Benchnotes

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Sale Under § 363(f) Strips Tenants of their § 365(h) Rights

In *In the Matter of Spanish Peaks Holdings II LLC*,[1] the Ninth Circuit Court of Appeals held that a sale of property under § 363(f) strips a tenant of its statutory right to remain on the premises notwithstanding rejection pursuant to § 365(h). Spanish Peaks was a 5,700-acre resort in Big Sky, Mont. Pre-petition, the debtors entered into two long-term, under-market commercial leases with tenants. Post-petition, the bankruptcy trustee moved for an order approving a sale process, which contemplated a sale "free and clear of any and all liens, claims, encumbrances and interests."

Relying on § 365(h), the tenants objected to the sale of the assets free and clear of their leasehold interests. After a two-day evidentiary hearing, the bankruptcy court, applying what it called a "case-by-case, fact-intensive" approach, held that the sale to the winning bidder was free and clear of the tenants' leases. The district court affirmed.

The Ninth Circuit stated that "the issue brings two sections of the Code into apparent conflict." Section 363(f) authorizes sales "free and clear" of any interest in such property, but § 365(a) authorizes a debtor to reject any unexpired lease subject to subsection (h), which allows a tenant to "retain any rights — including a right of continued possession — to the extent those rights are enforceable outside of bankruptcy."[2]

The "majority approach," adopted by numerous bankruptcy courts, concludes that the statutory provisions overlap. Such courts hold that § 365(h) trumps § 363(f) under the canon of statutory construction that the specific prevails over the general. Such courts further reason that "the legislative history regarding § 365 evinces a clear intent on the part of Congress to protect a tenant's estate when the landlord files [for] bankruptcy, and that the protection would be nugatory if the property could be sold free and clear of the leasehold under section 363."[3]

The "minority approach" is based on the Seventh Circuit's 2003 ruling in *In re Qualitech Steel Corp*.[4] that § 363(f) confers a right to sell property free and clear of "any interest," without excepting from that authority leases entitled to the protections of § 365(h). The *Qualitech* court found that the statutory provisions do not necessarily conflict with each other, reasoning that § 365(h) focuses solely on the rejection of an executory contract and says nothing at all about sales of estate property, "which are the province of section 363."

The Ninth Circuit adopted the "minority approach." While a sale of property free and clear of a lease "[might] be an effective rejection of the lease in some everyday sense," the court found that it is not the same thing as the "rejection" contemplated by § 365.[5] Section 363 "governs the sale of estate property, while § 365 governs the formal rejection of a lease. Where this is a sale but no rejection (or a rejection but no sale), there is no conflict."[6]

The court then responded to the argument that the "minority approach" results in "the effective repeal of § 365(h)."[7] It found that the mandatory language of § 363(e), which provides that a court must provide adequate protection for an interest that will be terminated by a sale if the holder of the interest requests it, addresses this concern. The court suggested that if the tenants had simply sought adequate protection of their leasehold interest, the bankruptcy court may have had no choice but to allow them to continue in possession.

Physical Possession Required for Purposes of § 503(b)(9)

In *In re World Imports Ltd*.,[8] two Chinese furniture manufacturers shipped goods to the debtor "free on board" (FOB) more than 20 days before the petition date, but the debtor took physical possession of the goods in the U.S. within the 20-day priority period contemplated in § 503(b)(9). Post-petition, the vendors filed motions for allowance of an administrative expense. The parties disagreed about which action (the transfer of title or the physical acceptance) constituted receipt for purposes of § 503(b)(9).

The bankruptcy court noted that the term "received" is not defined in the Bankruptcy Code and concluded that the authority controlling the definition of the term was international commercial law, not the Uniform Commercial Code (UCC), which defines "receipt" as "taking physical possession."[9] Accordingly, the court looked to the Convention on Contracts for the International Sale of Goods. While that treaty does not define the term "received," it does incorporate Incoterms, and the Incoterm governing FOB contracts makes it clear that title and the risk of loss transfers to the buyer when the seller

1 *In the Matter of Spanish Peaks Holdings II LLC*, 862 F.3d 1148 (9th Cir. 2017). *See also* Roy M. Terry, Jr. and Elizabeth L. Gunn, "Ninth Circuit Authorizes Sale of Property Free and Clear of Lessee's Unrejected Leasehold Interest," XXXVI *ABI Journal* 10, 32-33, 72-74, October 2017, *available at* abi.org/abi-journal.
2 *Spanish Peaks* at 1154.
3 *Id.* at 1155.
4 *Id.* (citing *In re Qualitech Steel Corp.*, 327 F.3d 537 (7th Cir. 2003)).
5 *Id.* at 1156.
6 *Id.*
7 *Id.* at *6 (citing *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696 (S.D.N.Y. 2014)).
8 *In re World Imports Ltd.*, 862 F.3d 338 (3d Cir. 2017).
9 *Id.* at 342 (citing U.C.C. § 2-103(1)(l)).

delivers the goods to the common carrier's vessel. Because the risk of loss transferred when the goods were shipped, the goods were "constructively received" by the debtor when they left the port in China. Accordingly, the court denied the vendors' motions.

The Third Circuit reversed, holding that goods are "received" for purposes of § 503(b)(9), but only when the debtor takes "physical possession" of them. The court recited the principle from Supreme Court case law that Congress does not write on a clean slate and that if a word incorporated in a statute had a well-known meaning, it is presumed to have been used in that sense. The court then noted that well-known dictionaries define the word "received" as requiring physical possession. These definitions, the court continued, comport with the definition found in the UCC.

The court also found ample evidence from the statutory context that Congress relied on the UCC definition when it enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). The court noted that § 503(b)(9) was enacted as part of a BAPCPA section entitled "Reclamation," which limited the reclamation remedy in § 546(c) and created § 503(b)(9) "as an *exemption* from § 546(c)'s reclamation conditions."[10] The interrelationship between §§ 546(c) and 503(b)(9) is also explicit in the Bankruptcy Code, given that § 546(c)(2) expressly references and preserves a vendor's rights under § 503(b)(9).

Finally, the court focused on the Third Circuit's precedent dealing with reclamation and noted that it had previously defined "receipt" for purposes of § 546(c) to mean "taking physical possession."[11] The court stated that this definition, like the reclamation provision itself, arose out of the UCC. Because Congress essentially borrowed the reclamation provision from the UCC, "it also borrowed the standard definition" of the term "receipt."[12]

The debtor argued that the goods were constructively received upon delivery because they were delivered FOB to a common carrier. Rejecting this argument, the court stated, "While it is true that a buyer may be deemed to have received goods when his agent takes physical possession of them, common carriers are not agents."[13] Accordingly, because the debtor took physical possession of the goods within 20 days before the petition date, the orders of the lower courts were reversed.

Miscellaneous

• *In re SRC Liquidation LLC*, 2017 WL 2992718 (Bankr. D. Del. July 31, 2017) (goods delivered to debtor's customers at the debtor's direction and utilizing the debtor's shipping account did not constitute goods "received by" the debtor; creditor held only general unsecured nonpriority claim and not a claim under § 503(b)(9));

• *In re Trigee Found. Inc.*, 2017 WL 3190737 (Bankr. D. D.C. July 26, 2017) (granting debtor's motion to quash *writ* of execution in favor of debtor's former chapter 11 counsel as allowed claims are not money judgments);

• *Andrade v. Essenfeld, et al. (In re Andrade)*, 2017 WL 2984110 (Bankr. D. Mass. July 12, 2017) (dismissing count in chapter 13 debtor's complaint that attempted to compel the sale of property co-owned with nondebtor as tenant-in-common, joint tenant or tenant by the entirety);

• *In re Ortiz-Peredo*, 2017 WL 3050486 (Bankr. W.D. Tex. July 18, 2017) (bankruptcy court held that chapter 13 debtor's exempt income from worker's-compensation claim was nonetheless "disposable income" under § 1325(b) and sustained trustee's objection to chapter 13 plan);

• *Coslow v. Reisz (In re Coslow)*, 2017 WL 3225450 (Bankr. W.D. Ky. July 28, 2017) (granting summary judgment for plaintiff/debtor, determining that equity in debtor's residence was determined as of petition date, and concluding that equity created post-petition did not inure to chapter 7 estate);

• *Clark's Crystal Springs Range LLC v. Gugino (In re Clark)*, 2017 WL 2963538 (9th Cir. July 12, 2017) (notwithstanding Supreme Court's decision in *Law v. Siegel*, bankruptcy court had power to enter a substantive consolidation order; "Ordering substantive consolidation ... does not contravene specific provisions of the Bankruptcy Code. While the Code does not explicitly authorize substantive consolidation, neither does the Code forbid it");

• *Freally v. Reynolds (In re Reynolds)*, 2017 WL 3482263 (9th Cir. Aug. 15, 2017) (following certification of issue to California Supreme Court, Ninth Circuit held that bankruptcy estate of beneficiary of spendthrift trust was entitled to receive full amount of spendthrift trust distributions due to be paid as of petition date; however, estate may not access any portion of that money that beneficiary needs for his support or education if trust instrument specifies that funds are for that purpose; Under California law, estate might also reach 25 percent of expected future payments from spendthrift trust, reduced by amount that beneficiary needs to support himself and his dependents);

• *In re CS Mining LLC*, 2017 WL 3208457 (Bankr. D. Utah July 27, 2017) (relying on plain language of § 502(d), court refused to approve a Rule 9019 settlement filed by debtor with respect to its secured creditor's claim because settlement precluded another creditor from prosecuting its own pending claim objection; court also found that cause existed to deny secured creditor's credit bid rights under § 363(k) because (1) secured creditor's claim was subject to a pending claim objection; (2) in light of the size of secured creditor's claim, "the bidding process would be chilled, then frozen"; and (3) secured creditor had close ties with debtor);

• *In re Rupari Holding Corp.*, 2017 WL 3600381 (Bankr. D. Del. Aug. 18, 2017) (bankruptcy court granted motion seeking declaration that trademark agreement cannot be assumed or assigned under § 365(c)(1) without the consent of the trademark owner; debtors could not rely on contractual provision providing that consent "shall not be unreasonably withheld or delayed" when assignment is part of a sale of substantially all of licensee's assets because it was undisputed in present case that debtors had already closed on asset sale without first obtaining consent or court order);

• *In re Taylor*, 2017 WL 3701475 (Bankr. E.D.N.C. Aug. 24, 2017) (noting a split in case law on question of whether private citizens bringing compliance suits pursuant to gov-

continued on page 86

10 *Id.* at 343 (emphasis in original).
11 *Id.* (citing *In re Marin Motor Oil*, 740 F.2d 220, 224-25 (3d Cir. 1984)).
12 *Id.*
13 *Id.* at 344.

ernment unit's "police power" are deemed to constitute "governmental units" for purposes of § 362(b)(4), bankruptcy court held that only actual governmental units fall within scope of police power exception to automatic stay, particularly where actual governmental units have refrained from participating in litigation);

• *In re Wagle LLC*, 2017 WL 3503664 (Bankr. W.D. Pa. Aug. 16, 2017) (court denied confirmation of a cramdown chapter 11 plan because it violated absolute priority rule; an $8,000 cash contribution by old equityholders (which would result in 2 percent distribution to unsecured creditors) was not reasonably equivalent to value of interest being retained by equity; in evaluating whether capital contribution is reasonably equivalent, reorganized enterprise must be valued on going-concern basis rather than as if assets were to be liquidated);

• *Jahn v. Burke (In re Burke)*, 863 F.3d 521 (6th Cir. 2017) (in issue of first impression, Sixth Circuit held that chapter 7 trustee could not evict debtors from their home in order to make property easier to sell by simply tendering check representing full value of homestead exemption; court rejected trustee's argument that debtors lacked standing and further ordered trustee to abandon property because it had inconsequential value to estate's unsecured creditors);

• *Norris v. Causey*, 2017 WL 3599878 (5th Cir. Aug. 22, 2017) (in litigation in which chapter 7 debtors sued and prevailed in federal court on claims that were arguably property of their bankruptcy estate, Fifth Circuit held that issue of whether debtors or their trustee were proper plaintiff does not implicate subject-matter jurisdiction; real party-in-interest challenges, the court found, are not jurisdictional but rather constitute affirmative defense that can be waived);

• *Oakland Police & Fire Ret. Sys. v. Mayer Brown LLP*, 861 F.3d 644 (7th Cir. 2017) (Seventh Circuit affirmed district court's dismissal of legal malpractice claims brought by lenders to General Motors against automaker's law firm regarding mistaken release of $1.5 billion lien; court agreed that law firm owed no duty to lenders notwithstanding fact that (1) lenders were clients of law firm in unrelated matters; (2) law firm agreed to draft closing documents; and (3) primary purpose of law firm's relationship with General Motors was to influence lenders);

• *Pirinite Consulting Grp. v. Kadant Solutions Div. (In re Newpage Corp.)*, 569 B.R. 593 (D. Del. 2017) (district court affirmed bankruptcy court, holding that payments made by debtor for custom equipment that creditor was not obligated to begin manufacturing under parties' agreement until after payments were received were in nature of "advance payments" and thus were not payments on account of antecedent debt for purposes of § 547; trustee's argument that "a contract creates a claim at the moment of its execution and is therefore an antecedent debt" was rejected; rather, court properly looked to terms of agreement and unrefuted facts to determine when right to payment arose); and

• *Pollitzer v. Gebhardt*, 860 F.3d 1334 (11th Cir. 2017) (consumer debtor filed chapter 13 case and made required payments under confirmed plan for more than two years before converting his case to chapter 7; relying on statutory language, debtor argued that means test set forth in § 707(b) did not apply because case was originally filed under chapter 13; Eleventh Circuit held that § 707(b) is equally applicable in cases converted to chapter 7 and thus dismissed case as abusive). abi