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Closing the Loophole in Commercial Landlord Bankruptcies: Why the Ninth Circuit Made the Right Decision in Matter of Spanish Peaks Holdings II, LLC

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CLOSING THE LOOPHOLE IN COMMERCIAL LANDLORD BANKRUPTCIES: WHY THE NINTH CIRCUIT MADE THE RIGHT DECISION IN *MATTER OF SPANISH PEAKS HOLDINGS II, LLC*

ABSTRACT

The Ninth Circuit's recent decision in Matter of Spanish Peaks Holdings II, LLC *exposes a major loophole in the Bankruptcy Code in the landlord-tenant context. To exploit this loophole, real estate developers can establish two entities and have them enter into a lease as landlord and tenant, with the lease's terms heavily favoring the tenant. Then, should the landlord have to file for bankruptcy relief and liquidate its encumbered property, most lower courts will let the tenant retain possession for the duration of the lease. In this way, the developer will receive a financial windfall in the form of either a buyout or the opportunity to continue running the tenant's business on the purchaser's land. This windfall will come at the expense of the landlord's creditors, since encumbered land sells for less at auction. The majority approach therefore fails to balance the Bankruptcy Code's competing goals of maximizing creditor recovery and protecting tenants.*

To prevent such an abuse of the bankruptcy system, the Ninth Circuit adopted a rule that requires tenants to request adequate protection prior to the bankruptcy auction to receive continued possession or compensation. Because the tenants in Spanish Peaks *failed to make such a request, the Ninth Circuit held that it was appropriate to terminate their leases without compensation. The court left open the more difficult question of what it would have done had the tenants requested adequate protection. This Comment explores that remaining issue. It first argues that* Spanish Peaks *was a result-oriented opinion aimed at depriving two tenant entities of continued possession or compensation. It next proposes a way for judges to fashion adequate protection so as to minimize the impact of an undeserving tenant's recovery on the landlord-debtor's legitimate creditors. Since the Ninth Circuit's holding allows judges to minimize tenant recovery and thereby deter developers from exploiting the loophole in the Bankruptcy Code, this Comment concludes that the minority approach of fashioning adequate protection is more pragmatic than the majority approach of always granting continued possession.*

INTRODUCTION

The Ninth Circuit's recent decision in *Matter of Spanish Peaks Holdings II, LLC* ("*Spanish Peaks*") has deepened an already great divide among the courts regarding what to do with a commercial tenant's leasehold interest when a landlord sells its encumbered land at bankruptcy auction.[1] Applying § 365 of title 11 of the U.S. Code (the "Bankruptcy Code"), most courts hold that any tenants automatically get to remain in possession until the lease expires.[2] *Spanish Peaks* departed from this majority approach because the sophisticated landlords involved devised a savvy way to abuse it.[3] Specifically, under the majority approach, an individual can establish two entities and have both entities enter into a lease as the landlord and tenant with terms that heavily favor the tenant entity. Then, should the landlord entity's business fail, forcing it to seek bankruptcy relief and liquidate its property, courts will permit the tenant entity to continue encumbering the land for the duration of the lease. The fact that the land comes with a bad bargain will presumably lower its value at auction, raising less money for the landlord's creditors.[4] Worse, to obtain full, unencumbered fee simple in the land, the purchaser will have no choice but to buyout any tenants. A tenant with a heavily one-sided, long-term lease could presumably demand (and receive) a high price. The individual whose landlord entity had just filed for bankruptcy relief would receive a huge windfall from such a buyout, since it would allow that person to recoup losses at the expense of any creditors. Therefore, there is a tremendous financial incentive for people to arrange real estate developments in a way that allows some recovery in case of bankruptcy liquidation.

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[1] Pinnacle Rest. at Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 872 F.3d 892 (9th Cir. 2017).

[2] *See, e.g.*, *In re* Haskell, L.P., 321 B.R. 1 (Bankr. D. Mass. 2005); *In re* Taylor, 198 B.R. 142 (Bankr. D.S.C. 1996). *See also In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898 (labelling this approach "the 'majority' approach"). Title 11 U.S.C. § 365(h)(1)(A)(ii) provides:

> If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and—if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.

[3] *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892.

[4] *Id*. at 898.

To avoid landlord recovery under this scenario, the Ninth Circuit adopted an approach that deprived commercial tenants of automatic continued possession.[5] Courts that follow the Ninth Circuit's "minority approach" to landlord bankruptcies hold that, under 11 U.S.C. § 363, trustees can sell property free and clear of a tenant entity's lease, provided that on request of the tenant, the bankruptcy judge grants it "adequate protection" for its interest.[6] In *Spanish Peaks*, the tenants failed to request adequate protection; therefore, the circuit court authorized a sale of the encumbered land free and clear of their leasehold interests.[7] The Ninth Circuit left open the more difficult question of what it would have done had the tenant entities sought to protect their rights prior to the bankruptcy auction.[8] Accordingly, no one knows exactly what adequate protection will look like under § 363(e).[9] Only the Southern District of New York, in *Dishi & Sons v. Bay Condos LLC* ("*Dishi & Sons*"), has discussed the adequate protection problem in this context. In *Dishi & Sons*, the court stated in dicta that continued possession would have been the appropriate form of adequate protection under the circumstances.[10] However, the Ninth Circuit in *Spanish Peaks* suggested that there could—and should—be other forms of adequate protection, although it did not say what those other forms might be.[11] Still, letting the tenants recover anything would not only be contrary to the Bankruptcy Code's goal of maximizing creditor recovery,[12] but it would also leave open the loophole that the landlord in *Spanish Peaks* attempted to exploit.[13]

Many judges will soon have to face this adequate protection problem in the commercial landlord-tenant context, considering that the minority approach posited by *Spanish Peaks*, which requires tenants to timely request adequate

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[5] *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892.

[6] *See, e.g.*, Precision Indus., Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp.), 327 F.3d 537 (7th Cir. 2003). *See also In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 899 (labelling this approach "the 'minority' approach"). Title 11 U.S.C. § 363 provides:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

[7] *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 896.

[8] *Id*. at 900.

[9] *See* Jerald I. Ancel et al., *Can A § 363 Sale Dispossess A Tenant Notwithstanding § 365(h)?*, AM. BANKR. INST. J., July/August 2003, at 18, 31. *See also In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 899.

[10] Dishi & Sons v. Bay Condos LLC, 510 B.R. 696, 711–12 (S.D.N.Y. 2014).

[11] *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 900.

[12] *Id*.

[13] *Id*. at 892.

protection, appears to be trending.[14] Indeed, in *Spanish Peaks* the Ninth Circuit became the second of two federal circuit courts of appeals to adopt it.[15] Thus, not only does the minority view now bind at least twelve states and the Western District of Pennsylvania,[16] but the weight of two circuit court opinions suggests that judges in other parts of the country will begin adopting it as well.[17] Therefore, in future landlord bankruptcies, well-informed tenants will likely ask for adequate protection as a precautionary measure,[18] which means that many judges will soon be forced to provide "adequate protection" for tenants under § 363(e).

This Comment explores the open issue of what a bankruptcy judge should have done had the tenants diligently requested adequate protection in *Spanish Peaks*. It proceeds in three parts. Part I begins by providing an overview of the two approaches to landlord bankruptcies, and then gives the facts of *Spanish Peaks*. Next, Part II argues that *Spanish Peaks* was a result-oriented opinion aimed at depriving the undeserving tenant entities of adequate protection. Given the outcome-oriented nature of the Ninth Circuit's decision, this Comment explores how a bankruptcy judge could have avoided granting compensation or continued possession to the tenants, even if they had requested adequate protection. Finally, Part III asserts that the minority approach is more practical than the majority approach because it offers judges more flexibility in dealing with the leases of commercial tenants; it is therefore less vulnerable to exploitation by sophisticated landlords. This Comment is limited to landlord

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[14] *See id*.; *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d 537; *In re* Hill, 307 B.R. 821, 825 (Bankr. W.D. Pa. 2004) (adopting the reasoning set forth in *Qualitech*).

[15] *See In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892; *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d 537; *In re* Hill, 307 B.R. at 825 (adopting the reasoning set forth in *Qualitech*).

[16] Illinois, Indiana, and Wisconsin in the Seventh Circuit; Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, and Washington in the Ninth Circuit. *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892; *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d 537; *In re* Hill, 307 B.R. 821 at 825 (adopting the reasoning set forth in *Qualitech*).

[17] *See* Robert M. Zinman, *Precision in Statutory Drafting: The Qualitech Quagmire and the Sad History of § 365 (h) of the Bankruptcy Code*, 38 J. MARSHALL L. REV. 97, 127 (2004) (stating that "there is a good possibility that [the law of the Seventh Circuit] will be followed by other courts"). *See also In re* Hill, 307 B.R. at 825 (adopting the Seventh Circuit's minority approach).

[18] See Dishi & Sons, 510 B.R. at 700, for a case in which the tenant of a bankrupt landlord requested adequate protection as precautionary measure. *See also* Gary F. Torrell, *Owner vs. Tenant Rights in a Property in Bankruptcy*, L.A. LAW., Jan. 2018, at 12, 14 ("For tenants of a bankrupt landlord, the lesson to be learned here is to aggressively pursue and protect one's rights and request 'adequate protection' under Bankruptcy Code Section 363 when any sale of the underlying real property is proposed free and clear of the tenant's lease."); Alan R. Lepene, Andrew L. Turscak, Jr., & Louis F. Solimine, *Ninth Circuit Reignites Debate over Interplay of Sections 363, 365*, L. J. NEWSL. (Oct. 2017), http://www.lawjournalnewsletters.com/sites/lawjournalnewsletters/2017/10/01/ninth-circuit-reignites-debate-over-the-interplay-of-sections-363-365/?slreturn=20180201205408.

bankruptcies in the commercial context and is agnostic with regard to residential leases.

I. BACKGROUND

A. Two Approaches to Landlord Bankruptcies

1. The Majority Approach

Courts are split on what to do with a commercial tenant's leasehold interest when a trustee or debtor-in-possession sells encumbered property in a bankruptcy sale.[19] While the only two circuit courts that have considered the issue required tenants to request adequate protection prior to the auction to receive the protections of the Bankruptcy Code,[20] most bankruptcy courts and district courts hold that tenants do not need to do anything to remain in possession for the duration of the lease.[21] For instance, the Bankruptcy Court for the District of South Carolina in *In re Taylor* granted the tenant continued possession until the lease's expiration.[22] In *Taylor*, the landlord-debtor leased out his five nursing homes to five related entities, collectively called the "Magnolia Entities."[23] After filing for chapter 11 bankruptcy, the debtor made a motion to sell the five nursing home facilities free and clear of the Magnolia Entities' leasehold interests pursuant to 11 U.S.C. §§ 363(b)(1) and (f).[24] The Magnolia Entities objected, and the bankruptcy court faced the issue of whether § 363 authorizes a sale of land free and clear of a lessee's interest.[25]

Like most lower courts that have considered this issue, the bankruptcy court denied the landlord-debtor's request under § 363 to sell the encumbered properties free and clear of the tenants' leases.[26] Instead, the court held that § 365(h) trumps § 363 and thus entitles a tenant in a landlord bankruptcy to elect

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[19] *See In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898.

[20] *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892; *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d 537.

[21] *See, e.g., In re* Taylor, 198 B.R. 142 (Bankr. D.S.C. 1996). *See also In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898 (listing *In re* Taylor as an example of the "'Majority' Approach").

[22] *In re* Taylor, 198 B.R. at 142. *See also In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898 (listing *In re* Taylor as an example of the "'Majority' Approach").

[23] *In re* Taylor, 198 B.R. at 144.

[24] *In re* Taylor, 198 B.R. at 152.

[25] *In re* Taylor, 198 B.R. at 153.

[26] *In re* Taylor, 198 B.R. at 168. *See also In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898 (listing *In re Taylor* as an example of the "'Majority' Approach").

either continued possession or a cause of action for breach of contract.[27] In reaching its conclusion, the court applied two lines of reasoning. First, the court invoked the canon *generalia specialibus non derogant*, or a specific provision prevails over a conflicting general provision.[28] Under this interpretive principle, the court determined that § 365(h), which "specifically references the situation where the debtor is the lessor and *with great particularity* sets forth the rights and duties of the lessor and lessee," should prevail over the less specific § 363.[29] Second, the court looked to the legislative history regarding § 365.[30] There, the court found "a clear intent on the part of Congress to protect a tenant's estate when the landlord files bankruptcy."[31] To let a debtor or trustee sell the encumbered land free and clear of any leasehold interests would, according to the court, "be in direct contravention of the lessee protections specifically afforded by § 365," even if the lessee received compensation for its interest from the proceeds of the auction.[32] Accordingly, the bankruptcy court denied the debtor's motion to sell the encumbered land free and clear of the tenant's lease.[33]

2. The Minority Approach: Qualitech

While most lower courts follow the holding in *Taylor*, which entitles tenants of bankrupt landlords to remain in possession,[34] the Seventh Circuit adopted a different view in 2003.[35] Specifically, in a case of first impression at the circuit level, the Seventh Circuit held in *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC (*In re *Qualitech Steel Corp. & Qualitech Steel Holdings Corp.)* ("*Qualitech*") that prior to a bankruptcy auction, a commercial lessee must request adequate protection from the bankruptcy judge to prevent the liquidation of the encumbered property free and clear of the leasehold interest.[36] *Qualitech* featured a land lease that the Qualitech Steel Corporation and Qualitech Steel

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[27] *In re* Taylor, 198 B.R. 142 at 168.

[28] *In re* Taylor, 198 B.R. at 165. The canon *generalia specialibus non derogant* provides that a specific provision prevails over a general provision. Nitro-Lift Techs., L.L.C. v. Howard, 568 U.S. 17, 21 (2012). Section 365(h)(1)(A) applies to situations in which "the trustee rejects an unexpired lease of real property under which the debtor is the lessor." It states that "if the term of such lease has commenced, the lessee may retain its rights under such lease . . . for the balance of the term of such lease." Section 363(f), on the other hand, applies more broadly to situations in which the trustee "sell[s] property . . . free and clear of any interest in such property."

[29] *In re* Taylor, 198 B.R. at 165 (emphasis in original).

[30] *Id*.

[31] *Id.*

[32] *Id*. at 165–66.

[33] *Id.* at 168.

[34] *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898 (labelling this approach "the 'majority' approach").

[35] *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d at 540.

[36] *Id*. at 540, 548.

Holdings Corporation (collectively "Qualitech") entered into with Precision Industries, Inc. and Circo Leasing Co., LLC (collectively "Precision") on February 25, 1999.[37] Under the agreement, Qualitech leased land at its Indiana steel mill facility to Precision for a term of ten years.[38] Precision intended to construct and operate a warehouse on the space to provide on-site supply services for Qualitech.[39] Precision paid nominal rent of $1 per year, and enjoyed exclusive possession of the warehouse for the term of the lease.[40] In exchange, the lease granted Qualitech the right at the expiration of the term to purchase the warehouse, its fixtures, and other improvements for $1.[41] In reliance on the lease, Precision built and stocked a warehouse on the steel facility, and Qualitech began purchasing goods from Precision.[42]

On March 22, 1999—fewer than four weeks after execution of the lease—Qualitech filed for chapter 11 bankruptcy.[43] About three months later, on June 30, 1999, Qualitech sold virtually all of its assets, including the encumbered land, at auction for $180,000,000 to a group of pre-petition lenders that held the primary mortgage on the Indiana facility.[44] By this time, there were more than $380,000,000 in claims against Qualitech's estate.[45] Qualitech owed more than $263,000,000 of this amount to the pre-petition lenders that purchased the property at auction.[46] On August 13, 1999, the bankruptcy court entered an order approving the sale and directing Qualitech to convey its assets "free and clear of all liens, claims, encumbrances, and interests" to the purchasers.[47] Shortly thereafter, on August 26, 1999, the purchasers transferred their interest in the assets to Qualitech Steel SBQ, LLC ("New Qualitech").[48] Fatal to its case, Precision neither objected to the sale nor requested adequate protection.[49]

After receiving the land, New Qualitech changed the locks on the warehouse Precision constructed.[50] This move led to a dispute between Precision and New Qualitech over whether Precision still had a leasehold interest in the property

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37 *Id*. at 540.
38 *Id*.
39 *Id*.
40 *Id*.
41 *Id*.
42 *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d at 540.
43 *Id*.
44 *Id*.
45 *Id*. at 540 n.1.
46 *Id*. at 540 n.2.
47 *Id*. at 540–41.
48 *Id*. at 541.
49 *Id*. at 548.
50 *Id*. at 541.

following the bankruptcy auction.[51] The parties took their dispute to the Bankruptcy Court for the Southern District of Indiana, which resolved the matter in New Qualitech's favor under the "unequivocal" language of the sale order.[52] Precision appealed, and the United States District Court for the Southern District of Indiana reversed, applying the majority approach of always granting continued possession.[53] New Qualitech then appealed the district court decision to the Seventh Circuit, arguing that § 363 extinguished Precision's possessory interest in the property.[54]

The Seventh Circuit adopted the rule that in a landlord bankruptcy, a commercial tenant must request adequate protection prior to the liquidation of the encumbered land to avoid losing its leasehold interest.[55] Although the Seventh Circuit acknowledged the South Carolina Bankruptcy Court's decision in *Taylor*,[56] it reached the opposite conclusion and held that § 365(h) does not supersede § 363(f).[57] Thus, the Seventh Circuit held that the land sale occurred free and clear of Precision's lease since Precision failed to timely request adequate protection.[58] The Seventh Circuit gave two main reasons for its conclusion.[59] First, it applied the canon that judges should interpret sections of the Code so as to avoid conflicts between them.[60] The Seventh Circuit thereby read §§ 363(f) and 365(h) in such a way that they could coexist.[61] Because the court observed that §§ 363(f) and 365(h) lack limiting cross-references found in other provisions of §§ 363 and 365, it stated under the maxim of *expressio unius est exclusio alterius* that Congress seemingly did not intend for § 365(h) to limit § 363(f).[62] Further, the plain language of § 365(h)(1) restricts it to cases in which the trustee (or debtor-in-possession) "rejects" a lease, saying nothing about sales of estate property.[63] The court took the view that Congress therefore left the

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51 *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d at 541.

52 *Id*.

53 *Id*. at 542.

54 *Id*. at 542–43.

55 *Id*. at 548.

56 *Id*. at 545, 546, 547.

57 *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d at 546-47.

58 *Id*. at 548.

59 *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d 537.

60 *Id*. at 548.

61 *Id*.

62 *Id*. at 547 (citing City of Chicago v. Envtl. Def. Fund, 511 U.S. 328, 338 (1994)). The canon *expressio unius est exclusio alterius* "instructs that, where a statute designates a form of conduct, the manner of its performance and operation, and the persons and things to which it refers, courts should infer that all omissions were intentional exclusions." 2A SUTHERLAND STATUTORY CONSTRUCTION § 47:23 (7th ed.) (2017).

63 *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d 537 at 547 (quoting 11 U.S.C. § 365(h)(1)(A)).

governance of bankruptcy sales to § 363.[64] Second, the Seventh Circuit noted that § 363 contains its own mechanism of protecting tenants: the adequate protection provision of § 363(e).[65] "Adequate protection," according to the court, "does not necessarily guarantee a lessee's continued possession of the property, but it does demand, in the alternative, that the lessee be compensated for the value of its leasehold—typically from the proceeds of the sale."[66] Hence, the Seventh Circuit arrived at the general rule that:

> 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 debtor 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.[67]

The Seventh Circuit defended its rule by pointing out that this interpretation honors the Bankruptcy Code's "twin purposes of maximizing creditor recovery and rehabilitating the debtor."[68] The court concluded that because Precision failed to object to the sale or seek adequate protection under § 363(e) prior to the auction, the trustee properly sold the land free and clear of Precision's leasehold interest.[69]

B. The Reception of Qualitech

Critics and lower courts alike have criticized the Seventh Circuit's holding because it yields harsh results, unresolved issues, and potential negative consequences; relies on questionable statutory construction; and conflicts with legislative history.[70] Thus, for nearly fifteen years, *Qualitech* had little influence

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64 *Id*.

65 *Id*. at 547–48.

66 *Id*. at 548 (internal citations omitted).

67 *Id*.

68 *Id*.

69 *Id*.

70 *See, e.g.*, *In re* Haskell, L.P., 321 B.R. 1 (Bankr. D. Mass. 2005); Daniel J. Ferretti, Note, *Eviction Without Rejection–The Tenant's Bankruptcy Dilemma: Bankruptcy Code Sections 363(f) and 365(h)(1)(a) and the Divergent Interpretations of* Precision Indus., Inc. v. Qualitech Steel SBQ, LLC *and In re* Haskell, 39 CUMB. L. REV. 707, 723-28 (2009); Michael St. Patrick Baxter, *Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in* Precision Industries v. Qualitech Steel, 59 BUS. L. REV. 475 (2004); Zinman, *supra* note 17, at 106-18; Bruce H. White & William L. Medford, *Rejection via Sale of Real Estate: Is Your Leasehold Interest Protected?*, 26 ABI J. 7, 28 (2007); Christopher C. Genovese, Precision Industries v. Qualitech Steel*: Easing the Tension Between Sections 363 and 365 of the Bankruptcy Code?*, 39 REAL PROP. PROB. & TR. J. 627 (2004). *But see In re* Hill, 307 B.R. at 825 (adopting the reasoning set forth in *Qualitech*).

on lower court holdings outside of the Seventh Circuit.[71] For instance, the Bankruptcy Court for the District of Massachusetts in *In re Haskill* concluded that "[i]f it were to [adopt the Seventh Circuit's reasoning], the provisions of § 365(h) would be eviscerated."[72] In *Haskill*, the landlord-debtor entered into a ninety-nine year lease with the tenant-hospital with no fixed rent, and granted the tenant a second mortgage in the land.[73] The landlord-debtor subsequently filed for relief under chapter 11 of the Bankruptcy Code.[74] In its proposed repayment plan, the debtor sought to liquidate the encumbered property free and clear of the tenant's unexpired lease.[75] As of the commencement of the case, the fair market value of the land at issue was approximately $6,500,000, and the amount of the first mortgage on the property was approximately $13,000,000.[76]

The landlord-debtor argued that because the government in an eminent domain taking could hypothetically compel a lessee to accept a money satisfaction of its leasehold interest, a trustee could sell the encumbered property free and clear of the lease under 11 U.S.C. § 363(f)(5).[77] Citing *Qualitech*, the debtor further asserted that § 365(h) did not apply, because a court could read that section to coexist with § 363(f).[78] Finally, the debtor insisted that the tenant's lien on the property constituted adequate protection of its interest, even though the debtor's attorney conceded that the tenant would likely receive no proceeds from a sale of the land.[79]

Despite the fact that the Seventh Circuit had recently ruled otherwise,[80] the Massachusetts bankruptcy court held that § 365(f)(5) automatically entitles tenants of bankrupt landlords to continued possession upon liquidation of the encumbered property.[81] First, the court looked at the legislative history of § 365(h), which showed that Congress intended to protect tenants' estates in landlord bankruptcies.[82] The bankruptcy court reasoned that allowing a trustee

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[71] *See, e.g.*, *In re* Haskell, L.P., 321 B.R. 1. *But see In re* Hill, 307 B.R. at 825 (adopting the reasoning set forth in *Qualitech*).

[72] *In re* Haskell, L.P., 321 B.R. at 9.

[73] *Id*. at 3–4.

[74] *Id*.

[75] *Id*. at 3.

[76] *Id*. at 5.

[77] *Id*. Section 363(f)(5) provides that "[t]he trustee may sell property . . . free and clear of any interest in such property of an entity other than the estate, only if . . . such entity could be compelled . . . to accept a money satisfaction of such interest." 11 U.S.C. § 363(f)(5).

[78] *In re* Haskell, L.P., 321 B.R. at 5. *See also* 11 U.S.C. § 365(h).

[79] *In re* Haskell, L.P., 321 B.R. at 5.

[80] *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d at 548.

[81] *In re* Haskell, L.P., 321 B.R. at 8–10.

[82] *Id*. at 7 (citing *In re Taylor*, 198 B.R. 142, 165-66 (Bankr. D.S.C. 1996)).

to sell land free and clear of any leasehold interests—as the Seventh Circuit had done—would dispossess a tenant and would therefore be contrary to the purpose of § 365(h).[83] Second, the court feared that letting the debtor dispossess the tenant would nullify § 365(h).[84] Finally, the lower court noted that if it were to grant adequate protection under § 363 by replacing the tenant's leasehold interest with a lien on the property, the tenant would be unlikely to recover any proceeds from the bankruptcy sale.[85] The court found this outcome unacceptable, and ultimately granted the lessee continued possession.[86] In arriving at its conclusion, the bankruptcy court in *Haskill* explicitly rejected the statutory interpretation and outcome of *Qualitech*[87] and instead adopted the majority view of always granting continued possession.[88]

Michael St. Patrick Baxter took the position that the Seventh Circuit wrongly decided *Qualitech* on both textual and pragmatic grounds.[89] Baxter first wrote that the Seventh Circuit was incorrect in its view that § 365(h) does not limit § 363(f).[90] To support this claim, Baxter observed that "the legislative history of § 365(h) reveals that Congress has consistently sought to strengthen lessee rights when [those rights] were threatened by narrow court interpretations."[91] Further, for purposes of §§ 363(f) and 365(h), a sale that effects the repudiation of a lease is not different from a sale that rejects a lease.[92] The Seventh Circuit's conclusion to the contrary effectively nullified § 365(h).[93] Additionally, Baxter argued that the Seventh Circuit erred in reasoning that adequate protection under § 363(e) could be an acceptable alternative to continued possession under § 365(h).[94] He elaborated that "[t]o convert a lessee's § 365(h) rights to cash compensation in the form of adequate protection under § 363(e), as suggested by the Seventh Circuit, would be tantamount to an impermissible cramdown of the lessee."[95] Finally, Baxter questioned how a court could place a value on a

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[83] *Id*.

[84] *Id*.

[85] *Id*. at 9–10.

[86] *Id*. at 10.

[87] *Id*. at 9.

[88] *Id*.

[89] Baxter, *supra* note 70, at 476 (Baxter is a partner with Covington & Burling LLP in Washington, D.C., and an adjunct professor of law at George Washington University School of Law.).

[90] *Id*. at 482 (citing *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp. 327 F.3d at 547).

[91] Baxter, *supra* note 70, at 484 (citing Robert M. Zinman, *Landlord's Lease Rejection and the 1984 Amendments to § 365(h)*, 16 AM. BANKR. INST. J. 31 (1994)).

[92] *Id*. at 486.

[93] *Id*.

[94] *Id*. at 491.

[95] *Id*.

lost leasehold interest, given that no precedent exists.[96] These textual issues with the *Qualitech* holding led Baxter to conclude that the Seventh Circuit incorrectly decided the case.[97]

Baxter also feared that the *Qualitech* decision would create a number of practical problems.[98] In particular, Baxter worried that the Seventh Circuit's reasoning would lead debtors to attempt "stealth rejections of leases" to avoid the requirements of § 365(h).[99] Such rejections "may be devastating to lessees and real estate lease financiers who rely on the ability of lessees to retain possession of their leasehold interests in the event of the bankruptcy of the lessor."[100] At the same time, the Seventh Circuit's opinion would be an advantage to the debtor because the debtor would be able to cramdown on the lessee.[101] Hence, Baxter discouraged all courts from following the Seventh Circuit's decision in *Qualitech*.[102]

Professor Robert Zinman specifically responded to Baxter's arguments.[103] While Zinman agreed with Baxter that *Qualitech* discouraged leasehold financing and conflicted with the congressional intent of § 365 to protect tenants in landlord bankruptcies, he pointed out that the Seventh Circuit was correct in its interpretation of the Bankruptcy Code.[104] Professor Zinman therefore concluded that the Seventh Circuit actually reached the right outcome.[105] Because a bankrupt landlord in a minority-approach jurisdiction could essentially ignore § 365(h) and sell encumbered land free and clear of leasehold interests, Zinman feared that the Seventh Circuit's decision in *Qualitech* would "completely disrupt leasehold investments."[106] These effects conflicted with Congress's intent "to protect the tenant's estate and the rights of those with interests in that estate when the lease is disaffirmed in the landlord's

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96 Baxter, *supra* note 70, at 491.

97 *Id*. at 477.

98 *Id*. at 495–99.

99 *Id*. at 496.

100 *Id*.

101 *Id*. at 497.

102 *Id*. at 500. Although beyond the scope of this Comment, Baxter also mentioned that *Qualitech* "may have substantial implications for the licensing of intellectual property." *Id.* at 475. Specifically, Baxter feared that *Qualitech* might "be applied . . . in § 363(f) sales to extinguish the rights of licensees of intellectual property under § 365(n)." *Id*. at 477.

103 Zinman, *supra* note 17 (Robert Zinman is a professor at St. John's University School of Law.).

104 *Id.* at 99-101, 127. *See also In re* Hill, 307 B.R. at 825 (adopting the reasoning set forth in *Qualitech*).

105 Zinman, *supra* note 17, at 127. Baxter reached this conclusion based on the language of the Bankruptcy Code.

106 *Id*. at 99–100.

bankruptcy."[107] Congress did not intend "that the landlord could easily avoid these protections by employing § 363 in lieu of § 365."[108] Nevertheless, based on the text of the Bankruptcy Code, the Seventh Circuit held that a landlord could do just that.[109]

Even though Zinman believed that the *Qualitech* decision conflicted with congressional intent, he found that the Seventh Circuit did not err in its textual analysis of the interplay between §§ 365(h) and 363.[110] Indeed, the canon that *generalia specialibus non derogant*—the canon on which the majority of lower courts relied—only applies when two provisions deal with the same situation and produce different results.[111] Sections 363 and 365 deal with distinct circumstances.[112] As such, Zinman agreed with the Seventh Circuit that § 365 should not trump § 363.[113] To support his conclusion, Zinman pointed out that "[§§ 363 and 365] are clear and make no reference to each other," while other Bankruptcy Code sections contain careful references to any other conflicting provisions.[114] The rule that *expressio unius est exclusio alterius* suggests that Congress purposefully omitted limiting cross-references, and thus intended that §§ 363 and 365 would not conflict.[115]

Zinman went on to expressly refute Baxter's argument that the Seventh Circuit had misinterpreted the text of the Bankruptcy Code.[116] Whereas Baxter found § 363(l) to evidence Congress's intent to subordinate all of § 363 to § 365,[117] Zinman claimed that § 363(l) only applies to limited circumstances, and thus only conflicts with certain clauses of § 365.[118] Additionally, "to put the 'subject to' language in the provision designed to deal with ipso facto clauses in

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107 *Id*. at 118.

108 *Id*.

109 *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d 537.

110 Zinman, *supra* note 17, at 100, 127.

111 *Id*. at 124. The canon *generalia specialibus non derogant* provides that a specific provision prevails over a general provision. Nitro-Lift Techs., L.L.C., 568 U.S. at 21.

112 Zinman, *supra* note 17, at 124. According to Zinman, "[u]nder § 365, the landlord retains ownership of the property, while under [§] 363, the landlord disposes of the fee interest either subject to, or free and clear of the lease."

113 *Id*.

114 *Id*. at 125. As an example, Zinman examined the cross-references contained in § 363(d).

115 *Id*. The canon *expressio unius est exclusio alterius* "instructs that, where a statute designates a form of conduct, the manner of its performance and operation, and the persons and things to which it refers, courts should infer that all omissions were intentional exclusions." 2A SUTHERLAND STATUTORY CONSTRUCTION § 47:23 (7th ed.) (2017).

116 Zinman, *supra* note 17, at 125–27.

117 Baxter, *supra* note 70, at 484; Zinman, *supra* note 17, at 125-26.

118 Zinman, *supra* note 17, at 125-27.

an attempt to subordinate all of § 363 to § 365," as Baxter argued Congress had done, "would simply constitute illogical drafting."[119] Even though Zinman disagreed with Baxter that the Seventh Circuit had errantly interpreted §§ 363 and 365, he questioned whether the *Qualitech* result was correct in practice and reflective of the spirit of § 365 to protect tenants.[120] Accordingly, Zinman called on Congress to amend the Bankruptcy Code to offer greater tenant protection in landlord bankruptcies.[121]

Scholars and attorneys have also criticized *Qualitech* for its negative real-world implications and its unresolved issues.[122] For example, one critic argued that *Qualitech* was contrary to Congress's intent to protect lessees in landlord bankruptcies, since the Seventh Circuit allowed a debtor-in-possession to effectively dispossess a tenant that had already greatly invested in the property.[123] Likewise, another critic noted that the protections afforded tenants under § 363 are inferior to those of § 365, and as such developer tenants may be reluctant to take the risk of developing or improving leased property.[124] Finally, one lawyer simply noted that *Qualitech* failed to define precisely what adequate protection would look like.[125]

C. Adequate Protection under Dishi & Sons

To date, only the Southern District of New York in *Dishi & Sons* has considered adequate protection in the landlord bankruptcy context, which the court stated in dicta that it would have provided to the tenant in the form of continued possession.[126] While *Dishi & Sons* offers some guidance, the Ninth Circuit's discussion in *Spanish Peaks* suggests that other forms of adequate protection exist.[127] *Dishi & Sons* involved a lease between the landlord, a majority owner of two commercial condominium units, and the tenant of one of those units, a pub called The Ginger Man ("TGM").[128] The landlord owed a

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[119] *Id*. at 127.

[120] *Id*. at 100, 167 ; Baxter, *supra* note 70, at 484.

[121] Zinman, *supra* note 17, at 100, 167.

[122] *See* Ferretti, *supra* note 70, at 726-27; Genovese, *supra* note 70, at 643, 646-47; Ancel et al., *supra* note 9, at 31.

[123] Ferretti, *supra* note 70, at 726-27.

[124] Genovese, *supra* note 70, at 646-47.

[125] *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d 537. *See also* Genovese, *supra* note 70, at 641; Ancel et al., *supra* note 9, at 31.

[126] Dishi & Sons, 510 B.R. 696. *See also In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 900 (citing only *Dishi & Sons* as authority on the issue of fashioning adequate protection for a tenant in the landlord bankruptcy context).

[127] *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 899.

[128] Dishi & Sons, 510 B.R. at 699.

creditor approximately $13,500,000 on these condominium units, with the creditor securing its interest with a mortgage on the property.[129] After the landlord-debtor filed a petition for relief under chapter 11 of the Bankruptcy Code, it filed a chapter 11 plan proposing to sell the condominium unit free and clear of TGM's lease.[130] Dishi & Sons ("Dishi") then purchased the property—purportedly free and clear of TGM's interest—at a bankruptcy auction with a bid of $6,075,000.[131] Before the bankruptcy court confirmed the landlord's chapter 11 plan and approved the sale, TGM requested continued possession for the duration of the lease under § 365(h) or, alternatively, adequate protection under § 363(e).[132]

The district court adopted the majority position and determined that § 365 entitled TGM to continued possession until the lease's expiration.[133] However, the court took a belt-and-suspenders approach and also addressed—in dicta—Dishi's argument that the bankruptcy court had erred in granting TGM continued possession under § 363(e).[134] Dishi asserted that adequate protection should have instead taken the form of a sum of money or possession for a limited term, since these solutions would be more fair to the purchaser.[135] The court rejected Dishi's arguments, first noting that "§ 363(e) is focused upon protecting the entity whose interest is threatened, not other creditors or the purchaser."[136] The court then gave the rule that "[w]here it is improbable that the lessee will receive any compensation for its interest from proceeds of the sale, and it is difficult to value the lessee's unique property interest . . . 'adequate protection can be achieved only through continued possession of the leased premises.'"[137] Because the landlord-debtor owed significantly more on the property than what the property was worth, TGM probably would not have received any compensation from the bankruptcy sale.[138] Additionally, the district judge found TGM's leasehold interest difficult to value.[139] Hence, the court concluded that had it been forced to provide adequate protection to TGM, continued possession would have been the proper solution.[140]

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129 *Id*.
130 *Id*.
131 *Id*. at 700.
132 *Id*.
133 *Id*. at 708.
134 *Id*. at 711.
135 *Id*.
136 *Id*.
137 *Id*. at 711-12 (quoting *In re* Haskell, L.P., 321 B.R. at 10).
138 *Id*. at 712.
139 *Id*.
140 Dishi & Sons, 510 B.R. at 712.

D. Spanish Peaks*: Facts and Holding*

In July 2017, the Ninth Circuit became only the second circuit court to deal with a tenant's leasehold interest in the bankruptcy liquidation of a landlord's encumbered property.[141] To avoid inequitable results in the case of *Spanish Peaks*, the Ninth Circuit adopted the Seventh Circuit's holding in *Qualitech*, despite that decision's unpopularity.[142] Had the appellate court in *Spanish Peaks* adopted the majority approach of always allowing lessees to remain in possession for the duration of the lease, the founders of a bankrupt business would have recovered millions of dollars at the expense of their creditors.[143] The Seventh Circuit's minority approach of requiring tenants to request adequate protection to prevent a sale free and clear of encumbrances enabled the Ninth Circuit to close the loophole—at least this one time.[144] Indeed, near the end of the opinion, the judges hinted that they did not know how they would have stopped the founders from exploiting the bankruptcy process by recovering millions of dollars at the expense of creditors had those founders diligently requested adequate protection.[145] Thus, while the Ninth Circuit's result-oriented approach prevented unjust results in *Spanish Peaks*, it remains unclear how judges will achieve similar outcomes in the future.[146]

Spanish Peaks involved Spanish Peaks Holdings, LLC ("SPH"), the owner of a 5,700-acre Montana ski resort; and two of its tenants.[147] The resort was "the brainchild of James J. Dolan, Jr., and Timothy L. Blixseth," who obtained financing for the project by obtaining a $130,000,000 loan secured by a mortgage and assignment of rents.[148] Spanish Peaks Acquisition Partners, LLC ("SPAP"), ultimately ended up with the note and mortgage.[149] The resort featured a number of specialized entities that owned and managed its amenities.[150] These entities included The Pinnacle Restaurant at Big Sky, LLC ("Pinnacle"); and Montana Opticom, LLC ("Montana Opticom"), a

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141 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892.

142 *Id*. *See also* Vicki R. Harding, *Sale Free and Clear of Lease: The Battle Between Section 363 and 365*, BANKRUPTCY-REALESTATE-INSIGHTS (Jan. 31, 2018), https://bankruptcy-realestate-insights.com/2018/01/31/sale-free-and-clear-of-lease-the-battle-between-section-363-and-section-365/ ("In [*Spanish Peaks*] it is likely that the [tenant entities'] blatant attempt to favor insiders made it more appealing to find in favor of the buyer.").

143 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892. *See also* Harding, *supra* note 142.

144 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892.

145 *Id*.

146 *Id*.

147 *Id*. at 894.

148 *Id*.

149 *Id*.

150 *Id*.

telecommunications company.[151] Both entities had leasehold interests in SPH's land.[152] Specifically, in 2006 Pinnacle entered into a ninety-nine-year lease with SPH, agreeing to pay rent of $1,000 per year in exchange for restaurant space.[153] Three years later, in 2009, SPH entered into a lease with Montana Opticom for a term of sixty years, with an annual rent of $1,285.[154] Dolan served as an officer of both SPH and Pinnacle, and was the sole member of Montana Opticom.[155] In these capacities, he signed the Pinnacle lease as both the lessor and the lessee, and the Montana Opticom lease as the lessee.[156] Notably, the mortgage securing SPH's $130,000,000 loan was senior to these two leases.[157] It is also important that neither tenant had a Subordination, Non-disturbance, and Attornment ("SNDA") agreement with the mortgagee or with the landlord.[158]

The Pinnacle lease provided that "[a]ll improvements constructed on the Premises by [the lessee, Spanish Peaks Development, LLC] shall be owned by [the lessee]" and that "any permanent improvements described in [the Pinnacle lease] shall become and remain [the lessor's (Spanish Peaks Holdings, LLC's)] property."[159] Despite any improvements that the lessees may have made to the restaurant space, in April 2011, Dolan and the Pinnacle Restaurant at Big Sky, LLC closed the doors to the Pinnacle Restaurant.[160] As of March 10, 2014—the day on which the bankruptcy court issued its order—they still had not reopened them.[161] The Montana Opticom lease provided for Montana Opticom to place telecommunication towers around the resort so that members of the Spanish Peaks club could have access to telephone and related services.[162] Presumably, Montana Opticom did just that.

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151 *Id*. at 894–95.

152 *Id*.

153 *Id*. at 894. The lease was actually between SPH and Spanish Peaks Development, LLC, but in 2008 Spanish Peaks Development, LLC, assigned its interest to Pinnacle Restaurant. Moreover, as originally drafted, the lease provided that Spanish Peaks Development would pay SPH $1,000 per month through November 30, 2007, and beginning December 1, 2007, the monthly payments would increase by a specified percentage. *In re* Spanish Peaks Holdings II LLC, No. 12-60041-7, 2014 Bankr. LEXIS 913, at *11 (Bankr. D. Mont. Mar. 10, 2014) (subsequent history omitted). Spanish Peaks Developments and SPH terminated that lease on December 14, 2007 and replaced it with the ninety-nine-year lease with annual rent of $1,000. *In re* Spanish Peaks Holdings II LLC, 2014 Bankr. LEXIS 913, at *11.

154 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 895.

155 *Id*. at 894.

156 *Id*. at 894-95 (9th Cir. 2017); *In re* Spanish Peaks Holdings II LLC, 2014 Bankr. LEXIS 913, at *11.

157 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 896.

158 Ninth Circuit Allows Lease Stripping in Bankruptcy, Practical Law Legal Update w-009-3321 (West) (hereinafter "Practical Legal Update").

159 *In re* Spanish Peaks Holdings II LLC, 2014 Bankr. LEXIS 913, at *9.

160 *Id*. at *12.

161 *Id*.

162 *Id*. at *11.

When SPH filed a petition for chapter 7 bankruptcy on October 14, 2011, it still owed SPAP $122,000,000 on the $130,000,000 loan.[163] After the commencement of SPH's bankruptcy case, SPAP assigned its interest to CH SP Acquisitions, LLC ("CH SP").[164] On June 3, 2013, the trustee sold SPH's land at auction to CH SP for $26,100,000.[165] Ten days later, on June 13, 2013, the bankruptcy court entered an order approving the sale.[166] This order provided that the trustee had sold the land free and clear of any leases.[167] After a hearing on the issue of whether the order preserved the leasehold rights of Pinnacle and Montana Opticom, the bankruptcy court held that it did not.[168] In reaching its conclusion, the bankruptcy court noted that neither Pinnacle nor Montana Opticom had requested adequate protection for their leasehold interests before the bankruptcy auction.[169] The bankruptcy judge further found that: "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,"[170] and "the leases were executed 'at a time when all parties involved were controlled by James J. Dolan.'"[171]

The District Court for the District of Montana affirmed,[172] and Pinnacle and Montana Opticom appealed.[173] On appeal, the Ninth Circuit became the second (of two) circuit courts to take the minority view when it held that "the Pinnacle and [Montana] Opticom leases [had not] survived the sale of the property to CH SP."[174] The court reached this result by incorporating by reference the Seventh Circuit's "sound textual analysis" of the interplay between §§ 363 and 365 in *Qualitech*.[175] The Ninth Circuit added to this reasoning two observations to support its position that § 363 should govern.[176] First, the Ninth Circuit pointed out that § 363(f) authorizes a free-and-clear sale if applicable

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163 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 895.

164 *Id*.

165 *Id*.

166 *Id*. at 896.

167 *Id*. There were certain exceptions to the free-and-clear sale, but none of them apply here.

168 *Id*.

169 *Id*.

170 Under the lease, Pinnacle agreed to pay rent of $1,000 per month for a term of ninety-nine years. *Id*. at 894.

171 *Id*. at 896.

172 *In re* Spanish Peaks Holdings II, LLC, No. BR 12-60041, 2015 U.S. Dist. LEXIS 77921, at *4 (D. Mont. 2015).

173 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892.

174 *Id*. at 896.

175 *Id*. at 899.

176 *Id*.

nonbankruptcy law permits such a sale.[177] Under Montana law, "a foreclosure sale to satisfy a mortgage terminates a subsequent lease on the mortgaged property."[178] Given that CH SP held a mortgage on the property securing the debt owed to it of $122,000,000, the court noted that but for SPH's bankruptcy filing, CH SP would have foreclosed on the property and thereby terminated all encumbrances.[179] Second, the court added that while § 365 does reflect a congressional intent to protect tenants in landlord bankruptcies, the Code also seeks to "maximiz[e] creditor recovery."[180] The Ninth Circuit concluded that only the minority approach balances these "competing purposes in the way Congress intended."[181] Because Pinnacle and Montana Opticom had failed to request adequate protection prior to the bankruptcy auction, the Ninth Circuit held that the bankruptcy and district courts had properly authorized a sale of the resort free and clear of the Pinnacle and Montana Opticom leases.[182]

Although the Ninth Circuit reached this conclusion quite easily under the Seventh Circuit's bright-line requirements for requesting adequate protection, in dicta it confessed that it did not know what it would have done had the tenants diligently sought to protect their rights.[183] Indeed, the Ninth Circuit remarked that "[s]ince Pinnacle and [Montana] Opticom did not ask for adequate protection until after the sale had taken place . . . the question of what protection the bankruptcy court could have or should have awarded is not before us."[184] Although the Ninth Circuit acknowledged that the district court in *Dishi & Sons* would have fashioned adequate protection in the form of continued possession,[185] the words "could have" here suggest that the Ninth Circuit envisioned other forms of adequate protection.[186] As for what those additional forms might be, the court did not say.[187] However, the words "should have" hint that the Ninth Circuit found adequate protection in the form of continued possession inappropriate under the facts.[188] The court's decision to adopt the Seventh Circuit's heavily criticized minority approach of requiring tenants to

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177 *Id.* at 899–900.

178 *Id.* at 900 (citing Ruby Valley Nat'l Bank v. Wells Fargo Delaware Trust Co., 317 P.3d 174, 178 (Mont. 2014); Williard v. Campbell, 11 P.2d 782, 787 (Mont. 1932)).

179 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 900.

180 *Id.* at 901 (quoting *In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d at 548) (internal quotation marks omitted).

181 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 901.

182 *Id.*

183 *Id.* at 900.

184 *Id.*

185 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 900 (citing Dishi & Sons, 510 B.R. at 711-12).

186 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 900.

187 *Id.*

188 *Id.*

request adequate protection suggests that *Spanish Peaks* was a result-oriented opinion.[189] The minority approach, despite its unpopularity, provided the court with a way to prevent debtor-affiliated entities from exploiting one-sided leases to the detriment of the creditors.[190]

II. ANALYSIS

A. Spanish Peaks: A Result-Oriented Opinion

The reason why the Ninth Circuit adopted the Seventh Circuit's unpopular approach of requiring tenants to request adequate protection to receive compensation or continued possession lies in the case's facts.[191] Specifically, had the court taken the more prevalent view among the lower courts that tenants are always entitled to continued possession, two undeserving individuals would have gotten a tremendous financial windfall at the expense of their resort's legitimate creditors. Worse, future land developers would have begun exploiting the same loophole, encouraging further inequity.

The earliest hint of a result-oriented outcome came in the opening sentence of the opinion when the Ninth Circuit mentioned Timothy Blixseth as one of the visionaries behind the Spanish Peaks project.[192] Blixseth, an ex-billionaire real estate mogul, ended up in solitary confinement in a Montana jail for fourteen months for civil contempt of court for disobeying an order of a United States district judge to not sell a separate resort in Mexico.[193] Now out of jail, Blixseth is still in financial trouble for his development of the Yellowstone Club, an elite ski resort neighboring the Spanish Peaks resort.[194] Blixseth's creditors for the Yellowstone Club are pursuing him for approximately $250,000,000.[195] They claim he borrowed $375,000,000 for the Yellowstone Club development and

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189 *Id*. at 899.

190 *Id*. at 894. *See also* Harding, *supra* note 142.

191 *See* Harding, *supra* note 142.

192 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 894. Nowhere else in the Ninth Circuit's opinion or in the Bankruptcy Court's order does Blixseth's name appear.

193 Rick Anderson, *Billionaire Who Went Bust Is Out of Jail and Still Owes Millions. Many Are Watching His Next Move*, L.A. TIMES (July 27, 2016), http://www.latimes.com/nation/la-na-bankrupt-billionaire-20160715-snap-story.html; Phil Drake, *What Will Tim Blixseth Do With His Freedom?*, GREAT FALLS TRIB., (July 7, 2016, 6:28 PM), http://www.greatfallstribune.com/story/news/local/2016/07/07/exclusive-blixseth-hopes-end-near-legal-saga/86825334/.

194 Phil Drake, *From Billionaire to Inmate, Yellowstone Club Founder Remains Defiant*, GREAT FALLS TRIB. (Mar. 9, 2016), http://billingsgazette.com/news/state-and-regional/montana/from-billionaire-to-inmate-yellowstone-club-founder-remains-defiant/article_8c4e399e-7aeb-5850-a7af-7467c32393e9.html.

195 *Id*.

then pocketed much of the loan.[196] The creditors are having significant issues: Blixseth's millions have gone missing.[197] As Blixseth said about the money, "I think that [a lot of it is offshore], but I don't know where it is."[198] Even though the Ninth Circuit judges ordered Blixseth's release from jail,[199] the fact that he was a visionary behind the Spanish Peaks ski resort may have made the judges suspicious from the start about the tenants' worthiness of continued possession or compensation.

The values that the Ninth Circuit mentioned in the case add further evidence that the judges were looking to deprive the tenants of continued possession in *Spanish Peaks*.[200] The Ninth Circuit specifically noted that Pinnacle's $1,000 annual rent was up to $99,000 less than the fair market annual rental value of the leased parcel of land.[201] To grant continued possession for approximately ninety-two years—the remaining period on the lease at the time of the 2013 bankruptcy sale—would have therefore deprived the purchaser of an opportunity to earn up to $92,000,000 in rent.[202] Ignoring any possible deductions or exemptions, it would also deny the Government the opportunity to tax up to $92,000,000 of income as opposed to a meager $92,000.[203] Moreover, given that the fair market rental value of the leased restaurant space was estimated at up to $100,000 per year, the lessee could presumably sell the right to use and enjoy the space for ninety-two years for a large sum of money. Recalling that Dolan controlled both the restaurant and SPH at the time the lease was executed,[204] he presumably would have been the one to profit on a sale of Pinnacle's remaining interest in the resort property.[205] The fact that Dolan fought so hard for continued possession for a boarded-up restaurant suggests that he was seeking a buyout from the purchaser in an amount exceeding his legal fees incurred in taking the dispute all the way to the Ninth Circuit.[206] Indeed, pursuant to the restaurant

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196 *Id*.

197 Daniel Fisher, *Former Billionaire Tim Blixseth Jailed Over Missing Funds*, FORBES (Dec. 18, 2014, 10:13 PM), https://www.forbes.com/sites/danielfisher/2014/12/18/former-billionaire-tim-blixseth-jailed-over-missing-funds/#75fca9e476ae.

198 *Id*.

199 Drake, *supra* note 193.

200 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892. *See also* Harding, *supra* note 142.

201 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 896.

202 $92,000,000 is the aggregation of $100,000 of annual rent for ninety-two years.

203 $92,000 is the aggregation of $1,000 of annual rent for ninety-two years.

204 *Id*.

205 Harding, *supra* note 142.

206 *See In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892. Dolan could have also been looking to reopen the restaurant to profit on the subsequent developers' investments in the resort. Given that Dolan closed Pinnacle years before the Spanish Peaks Resort filed for bankruptcy, *id*. at 896 , this possibility seems less likely than the possibility that Dolan was just seeking a buyout.

lease, Dolan had a right to encumber valuable space on the resort for more than ninety years at nominal rent of $1,000.[207] Any subsequent owner of the land would thus have a strong incentive to buy out the lessees rather than allow continued possession at monthly rent of approximately $1,000.

The location of Pinnacle within the Spanish Peaks Resort and the nature of Montana Opticom's business is further evidence that Dolan was just seeking a buyout. As pre-bankruptcy maps of the resort show, Pinnacle sat atop Andesite Mountain at a point of convergence of multiple ski lift lines and the point of origin of multiple ski runs.[208] Pinnacle was the only business operating on the Andesite Mountain summit.[209] From this central location of the resort, Dolan could have used the restaurant entity's leasehold interest to try to sabotage the resort's purchaser. For instance, Dolan could have allowed the restaurant building to fall into a state of disrepair, thereby deterring skiers from visiting Andesite Mountain at all.[210] Relatedly, Dolan could have used the Montana Opticom lease to cut off all telecommunications to the remote resort, making it an undesirable destination for vacationers. Absent any possible (and unlikely) provisions in the lease imposing duties on the tenants, and ignoring any potential common law claims, the subsequent owners of the resort would have likely had no recourse against the tenant entities.[211] Worse, the more damage Dolan could have inflicted upon the purchaser, the more he would have been able to demand in a buyout. Dolan could have therefore used the restaurant entity's leasehold

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[207] *Id*. at 894. *See Spanish Peaks Resort*, SKIMAP.ORG (Feb. 3, 2012), https://skimap.org/skiAreas/view/1026, for the precise location of Pinnacle Restaurant on the Spanish Peaks Resort. The 2007 map indicates that the Pinnacle Restaurant was on Andesite Mountain. The 2010 map shows the ski runs on Andesite Mountain, as well as the restaurant.

[208] *See About Spanish Peaks*, SPANISH PEAKS MOUNTAIN CLUB (2015), http://spanishpeaks.findyourbigsky.com/about-spanish-peaks/; Spanish Peaks Resort, SKIMAP.ORG (Feb. 3, 2012), https://skimap.org/skiAreas/view/1026.

[209] *Id*.

[210] One could easily imagine more colorful (and more effective) ways in which Dolan could have deterred vacationers from visiting Andesite Mountain.

[211] Eviction would be a check on what Dolan could do, but unless Dolan actually triggered a ground for eviction under Montana law, this remedy would be unavailable to the landlord. MONT. CODE ANN. § 70-24-422. The grounds for eviction in Montana include: (1) noncompliance by the tenant with the rental agreement; (2) failure to pay rent; (3) destruction, defacement, damage, impairment, or removal of any part of the premises by the tenant; and (4) creation of a reasonable potential by the tenant that the premises may be damaged or destroyed or that neighboring tenants may be injured. *Id*. Given the nominal rent of the leases at issue in *Spanish Peaks*, *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 894, failure to pay rent would almost certainly not be grounds for eviction. Likewise, given that Dolan controlled the parties on both sides of the leases, there were probably no robust obligations on the tenant entities. Ground (1) would be unlikely to be triggered. Grounds (3) and (4) would be possible if Dolan tried use the tenant leases to cause problems in an effort to negotiate a larger buyout. However, with good legal counsel, a tenant could easily avoid triggering § 70-24-422. Accordingly, eviction rights are unlikely to fully protect landlords.

interest to hold the entire mountain hostage, causing problems until the subsequent owner agreed to buy his entities out of the leases. From the purchaser's perspective, it would be far better to just have a court fashion adequate protection in the form of compensation than to grant the tenant continued possession and leave it to the lease parties to reach an agreement outside of the bankruptcy proceedings.[212] Accordingly, purchasers would likely bid more for land at auction in a jurisdiction that applied the minority approach.[213] Higher bids honor the Bankruptcy Code's goal of maximizing creditor recovery.[214] At the same time, adequate protection ensures that tenants' property interests are protected.[215] Hence, the minority view balances the competing purposes of the Code better than the majority view.[216]

Had the court granted continued possession, the need to make such a buyout would have presumably reduced the amount the mortgagee could have recovered from the bankruptcy sale.[217] Creating a need to make a buyout would have failed to honor the Bankruptcy Code's purpose of maximizing creditor recovery.[218] Indeed, there are three ways a tenant could receive a buyout following a bankruptcy auction, all of which detract from creditor recovery. First, the mortgagee, CH SP, could itself buy out the lessees, which would be functionally equivalent to CH SP having to pay an increased price for the property at the bankruptcy sale. Second, CH SP could sell the property before dealing with the remaining tenants. Here, however, the encumbrance would reduce the amount a buyer would be willing to pay. Finally, a party other than the mortgagee could purchase the property at auction at a reduced price due to the need to buyout the

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[212] Adequate protection could likely take the form of continued possession. *See In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d at 548 (internal citations omitted); Dishi & Sons, 510 B.R. 696. Under the minority view, if the bankruptcy judge determines that the tenant entity is only requesting continued possession to seek a large buyout, the judge can fashion adequate protection in the form of compensation. *See In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d at 548 (internal citations omitted) (stating that adequate protection should take the form of compensation if not continued possession).

[213] *See In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 900 ("To some extent, . . . estate property presumably fetches a lower price if it is subject to a lease.").

[214] *Id*. at 900–01 (calling it a "core purpose of the Code" to "maximiz[e] creditor recovery").

[215] *Id*. at 900.

[216] *See id*. at 894, 901 (calling the protection of tenants and the maximization of creditor recovery the "core purpose[s]" of the Bankruptcy Code).

[217] *See id*. at 900–01 (noting that "[t]o 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" (internal citation omitted) (internal quotation marks omitted)).

[218] *See id.* (noting that "[t]o 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" (internal citation omitted) (internal quotation marks omitted)).

unwanted tenants. Letting the same individual whose ski resort filed for bankruptcy recover a large sum of money from the two leases following the auction would have been a tremendous abuse of the bankruptcy system. By adopting the Seventh Circuit's approach of requiring tenants to request adequate protection, the Ninth Circuit found an easy way to simultaneously maximize creditor recovery and foil Dolan's scheme to use his tenant entities' one-sided leases to negotiate an unfair buyout.[219]

The Ninth Circuit likewise avoided granting the tenants a right to recover proceeds from the auction at the expense of SPH's legitimate creditors, which also would have been unjust.[220] Indeed, both companies' leases arose after SPH obtained the $130,000,000 loan, and the same individual who founded and controlled the bankrupt ski resort also controlled each of the tenants.[221] Letting Dolan wedge the claims of Pinnacle and Montana Opticom in front of the secured claim of the senior mortgagee is thus not an especially attractive solution.[222] The Ninth Circuit in *Spanish Peaks* had a fairly easy escape valve: by taking the Seventh Circuit's established approach to §§ 363 and 365, the appellate judges managed to evade having to fashion adequate protection at all.[223] While that solution worked in *Spanish Peaks*, it will probably not work in future cases since tenants will likely begin requesting adequate protection in almost all landlord bankruptcies.[224] Thus, in cases where undeserving tenants with bad intentions diligently request adequate protection, judges will be trapped between the Scylla of continued possession and the Charybdis of compensation.[225]

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219 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892. *See also* Harding, *supra* note 142.

220 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892.

221 *Id*. at 896.

222 *See* Harding, *supra* note 142.

223 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898.

224 *See* Torrell, *supra* note 18, at 14 ("For tenants of a bankrupt landlord, the lesson to be learned here is to aggressively pursue and protect one's rights and request 'adequate protection' under Bankruptcy Code Section 363 when any sale of the underlying real property is proposed free and clear of the tenant's lease."); Harding, *supra* note 142 ("From the viewpoint of a tenant, the clear message is that it should object early and often, and in particular, should push for adequate protection (getting creative if necessary).").

225 Scylla and Charybdis were, "in Greek mythology, two immortal and irresistible monsters who beset the narrow waters traversed by the hero Odysseus in his wanderings described in Homer's *Odyssey*, Book XII . . . . To be 'between Scylla and Charybdis' means to be caught between two equally unpleasant alternatives." Scylla and Charybdis, BRITANNICA, https://www.britannica.com/topic/Scylla-and-Charybdis (last visited Nov. 17, 2018).

B. Limiting Adequate Protection for Undeserving Tenants

Had the tenants in *Spanish Peaks* diligently requested adequate protection prior to the bankruptcy auction, the bankruptcy judge would have faced the task of fashioning a remedy for two commercial tenants that deserved nothing. This situation will arise in cases where someone is trying to exploit the bankruptcy system, such as in *Spanish Peaks* where James Dolan controlled the parties on both sides of an extremely one-sided lease.[226] The easy solution would be for the judge to simply terminate the lease, thereby raising more money for the debtor's legitimate creditors and allowing the purchaser to take the land free and clear of the encumbrance. However, the Takings Clause of the Fifth Amendment of the United States Constitution prohibits such a solution.[227] Likewise, courts are unlikely to grant a security interest in property that is already totally encumbered, since this solution would leave the tenant with little or nothing in exchange for its property interest.[228] Judges will accordingly have to use a bit more creativity to minimize adequate protection for commercial tenants that deserve nothing.

The solution to granting undeserving tenants adequate protection really just involves adjusting the value placed on the leasehold interest. For instance, to minimize Pinnacle's ability to recover from the bankruptcy sale of the ski resort in *Spanish Peaks*, the judge could give credence to an expert who values the leasehold interest as that of a long out-of-business restaurant located on a failed ski resort on a steep, remote mountaintop.[229] Likewise, the expert could regard Montana Opticom as a company providing telecommunications services to a boarded-up ski resort.[230] Perhaps the expert could even factor in the nominal rent that the two entities paid to the landlord entity.[231] An expert who looked at the businesses in this light would surely estimate that the leases were worth far less than would an expert who considered the earning potential of Pinnacle and Montana Opticom should the ski resort reopen. It would only be incumbent on the ski resort's purchaser to find an expert who would produce such numbers.

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[226] *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892. *See also* Harding, *supra* note 142.

[227] U.S. CONST. amend. V; *see generally* DAVID G. EPSTEIN ET AL., BANKRUPTCY: DEALING WITH FINANCIAL FAILURE FOR INDIVIDUALS AND BUSINESSES 124 (4th ed. 2015). Under Montana law, a term of years is an interest in real property. MONT. CODE ANN. § 70-15-202; Ditto v. Kipp, 300 Mont. 278, 282 (2000) ("A leasehold interest in land is an estate for years which is classified as an interest in real property.").

[228] *See In re* Haskell, L.P., 321 B.R. at 5, 9-10 (rejecting the debtor's argument that the court could just give the tenant a security interest in the totally encumbered hospital in exchange for the lost leasehold interest on the ground that the tenant would likely recover nothing from such a lien).

[229] *See In re* Spanish Peaks Holdings II, LLC, 2015 U.S. Dist. LEXIS 77921, at *12.

[230] *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892.

[231] *Id*. at 894–95.

Given that the Bankruptcy Code's standard for placing a value on real property, found in 11 U.S.C. § 506(a)(1), is extremely malleable,[232] finding such an expert should not be exceedingly difficult. After placing a low value on the leases, the judge could grant the tenants adequate protection in the form of a lien on property of the debtor[233] (assuming the debtor has property that is not totally encumbered).[234] Although the tenants would recover some proceeds, in this way the judge could minimize the impact of tenant recovery on the debtor's other, lower-priority creditors, all while avoiding violation of the Takings Clause of the Fifth Amendment.[235]

The appellate process presents one obstacle to this solution, although observant judges will be able to overcome this hurdle. The standard of review on appeal of valuation is de novo,[236] meaning the bankruptcy judge's valuation of the leasehold interests will get no deference. Hence, for the bankruptcy judge's strategy to hold, any appellate judges would have to recognize the bankruptcy judge's true reason for placing a low value on the lost leasehold interests. A surprisingly low valuation might in itself work to ensure this result by inspiring subsequent judges to investigate why the bankruptcy judge produced such a low value.[237] Should the bankruptcy judge's determination

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[232] *See* DAVID G. EPSTEIN ET AL., *supra* note 227, at 75-78. Section 506(a)(1) provides that the value of a claim secured by real property "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 U.S.C. § 506(a)(1) (2016).

[233] In the case of a ski resort such as the Spanish Peaks resort, this property might include snowmobiles, trucks, rental ski equipment, and furniture from the hotel. Such assets would likely have enough value to accommodate both a small debt to the tenants and part of the claims of the other creditors. A clever judge would assess the value of all the debtor's unencumbered property prior to placing a value on the tenant's leases to ensure that the other creditors would still recover something on their unsecured claims.

[234] Additional difficulties will arise if all of the debtor's property is totally encumbered by security interests. For example, suppose the resort entity's only assets were the land and the snowmobiles, and that both the land and the snowmobiles were totally encumbered. In this case, the judge would have no way to provide compensation to the tenant without displacing the senior liens of the mortgage holder and the creditor(s) with security interests in the snowmobiles. *See* Baxter, *supra* note 70, at 490. Short of finding some way to invalidate the leases, a judge might have to grant continued possession in such a situation.

[235] U.S. CONST. amend. V; *see generally* DAVID G. EPSTEIN ET AL., *supra* note 227, at 124. The judge could also use his/her discretion to vary adequate protection with this method. Indeed, should the judge think that a particular tenant deserves continued possession for less than the full duration of the lease, the judge could reduce the term of years and provide the tenant with compensation for the time lost. Such a solution would avoid hardships resulting from immediate dispossession, raise creditor recovery, and allow the purchaser to use the land for a different purpose sooner.

[236] FED. R. BANKR. P. 9033(d) (2018).

[237] Although having faith in appellate judges to pick up on a bankruptcy judge's unstated reasoning is not a perfect solution, it at least seems to have worked in *Spanish Peaks*. In that case, both the bankruptcy judge and the Ninth Circuit judges seem to have recognized that Dolan was trying to exploit the bankruptcy system with his tenant entities and their one-sided leases. *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892; *In re* Spanish Peaks Holdings II LLC, 2014 Bankr. LEXIS 913. *See also* Harding, *supra* note 142. Indeed, both the Bankruptcy

stand, the tenants would then only collect on the liquidation of the property securing their small claim (assuming there was enough value in the debtor's other property for them to fully recover, and assuming they did not also hold some other claim).

This solution of placing a low value on the leasehold estate and securing that debt with a lien on property of the debtor would benefit the debtor's other creditors and the purchaser of the liquidated property. The purchaser would take the land unencumbered, which would avoid the problem of the tenants sitting on their long leasehold interests and nominal rent in an effort to receive a large buyout. Additionally, the fact that the land would no longer come with a bad bargain would presumably raise the purchase price at auction, benefitting the other creditors.[238] By contrast, in a jurisdiction that follows the majority approach, a judge would have to grant continued possession,[239] which would lower the purchase price at auction and thereby generate less money for the creditors.[240] Thus, the minority approach of fashioning adequate protection for tenants can produce much better outcomes for creditors and purchasers than the majority approach of always granting continued possession.

The solution proposed in this Comment, of valuing leasehold interests based on the tenants' worthiness of adequate protection, would also close the loophole in the majority approach.[241] Specifically, by giving undeserving tenants the smallest justifiable recovery for their prematurely terminated leasehold interests, a judge could deter individuals from arranging real estate developments in the same way Dolan did.[242] Although this Comment's solution may still allow tenants to recover some money from the bankruptcy liquidation of the landlord entity's assets, the tenants would recover much less than they might if they received continued possession. Consequently, in minority-approach jurisdictions that adopt this Comment's suggestions, the loophole that Dolan was attempting to exploit will become much less lucrative. Indeed, founding a number of separate entities, and preparing leases for each tenant entity to enter into with the landlord entity, would involve too much time, effort, and legal fees. Hence, the minority approach, coupled with the solution proposed in this

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Court and the Federal Court of Appeals authorized a sale of the ski resort free and clear of the tenants' leasehold interests. *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892; *In re* Spanish Peaks Holdings II LLC, 2014 Bankr. LEXIS 913.

238 *See In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 900-01.

239 *See, e.g.*, *In re* Haskell, L.P., 321 B.R. 1. *See also In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898 (describing the majority approach).

240 *See In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898.

241 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892.

242 *Id*. *See also* Harding, *supra* note 142.

Comment, has the potential to close the loophole in the bankruptcy process that the individuals in *Spanish Peaks* were trying to exploit.[243]

C. SNDA Clauses: A Weakness to the Minority Approach and the Proposed Solution

In addition to a request for adequate protection, judges might face the obstacle of Subordination, Non-disturbance, and Attornment agreements (commonly referred to as "SNDA agreement").[244] In entering into a leasehold interest, tenants can protect themselves upfront by obtaining an SNDA agreement, which they would ideally negotiate concurrently with the lease.[245] An SNDA is a contract between a tenant and the mortgage lender of the tenant's landlord that specifies in advance what will happen with the tenant's leasehold interest in the event of a foreclosure.[246] Parties to leases draft SNDA clauses to protect tenants' interests should the landlord liquidate its encumbered property at bankruptcy auction.[247] According to Andrew Royce:

> The typical SNDA states that the lease is subordinate (or junior) to the mortgage, but that *if the mortgage is foreclosed*, the new owner will not disturb the tenant's possession under its lease so long as the tenant is not in default of the lease's provisions, and the tenant will attorn to and recognize the new owner as its landlord. Thus[,] the lease will remain in effect, with the new owner becoming the landlord.[248]

Importantly, the typical SNDA clause addresses the event of "foreclosure," not bankruptcy.[249] If Dolan had used such clauses in *Spanish Peaks*, they might have created an insurmountable obstacle for the judges to overcome in dispossessing the undeserving tenants. This concern might be much ado about nothing, though, given that tenants would presumably have to bargain for SNDA agreements with the landlord's mortgage holder,[250] which would in itself deter exploitation of the Bankruptcy Code.

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243 *In re* Spanish Peaks Holdings II, LLC 872 F.3d 892.

244 *See* Practical Legal Update, *supra* note 158 (providing that an SNDA will allow a tenant's leasehold interest to survive liquidation in a bankruptcy sale). *See also* Andrew Royce, *SNDA Agreements Benefit Both Tenants and Lenders*, LAW360 (Mar. 6, 2017)(url omitted).

245 Practical Legal Update *supra* note 158 (providing that an SNDA will allow a tenant's leasehold interest to survive liquidation in a bankruptcy sale). *See also* Andrew Royce, *supra* note 244.

246 *Id*.

247 *Id*.

248 *Id*. (emphasis added) (Andrew Royce is a partner in Sherin and Lodgen's real estate department).

249 *See id*.

250 *Id*.

Had Pinnacle Restaurant and Montana Opticom entered into a garden-variety SNDA agreement with the mortgage lender of the Spanish Peaks Resort, a judge likely could have found the clause inapplicable.[251] Indeed, SNDA clauses generally specify a tenant's rights in the event of foreclosure.[252] Ordinary SNDA clauses therefore do not speak to a tenant's rights in the event of bankruptcy liquidation.[253] Given that a foreclosure and a bankruptcy liquidation are distinguishable events, a judge could simply look to the plain language of the SNDA clause and thereby refuse to apply it to the purchase of land at bankruptcy auction. A finding that the SNDA clause does not apply to landlord bankruptcies would leave the tenant with only the remedy provided for under the holding of the Ninth Circuit; namely, that the tenant will have to request adequate protection prior to the bankruptcy auction to receive any compensation or continued possession.[254]

The real problem with SNDA agreements will arise when tenants begin stipulating in advance with the landlord's mortgagee what will happen in the event of a bankruptcy liquidation of the encumbered property.[255] Had the restaurant and telecommunications company in *Spanish Peaks* entered into such an agreement with Spanish Peaks Acquisition Partners, LLC, the mortgagee of the landlord-resort at the time of creation of the leases,[256] the bankruptcy judge would have had tremendous difficulty depriving them of continued possession. Indeed, after Pinnacle and Montana Opticom entered into lease agreements with the Spanish Peaks Ski Resort, and after the resort's bankruptcy filing, SPAP assigned its interest to CH SP Acquisitions, LLC, which was the mortgagee at the time of the bankruptcy auction.[257] CH SP then purchased the land at auction.[258] Therefore, had there been an SNDA contract that applied in the event of bankruptcy liquidation, it arguably would have been binding on CH SP as the ultimate assignee of all rights of SPAP.[259] CH SP also would have lost the policy argument that the Bankruptcy Code seeks to maximize creditor recovery,[260] since it had essentially agreed to the clause (and thus consented to the risk of a

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251 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892.

252 Royce, *supra* note 244.

253 *Id*.

254 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892.

255 *See* Practical Legal Update, *supra* note 158.

256 *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 894. The original mortgagee was Citigroup Global Markets Realty Corp., which assigned the note and mortgage to Spanish Peaks Acquisition Partners, LLC, prior to the creation of the leases. *Id*.

257 *Id*. at 894-95.

258 *Id*. at 895.

259 *Id*.

260 *Id*. at 900-01.

reduced price at auction).[261] Hence, a judge would probably have to apply the SNDA, since the clause would specifically speak to landlord bankruptcies and bind the landlord-debtor's mortgage holder.

Although the application of an SNDA agreement to allow tenants to remain in possession after bankruptcy liquidation of the encumbered land might at first seem unjust in facts like those of *Spanish Peaks*,[262] a closer look shows that application of such clauses might not be so troublesome. In exchange for a right to remain in possession in the event of a landlord bankruptcy, the tenants would have to give the landlord's mortgagee additional consideration. Depending on how much the tenants would have to pay for an SNDA clause that applies to bankruptcies, the need to give consideration would in itself discourage individuals from seeking to exploit the loophole in the bankruptcy system via contractual agreements. Further, a subsequent mortgage holder such as CH SP would presumably acquire the mortgage at a reduced value due to the broader SNDA clause. At the very least, CH SP would be on notice that the restaurant and telecommunications company had a contractual right to continued possession in the event of a landlord bankruptcy. In this light, SNDA agreements that protect tenants from the risk of dispossession in landlord bankruptcies no longer seem so problematic.

In fact, SNDA clauses offer tenant entities one way to protect themselves from harsh results under the minority approach.[263] Use of SNDA agreements would dispel many of the complaints critics had about the negative real-world effects of the Seventh Circuit's holding in *Qualitech*.[264] Indeed, had the tenant entity there negotiated an SNDA clause with the landlord's mortgage lender upon entering into the lease, the landlord would not have been able to liquidate the encumbered property free and clear of the tenant's interest.[265] Further, tenants with SNDA-agreement protections would presumably not hesitate to make improvements to leased property for fear of dispossession upon landlord bankruptcy.[266] Most importantly, if tenants negotiate SNDA clauses, judges will not have to worry about the minority approach yielding less tenant protection—

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[261] *Id*. at 894-95.

[262] *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892.

[263] *See* Practical Legal Update, *supra* note 158.

[264] *See, e.g.*, *In re* Haskell, L.P., 321 B.R. 1; Ferretti, *supra* note 70, at 723–28; Baxter, *supra* note 70; Zinman, *supra* note 17, at 106-18; White & Medford, *supra* note 70, at 28; Genovese, *supra* note 70.

[265] *See* Practical Legal Update, *supra* note 158; Royce, *supra* note 244.

[266] See Zinman, *supra* note 17, at 99–100, for a discussion of the potential of the Seventh Circuit's holding to disrupt leasehold investment.

the main criticism of the Seventh Circuit's holding.[267] At the same time, judges could probably prevent SNDA clauses from enabling real estate developers such as Dolan to exploit the bankruptcy system. Indeed, should a judge ever think it necessary to invalidate an SNDA clause in a case involving a landlord bankruptcy, there might be a creative way to do so. Such a solution, however, can remain a topic for another paper.

D. Protecting Small Business under the Minority Approach

Businesses that do not seek assistance of legal counsel will be the most vulnerable to undesirable results under the minority approach due to the incentives for bankrupt landlords to not inform their tenants of the need to seek protection. These entities are less likely to negotiate an SNDA clause and less likely to request adequate protection prior to the bankruptcy auction; they will consequently lose any right to compensation or continued possession.[268] Represented lessors will avoid voluntarily informing lessees of the benefits of an SNDA agreement and of the need to request adequate protection prior to a bankruptcy sale. Indeed, if the lessor is seeking to reorganize under chapter 11 of the Bankruptcy Code, it will seek to maximize proceeds from liquidation of the land. Except in cases like *Spanish Peaks*, where the same person controlled the landlord entity and the tenant entities, the landlord will hope to strip off any leases, since any encumbrances will reduce the sale price of land at auction.[269] By choosing to not tell its tenants that they need to obtain an SNDA agreement or request adequate protection to avoid losing their leasehold interests, the landlord will have a greater chance of being able to sell the property free and clear of any leases. The landlord will then have more money to allocate to its creditors, which will increase its chances of getting an approved plan. Further, in cases where the landlord intends to reacquire the property following the bankruptcy sale, stripping off encumbrances will allow the landlord to both evict the tenant and keep any of the tenant's improvements. Thus, as the law currently stands, leaving it to the landlord-debtor to give the tenant notice of the need to request adequate protection would be akin to letting the fox guard the henhouse. The lesson to be learned here is simple: to ensure that their rights will be

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[267] *See In re* Haskell, L.P., 321 B.R. 1; Ferretti, *supra* note 70, at 723–28; Baxter, *supra* note 70; Zinman, *supra* note 17, at 106–18.

[268] *See In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d at 540. *See also* Practical Legal Update, *supra* note 158 (providing that an SNDA will allow a tenant's leasehold interest to survive liquidation in a bankruptcy sale). *See also* Royce, *supra* note 244.

[269] *See In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 900.

protected should landlord bankruptcy occur, small businesses just need to seek counsel before entering into leasehold agreements.[270]

CONCLUSION

Spanish Peaks exposes a major loophole in the Bankruptcy Code in cases involving landlord bankruptcies;[271] this Comment has shown how judges might close it to honor the Bankruptcy Code's core policies of tenant protection and maximization of creditor recovery.[272] To exploit the loophole, a real estate developer can create two entities and have them enter into a lease as landlord and tenant. In the event the landlord entity must file for bankruptcy relief and liquidate its encumbered land, the developer can sit on the tenant entity's lease to either remain in possession or receive compensation.[273] If the tenant entity gets to retain possession, the sale price of the land at auction will presumably be lowered;[274] at the same time, the developer will get a financial windfall from either a buyout by the subsequent landlord or profits from the tenant entity's business.[275] If, instead of continued possession, the tenant entity receives compensation for its lost leasehold interest, that money will have to come out of the landlord-debtor's estate, reducing the pool of funds available for the repayment of the debtor's other creditors. Either possibility overprotects the tenants and detracts from creditor recovery, thereby failing to properly balance the Bankruptcy Code's two competing goals.[276]

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[270] *See* Torrell, *supra* note 18, at 14 ("For tenants of a bankrupt landlord, the lesson to be learned here is to aggressively pursue and protect one's rights and request 'adequate protection' under Bankruptcy Code Section 363 when any sale of the underlying real property is proposed free and clear of the tenant's lease."); Harding, *supra* note 142 ("From the viewpoint of a tenant, the clear message is that it should object early and often, and in particular, should push for adequate protection (getting creative if necessary)."). Ideally, the small business's counsel will not only negotiate an SNDA agreement with the landlord's mortgage holder, Practical Legal Update, *supra* note 158, Royce, *supra* note 244, but will also alert the business of the need to immediately seek counsel again in the event of a landlord bankruptcy.

[271] *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 899-900.

[272] *See id*. at 900-01 (defining the maximization of creditor recovery and the protection of tenants as the "core purpose[s]" of the Bankruptcy Code).

[273] *See In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d at 548 (stating that adequate protection will take the form of either continued possession or compensation); *In re* Taylor, 198 B.R. 142 (Bankr. D.S.C. 1996) (granting continued possession to the tenant of a bankrupt landlord). *See also In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898 (listing *In re Taylor* as an example of the "'Majority' Approach" and *Qualitech* as an example of the "'Minority' approach").

[274] *See In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 900.

[275] *See* Harding, *supra* note 142.

[276] *See In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892 (defining the maximization of creditor recovery and the protection of tenants as the "core purpose[s]" of the Bankruptcy Code).

Now that the Ninth Circuit has analyzed the facts of *Spanish Peaks*,[277] other real estate developers who were previously unaware of the Bankruptcy Code's loophole might start using the above business model as a blueprint for their own developments.[278] This will be especially true of developers in majority jurisdictions, since tenant entities always receive continued possession in landlord bankruptcies under the majority approach.[279] Even in minority jurisdictions, though, developers will request adequate protection in an effort to manipulate judges into having to grant the tenant entities continued possession or compensation.[280] Most developers will probably arrange their businesses with a landlord entity and various tenant entities as a safety net in case the landlord entity fails and has to file for bankruptcy relief.[281] Furthermore, bad actors could file for bankruptcy relief from the start and use the tenant entities as a way to make additional money at the expense of the landlord's legitimate creditors.[282] The majority approach of always granting continued possession offers courts little flexibility in protecting creditors against such schemes.[283]

As this Comment has shown, however, the minority approach provides judges with a way to deter developers from attempting to exploit the loophole in the Bankruptcy Code. By placing a low value on a tenant entity's leasehold

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[277] *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892; *In re* Spanish Peaks Holdings II LLC, 2014 Bankr. LEXIS 913.

[278] One could easily imagine other real estate developments that could be arranged like the Spanish Peaks Resort, with a landlord entity owning the resort property and a number of smaller tenant entities providing the amenities. For instance, a developer might set up a golf resort to have a landlord entity that owns the golf course and the surrounding property and various tenant entities that run businesses such as a hotel, a pro shop, and a nineteenth-hole bar.

[279] *See, e.g.*, *In re* Taylor, 198 B.R. 142 (Bankr. D.S.C. 1996). *See also In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898 (listing In re Taylor as an example of the "'Majority' Approach").

[280] *See In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., 327 F.3d at 548 ("'Adequate protection' does not necessarily guarantee a lessee's continued possession of the property, but it does demand, in the alternative, that the lessee be compensated for the value of its leasehold—typically from the proceeds of the sale."); Torrell, *supra* note 18, at 14 ("For tenants of a bankrupt landlord, the lesson to be learned here is to aggressively pursue and protect one's rights and request 'adequate protection' under Bankruptcy Code Section 363 when any sale of the underlying real property is proposed free and clear of the tenant's lease."); Harding, *supra* note 142 ("From the viewpoint of a tenant, the clear message is that it should object early and often, and in particular, should push for adequate protection (getting creative if necessary).").

[281] This actually seemed to be the case in *Spanish Peaks*. Dolan ran a legitimate ski resort on the land at issue for approximately five years. *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 894; *In re* Spanish Peaks Holdings II LLC, 2014 Bankr. LEXIS 913, at *4-13. Only after the resort filed for chapter 7 bankruptcy and sold its property at auction did Dolan try to recover losses with the restaurant lease and the telecom lease. *See In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892.

[282] *See generally* Anderson, *supra* note 193; Drake, *supra* note 199; Drake, *supra* note 194; Fisher, *supra* note 197.

[283] *See, e.g., In re* Taylor, 198 B.R. at 142. *See also In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898 (listing *In re* Taylor as an example of the "'Majority' Approach").

interest, the judge can minimize the amount of compensation the tenant receives in the bankruptcy distribution process. No longer will it be worth the time, effort, and expense for developers to set up a business so as to recoup losses in the event of bankruptcy. At the same time, in cases where the tenants of bankrupt landlords really do deserve protection, this Comment's suggestions still allow judges to grant continued possession or to place a fair value on the tenant's leasehold interest. In other words, the solution proposed in this Comment enables a judge to use his/her discretion on a case-by-case basis to strike the right balance between the Bankruptcy Code's competing policies of protecting tenants and maximizing creditor recovery.[284] Only in a minority jurisdiction will a judge be able to make this determination.[285] The Ninth Circuit got it right. Other courts should follow its lead.

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[284] *See id*. at 900-01 (defining protecting tenants and maximizing creditor recovery as the competing "core purpose[s]" of the Bankruptcy Code).

[285] Majority jurisdictions require bankruptcy judges to grant the tenants of bankrupt landlords continued possession for the duration of the lease. *See, e.g., In re* Taylor, 198 B.R. 142. *See also In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898 (listing *In re* Taylor as an example of the "'Majority' Approach"). As such, judges have no discretion in deciding what to do with the leasehold interest of an undeserving tenant.

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