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## Peril on the Peaks: Ninth Circuit Reconciles Section 365 and 363 to Permit Stripping of Leases in Bankruptcy Sales

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**December 14, 2017** - What happens when property that a trustee wants to sell in a section 363 sale is subject to unexpired leases that the trustee is empowered to reject under section 365(h)? The Ninth Circuit faced this conundrum in a recent case involving a luxury real estate development in Montana, *Pinnacle Restaurant at Big Sky, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holdings II, LLC)*, 892 F.3d 892 (9th Cir. 2017). Wrestling with a split between its sister circuits, the Ninth Circuit ultimately concluded that, “[w]here there is a sale, but no rejection (or a rejection, but no sale), there is no conflict,” and the trustee could properly proceed with the sale.

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

At issue on appeal were two leases at the resort. The first was a restaurant space that Spanish Peaks Holdings, LLC (“SPH”) leased for \$1,000 per month to Spanish Peaks Development, LLC (“SPD”). SPH and SPD later replaced the lease with a 99-year leasehold for \$1,000 per year in rent. SPD assigned its interest to The Pinnacle Restaurant at Big Sky, LLC (“Pinnacle”). The second was a parcel of commercial real estate SPH leased to Montana Opticom, LLC (“Opticom”), for a term of 60 years and annual rent of \$1,285.

SPH defaulted on its loan payments and filed, along with two related entities, Chapter 7 petitions in Delaware. SPAP, SPH’s largest creditor with a claim of \$122 million secured by the mortgage, assigned its claim to CH SP Acquisitions, LLC (“CH SP”). The trustee and SPAP agreed to a plan to liquidate “substantially” all of the debtors’ property through an auction with a minimum bid of \$20 million. The trustee sought approval for sale of the property “free and clear of all liens,” except for certain enumerated encumbrances and liens to be paid out of the sale proceeds or otherwise protected.

The Pinnacle and Opticom leases were mentioned neither on the list of surviving encumbrances nor on the list of protected liens.. Both entities thus objected to any sale “free and clear of [their] leasehold interests.” 872 F.3d at 895. The bankruptcy court authorized the sale but did not rule on Pinnacle’s and Opticom’s objections. The court instead deferred them until the hearing on the motion to approve the sale.

At the auction and approval hearing on June 3, 2013, CH SP won the auction with a bid of \$26.1 million. Pinnacle and Opticom renewed their claim that their leases allowed them to retain possession and objected to the “free and clear” language in the proposed approval order.

The bankruptcy court approved the sale, holding that the sale was free and clear of any “Interests,” including any leases “except any right a lessee 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 896. After some procedural back-and-forth and another evidentiary hearing, the bankruptcy court found defects in Pinnacle’s and Opticom’s leases, and noted that they had neither requested adequate protection for their interests nor proven that they would suffer economic harm if their interests were terminated. The bankruptcy court thus held the sale was free and clear of the Pinnacle and Opticom leases, and the district court affirmed.

On appeal, the Ninth Circuit considered whether the leases survived the sale to CH SP, which gave rise to an apparent conflict between the trustee’s ability to sell property of the estate under section 363 and authority to assume or reject unexpired leases under section 365(a) and (h). Section 365 gives a lessee in possession with two choices: “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.* at 898.

Other circuits had taken one of two approaches to the apparent conflict. The majority held that section 365 outweighed section 363 “under the canon of statutory construction that ‘the specific prevails over the general.’” *Id.* (internal citation omitted).

In contrast, the Seventh Circuit had held that “the statutory provisions themselves do not suggest that one supersedes or limits the other.” *Id.* (quoting *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)). In other words, section 363 confers a right to sell property free and clear of “any interest” without exempting leases protected under section 365, while section 365(h) focuses on the specific event of the rejection of an executory contract without reference to sales of estate property under section 363. The Seventh Circuit explained:

Where estate property under lease is to be sold, section 363 permits the sale to occur free and clear of a lessee’s possessory interest--provided that the lessee (upon request) is granted adequate protection for its interest. Where the property is not sold, and the [estate] remains in possession thereof but chooses to reject the lease, section 365(h) comes into play and the lessee retains the right to possess the property. So understood, both provisions may be given full effect without coming into conflict with one another and without disregarding the rights of lessees.

327 F.3d at 548.

The Ninth Circuit agreed with the Seventh Circuit’s approach as the best way to reconcile the two statutes, noting that while “[a] sale of property free and clear of a lease may be an effective rejection of the lease in some everyday sense, . . . it is not the same thing as the ‘rejection’ contemplated by section 365.” 872 F.3d at 899.

Here, then, the trustee had not rejected the Pinnacle and Opticom leases, so section 365 was not in play, and section 363(f)(1) authorized the sale of the property free and clear of the leases. The Ninth Circuit therefore

affirmed the judgment of the district court.

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