of disputed and competing claims cannot be a taking." *Id.* (citation omitted).

Denial of Due Process

Finally, the court rejected the landlord's argument that it had not been able to "present its case in a meaningful way" because the bankruptcy court "should have held an adversary proceeding…." *Id.* In fact, the landlord "was able to present its case" with lengthy opposition papers, "and the Bankruptcy Court conducted a hearing with oral argument on that motion." *Id.* In other words, the relief sought by the reorganized debtors was merely the enforcement of an order previously entered by the bankruptcy court, making an adversary proceeding unnecessary. *Id.*

Comment

This case shows, unfortunately, how much time and money can be expended over a straightforward bankruptcy court order. It turned on a debtor's assumption and assignment of a lease containing a purchase

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option. Nevertheless, the landlord raised a raft of procedural obstacles obscuring the real dispute over a two-year period in two appellate courts.

Authored by Michael L. Cook and Lawrence V. Gelber.

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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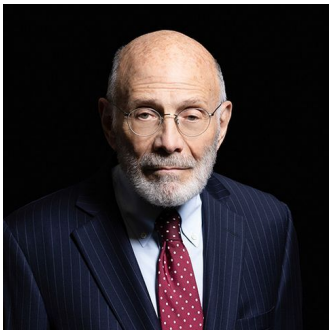

Michael Cook

Of Counsel

New York

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