



Creditors' Rights and Bankruptcy Practice Group
GOODSILL ALERT

July 19, 2017

**NINTH CIRCUIT BANKRUPTCY OPINION ALLOWS
PROPERTY SALE FREE AND CLEAR OF LEASES**



In the case of *Pinnacle Restaurant at Big Sky LLC v. CH SP Acquisitions LLC (In re Spanish Peaks Holdings II LLC)*, 15-35572 (9th Cir. July 13, 2017), the U.S. Court of Appeals for the Ninth Circuit held that section 363 of the Bankruptcy Code allows a trustee to sell real property free and clear of unexpired leases.

BACKGROUND FACTS

Spanish Peaks was a 5,700-acre resort in Big Sky, Montana. *Id.* at 4. The project was financed by a \$130 million loan, secured by a mortgage and assignment of rents, from Citigroup Global Markets Realty Corp. (“Citigroup”). *Id.* Citigroup later assigned the note and mortgage to Spanish Peaks Acquisition Partners, LLC (“SPAP”). *Id.*

In 2006, Spanish Peaks Holdings, LLC (“SPH”), leased restaurant space to Spanish Peaks Development, LLC (“SPD”), for \$1,000 per month. *Id.* A year later, SPH and SPD replaced the 2006 lease with a lease under which SPD received a 99-year leasehold in the restaurant property in exchange for \$1,000 per year in rent. In 2008, SPD assigned its interest to The Pinnacle Restaurant at Big Sky, LLC (“Pinnacle”), a company specially created for that purpose. *Id.* In 2009, SPH leased a separate parcel of commercial real estate at the resort to Montana Opticom, LLC (“Opticom”). *Id.* That lease had a term of sixty years and an annual rent of \$1,285. *Id.*

Facing a shrinking real-estate market and mounting operational losses, SPH began to default on its loan payments. *Id.* at 5. On October 14, 2011, SPH and two related entities—The Club at Spanish Peaks, LLC, which managed the resort’s ski and golf

facilities, and Spanish Peaks Lodge, LLC, which managed its real-estate sales—filed for chapter 7 bankruptcy protection. *Id.*¹

SPH’s largest creditor was SPAP, which had a claim of more than \$122 million secured by the mortgage on the property. *Id.* SPAP subsequently assigned its interest to CH SP Acquisitions, LLC (“CH SP”). *Id.* The trustee and SPAP agreed to a plan for liquidating “substantially” all of the debtors’ real and personal property. *Id.* Their stipulation contemplated an auction with a minimum bid of \$20 million. *Id.* It further stated that the sale would be “free and clear of all liens.” *Id.*

The trustee then moved the Bankruptcy Court for an order authorizing and approving the sale “free and clear of any and all liens, claims, encumbrances and interests,” except for certain specified encumbrances, and that other specified liens would be paid out of the proceeds of the sale or otherwise protected. *Id.* at 6. The Pinnacle and Opticom leases were not mentioned in either the list of encumbrances that would survive the sale or the list of liens for which protection would be provided. *Id.*

Pinnacle and Opticom both objected to “any effort to sell the Debtors[’] assets free and clear of [their] leasehold interests,” arguing that Section 365 of the Bankruptcy Code gave them the right to retain possession of the property notwithstanding the sale. *Id.* at 6. After a hearing, the Bankruptcy Court authorized the sale and did not rule on Pinnacle’s and Opticom’s objections. *Id.* Instead, the Bankruptcy Court deferred the decision on claimed right to possession to the hearing on the motion to approve the sale. *Id.*

On June 3, 2013, the auction and the sale approval hearing took place. *Id.* CH SP won the auction with a credit bid of \$26.1 million. *Id.* At the approval hearing, Pinnacle and Opticom renewed their objections that they were entitled to retain possession pursuant to their leases, and argued that language in the proposed approval order providing that the sale would be free and clear of those interests was inconsistent with their claimed rights. *Id.* In response, CH SP’s principal testified that its bid was contingent on the property being free and clear of the leases. *Id.* at 6-7.

On June 13, 2013, the Bankruptcy Court entered an order approving the sale free and clear of any “Interests,” a term defined to include any leases “(except any right a lessee

¹ The petitions were filed in Delaware, but the proceedings were transferred to the Bankruptcy Court for the District of Montana, where they were consolidated for joint administration. *Id.*

may have under 11 U.S.C. § 365(h), with respect to a valid and enforceable lease, all as determined through a motion brought before the Court by proper procedure).” Id. at 7.

Both sides moved for clarification of the approval order. Id. Pinnacle and Opticom sought clarification that the order preserved their rights under the leases, while CH SP sought clarification that the order approved a sale free and clear of those interests. Id. The Bankruptcy Court denied having ruled one way or the other, explaining that it would not consider the issue until the parties had “file[d] an appropriate motion, notice[d] the matter for hearing, and present[ed] their evidence.” Id. The trustee then filed a motion to reject the Pinnacle and Opticom leases on the ground that the subject property was no longer property of the estate. Id. CH SP moved for a determination that the property was free and clear of the leases. Id. Pinnacle and Opticom did not object to the trustee’s motion, which was granted. Id. They did, however, renew their previous arguments as objections to CH SP’s motion. Id. After a two-day evidentiary hearing on that motion, the Bankruptcy Court made the following findings of fact:

- Pinnacle had not operated a restaurant on the property since 2011;
- Pinnacle’s rent was far below the property’s fair market rental value of \$40,000 to \$100,000 per year;
- Opticom’s lease was not recorded;
- The leases were executed “at a time when all parties involved were controlled by James J. Dolan”;
- The leases were the subject of bona fide disputes;
- Citigroup’s mortgage was senior to the leases; and
- The leases were not protected from foreclosure of the underlying mortgage by subordination or nondisturbance agreements.

Id. at 7-8. Based on those findings, the Bankruptcy Court—applying what it called a “case-by-case, fact-intensive, totality of the circumstances, approach”—held that the sale was free and clear of the Pinnacle and Opticom leases. Id. at 8.

Pinnacle and Opticom appealed to the U.S. District Court, which affirmed. Id. The District Court held that the sale extinguished the leases because the foreclosure of a mortgage would, under Montana law, terminate any leasehold interests junior to the mortgage. Id. at 9.

THE NINTH CIRCUIT’S DECISION

The Ninth Circuit explained that two sections of the Bankruptcy Code were in apparent conflict: (1) Section 363, which authorizes the trustee to sell property of the estate, both within the ordinary course of business (see 11 U.S.C. § 363(c)), and outside of it (see 11 U.S.C. § 363(b)) sometimes authorized to be “free and clear of any interest in such property of an entity other than the estate,” and (2) Section 365, which authorizes the trustee, “subject to the court’s approval,” to “assume or reject any executory contract or unexpired lease of the debtor.” *Id.* at 10-11.²

The Ninth Circuit noted that Section 365(h) of the Bankruptcy Code makes a special provision for rejected leases, which essentially provides that the rejection of an unexpired lease leaves a lessee in possession with two options: treat the lease as terminated (and make a claim against the estate for any breach), or retain any rights—including a right of continued possession—to the extent those rights are enforceable outside of bankruptcy. *Id.*

The Ninth Circuit explained that a majority of courts to have addressed this issue have held that section 365 trumps section 363 and that the property cannot be sold “free and clear” of the leasehold. *Id.* at 12. However, the Ninth Circuit rejected this majority approach and explained that, “we agree with the Seventh Circuit that sections 363 and 365 do not conflict.” *Id.* at 14.³ The Ninth Circuit explained that “Where there is a sale, but no rejection (or a rejection, but no sale), there is no conflict.” *Id.*⁴

² The Bankruptcy Court had explained that, “Section 363, confers a right to sell property free and clear of ‘any interest,’ without excepting from that authority leases entitled to the protections of section 365.” *Id.* at 12. Focusing on the statutory text, the Bankruptcy Court noted that lessees are entitled to seek “adequate protection” under section 363(e), so “Lessees . . . are therefore not without recourse in the event of a sale free and clear of their interests. *Id.* They have the right to seek protection under section 363(e), and upon request, the bankruptcy court is obligated to ensure that their interests are adequately protected.” *Id.*

³ In Precision Industries, Inc. v. Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.), 327 F.3d 537, 547 (7th Cir. 2003), the Seventh Circuit observed that “the statutory provisions themselves do not suggest that one supersedes or limits the other.”

⁴ The Ninth Circuit explained that Section 365 has a “limited scope”:

Section 365(h) . . . focuses on a specific type of event—the rejection of an executory contract by the trustee or debtor-in-possession—and spells out the rights of parties affected by that event. It says nothing at all about sales of estate property, which are the province of section 363.

Id. at 13.

The Ninth Circuit explained that “[t]he Pinnacle and Opticom leases were not “rejected” prior to the sale . . . Under our interpretation, then, section 365 was not triggered.” Id. at 15. The Court also found that “Pinnacle and Opticom did not ask for adequate protection until *after* the sale had taken place.” Id. at 16.

Additionally, the Ninth Circuit explained, “Under Montana law, a foreclosure sale to satisfy a mortgage terminates a subsequent lease on the mortgaged property.” Id. at 16. The Court further explained:

SPH’s bankruptcy proceeded, practically speaking, like a foreclosure sale—hardly surprising since its largest creditor was the holder of the note and mortgage on the property. Indeed, had SPH not declared bankruptcy, we can confidently say that there would have been an actual foreclosure sale. Such a sale would have terminated the Pinnacle and Opticom leases.

Id. at 17. The Court explained that Section 363(f)(1) allows a “free and clear” sale if “applicable nonbankruptcy law permits sale of such property free and clear of such interest,” Id. at 16, and that, “[w]e see no reason to exclude the law governing foreclosure sales from the . . . language in section 363(f)(1).” Id. at 17. The Ninth Circuit explained:

We agree that section 365 embodies a congressional intent to protect lessees. But that intent is not absolute; it exists alongside other purposes and sometimes conflicts with them. To some extent, protecting lessees reduces the value of the estate—property presumably fetches a lower price if it is subject to a lease—and is therefore contrary to the goal of “maximizing creditor recovery,” another core purpose of the Code. The statutory text is the best assurance we have that we are balancing competing purposes in the way Congress intended.

Id. at 17-18.

CONCLUSION

Owners of leases, as well as lenders with security interests in such leases, should be aware of the implications of Ninth Circuit’s recent decision in *Pinnacle Restaurant*.

Although the Ninth Circuit attempts to limit its decision based upon “on the facts of this case,” the implications of this decision could be far-reaching and could affect substantial property interests of creditors unless appropriate objections, requests for adequate protection, and other necessary actions are timely taken.



This **Goodsill Alert** was prepared by Johnathan C. Bolton (jbolton@goodsill.com or (808) 547-5854) of Goodsill’s Creditors’ Rights and Bankruptcy Practice Group.

Creditors’ Rights and Bankruptcy. Goodsill’s attorneys practicing in the area of creditors’ rights and bankruptcy concentrate on the representation of lenders, creditors, trustees, committees and other interestholders in complex bankruptcy, foreclosure, receivership, commercial landlord-tenant, collection and commercial litigation matters. Goodsill attorneys are adept at helping creditors avoid protracted litigation through creative workouts and settlements. Goodsill attorneys in this practice area frequently contribute to publications and lecture at bankruptcy and collection law seminars.

Notice: We are providing this Goodsill Alert as a commentary on current legal issues, and it should not be considered legal advice, which depends on the facts of each specific situation. Receipt of the Goodsill Alert does not establish an attorney-client relationship.