NOTE

INSIDER LEASES IN BANKRUPTCY: THE *SPANISH PEAKS* PROBLEM[*]

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INTRODUCTION

Section 363 and section 365 of the Bankruptcy Code are invaluable tools for a successful corporate reorganization. Section 363 allows the debtor to sell property for more money than the debtor would have gotten outside of bankruptcy because the debtor may sell the asset free and clear of any interest.[1] Section 365 allows debtors to reject burdensome contracts.[2] Debtors no longer have to perform obligations under contracts once they have been rejected pursuant to section 365, and section 365 limits all past and future damages for the breach of the contract to a pre-petition claim in the bankruptcy estate.[3] The pre-petition claim for damages allows the debtor to reorganize without worrying about paying large amounts in damages for breaching contracts.[4]

Section 363 and section 365 often operate independently. However, they frequently conflict when a bankruptcy case involves the sale of property encumbered by a lease.[5] A lease is a contract that modifies an interest in property.[6] Thus, whether the sale of property encumbered by a lease is governed by section 363 or section 365 is frequently litigated and the determination results in drastic consequences for the lessee. Recently, the choice of which statute governs determined the fate of insider leases.[7] This article analyzes the debate over whether section 363 or section 365 applies to leases, and how that debate can impact insider leases in bankruptcy.

I. BACKGROUND

A. Conflict of Statutes

In 2003, the Seventh Circuit Court of Appeals became the first circuit court to address a conflict of statutes in the Bankruptcy Code over which statute applies when a debtor/lessor wants to sell property that is encumbered by a lease.[8] The Bankruptcy Code does not provide a clear answer[9] and many scholars have written about the

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[1] *See* 11 U.S.C. § 363(f) (2018).

[2] *See id.* § 365(h).

[3] *See* Mission Prod. Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1658 (2019) ("As both parties here agree, the counterparty thus has a claim against the estate for damages resulting from the debtor's nonperformance.").

[4] *See id.* (highlighting that the counterparty is "in the same boat as the debtor's unsecured creditors, who in a typical bankruptcy may receive only cents on the dollar").

[5] *See, e.g., In re* Churchill Props. III, Ltd., 197 B.R. 283, 286 (Bankr. N.D. Ill. 1996); *In re* MMH Auto. Grp., 385 B.R. 347, 361 (Bankr. S.D. Fla. 2008).

[6] *See* Anthony Asebedo, *The Sale of Real Property Free and Clear of a Lease: Making Sense of Sections 363(f) and 365(h) of the Bankruptcy Code*, 24 AM. BANKR. INST. L. REV. 279, 290 (2016).

[7] *See* Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 872 F.3d 892, 901 (9th Cir. 2017).

[8] *See* Precision Indus. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp.), 327 F.3d 537, 548 (7th Cir. 2003) (holding 11 U.S.C. § 363(f) applies and the property could be sold free and clear of the lease).

[9] 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, 631 (2004) ("Unfortunately, the

conflict.[10] Section 363(f) of the Bankruptcy Code states that property may be sold free and clear of any interest if one of five conditions is met.[11] Section 363(e) of the Bankruptcy Code states that a court may prohibit or condition the sale of property by requiring adequate protection.[12] An interest is not defined in the Bankruptcy Code, but courts hold that a lessee's right to possession is an interest in that property.[13] Adequate protection is defined by section 361 and includes "granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property."[14] Some courts and scholars believe that adequate protection can include the lessee retaining the right to continued possession after the sale.[15] Reading these statutes together, one could conceivably believe that property could be sold free and clear of a lease under section 363 but that adequate protection—in the form of continued possession of the property by the lessee pursuant to the lease—could be granted by a court.

However, section 365 of the Bankruptcy Code permits debtors or trustees to assume, assign, or reject executory contracts.[16] Some courts have held that section 365 governs and a lease must first be rejected before the property encumbered by the lease can be sold.[17] Section 365 provides that a lessee may retain its rights under the lease if the Trustee—or the debtor in possession[18]—rejects the lease in bankruptcy.[19]

Section 365(h) specifically names the right to possession as one of the rights a lessee may retain in the event the lease is rejected by the landlord/debtor.[20] If the lease is rejected and treated as terminated under section 365(h)(1), the lessee will receive a claim in the bankruptcy estate for any damages resulting from the debtor's

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Code does not explain what should happen when opposing parties invoke both section 363(f) and section 365(h).").

[10] *See, e.g.*, Patrick A. Jackson & Ian J. Bambrick, *Debunking the Perceived Conflict Between §§ 365(h) and 363(f)*, 33 AM. BANKR. INST. J., Oct. 2014 at 52.

[11] 11 U.S.C. § 363(f) (2018).

[12] *Id.* § 363(e).

[13] *See, e.g., In re* Qualitech Steel Corp., 327 F.3d at 548 (holding that a free and clear sale of debtor's assets terminated claimant's possessory interest in such property); Dishi & Sons v. Bay Condos LLC, 510 B.R. 696, 701 (S.D.N.Y. 2014) ("Courts have construed the broad language of 'any interest' to encompass leasehold interests.").

[14] 11 U.S.C. § 361(3).

[15] *See, e.g., Dishi & Sons*, 510 B.R. at 711; Jackson & Bambrick, *supra* note 10, at 90.

[16] *See* 11 U.S.C. § 365.

[17] *See In re* Taylor, 198 B.R. 142, 167 (Bankr. D.S.C. 1996) ("It appears to the Court that Congress intended § 365(h) to control the rights of the landlord and the tenant when a landlord files bankruptcy . . . ."); *see also In re* Haskell L.P., 321 B.R. 1, 7 (Bankr. D. Mass. 2005).

[18] *See* 11 U.S.C. § 1107(a) (2018); *see also* 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, 97 n.9 (2004) ("In Chapter 11, § 1107(a) provides that a debtor in possession, with certain limitations, has all of the rights (other than compensation) and powers of a trustee.").

[19] *See* 11 U.S.C. § 365(h)(1)(A).

[20] *See id.* § 365(h)(1)(A)(ii).

nonperformance.[21] It appears—and many scholars argue[22]—that if a debtor/lessor wants to sell property encumbered by a lease, it must first reject that lease pursuant to section 365(h)(1)(A) and the creditor/lessee will be able to retain its right to continued possession under the lease pursuant to section 365(h)(1)(A)(ii).

It seems possible to reach the same result whether the court applies section 363 or section 365 to the sale of a property subject to a lease in bankruptcy. The creditor/lessee can either request adequate protection in the form of continued possession under section 363 or it can retain its rights under the lease—which may include the right to continued possession in the event of a breach by the lessor—via section 365.[23] However, the choice of which statute applies can determine if the leasehold interest survives the bankruptcy. The Seventh Circuit Court of Appeals addressed this problem in *Precision Industries Inc. v. Qualitech Steel SBQ, LLC*, where the debtor/lessor sold its property under section 363(f) free and clear of all interests without rejecting the lease prior to the sale pursuant to section 365(h).[24]

B. The Seventh Circuit Adopts the Minority Approach

Qualitech Steel Corporation and Qualitech Steel Holdings ("Qualitech") operated a steel mill on a 138-acre tract of land in Indiana.[25] Qualitech reached two agreements with Precision Industries, Inc. and Circo Leasing Co., LLC ("Precision") where Precision agreed to build and operate a supply warehouse to support Qualitech's steel mill, and Qualitech agreed to lease the warehouse property to Precision for ten years.[26] Shortly after these agreements, Qualitech filed for bankruptcy.[27] Most of Qualitech's property was sold at an auction to the senior secured lenders ("New Qualitech"); that sale order declared the senior secured lenders received the property "'free and clear of all liens, claims, encumbrances, and *interests*,' . . . pursuant to section 363(f). . . ."[28]

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[21] *See* Mission Prod. Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1658 (2019) ("As both parties here agree, the counterparty thus has a claim against the estate for damages resulting from the debtor's nonperformance.").

[22] *See, e.g.*, 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. LAW. 475, 501 (2004) (arguing "a sale effecting the repudiation of a lease is tantamount to rejection"); Daniel J. Ferretti, *Eviction Without Rejection—The Tenant's Bankruptcy Dilemma: Bankruptcy Code Sections 363(f) and 365(h)(1)(A) and the Divergent Interpretations of* Precision Industries, Inc. v. Qualitech Steel Sbq, LLC *and In re* Haskell, 39 CUMB. L. REV. 707, 746 (2009) (arguing for an "interpretation that section 363(f) is subject to section 365(h)(1)(A)"); Michael St. James, *Throwing Tenants Off* Spanish Peaks, 34 CAL. BANKR. J. 243, 253 (2018) ("If the lease is rejected first, the tenant's right to ongoing possession would be clearly established by the express provisions of section 365(h)."). *But see* Jackson & Bambrick, *supra* note 10, at 92 ("Under § 365(h) of the Bankruptcy Code, rejection of such a lease affects only the debtor/lessor's obligations and not the nondebtor lessee's rights . . . .").

[23] *See* 11 U.S.C. § 363(i); *id.* § 365(h)(1)(A)(ii).

[24] *See* 327 F.3d 537, 548 (7th Cir. 2003).

[25] *Id.* at 540.

[26] *Id.*

[27] *Id.*

[28] *Id.* at 541.

Precision had notice of the sale but neither objected to the basis of the sale nor sought adequate protection of their leasehold interest.[29] Instead, Precision negotiated the assumption of their lease and supply agreement with New Qualitech; those negotiations ultimately failed, and both contracts were rejected after the sale.[30]

Precision sued New Qualitech after Precision was locked out of its warehouse it constructed on the Qualitech property.[31] The Seventh Circuit Court of Appeals had to determine "whether a sale order issued under section 363(f), which purports to authorize the transfer of a debtor's property 'free and clear of all . . . interests,' operates to extinguish a lessee's possessory interest in the property, or whether the terms of section 365(h) operate to preserve that interest."[32] The court held that section 363(f) applies because (1) the term "any interest" used in section 363 includes leasehold interests,[33] (2) sections 363(f) and 365(h) can operate independently,[34] and (3) the section 363(e) requirement of adequate protection is a sufficient safeguard to protect a leasehold interest in a section 363(f) sale.[35]

The Seventh Circuit Court of Appeals' decision in *Qualitech* did not end the debate on which statute applies to the debtor's sale of its property subject to a lease; some bankruptcy courts have followed *Qualitech*[36] while others have held the opposite of *Qualitech*.[37] Similarly, some scholars have cited *Qualitech* with approval,[38] while others have written about the problems with its reasoning and the negative consequences of the holding.[39] In 2013, the Third Circuit Court of Appeals had an opportunity to address the issue but ultimately decided the case on other

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[29] *Id.* at 548.

[30] *See id.* at 541.

[31] *Id.*

[32] *Id.* at 543.

[33] *See id.* at 545.

[34] *See id.* at 547 (reasoning that unlike other sections of the Bankruptcy Code, there is no cross reference between sections 363(f) and 365(h), and 365(h) is only triggered when a contract has been rejected prior to a section 363(f) sale).

[35] *See id.* at 547–48.

[36] *See, e.g., In re* Hill, 307 B.R. 821, 825–26 (Bankr. W.D. Pa. 2004); *In re* MMH Auto. Grp., 385 B.R. 347, 372 (Bankr. S.D. Fla. 2008) (holding the trustee had the right to sell the property pursuant to section 363(f)(5) but there was no adequate notice of the sale, so the lessee retains the right to adequate protection of its lease after the sale).

[37] *See, e.g., In re* Haskell L.P., 321 B.R. 1, 9–10 (Bankr. D. Mass. 2005) (holding that lessee's interest can only be adequately protected through continued possession); *In re* Zota Petroleums, LLC, 482 B.R. 154, 163 (Bankr. E.D. Va. 2012) ("The rights of the tenant may not be extinguished by a § 363 sale . . . ."); *In re* Samaritan All., LLC, No. 07-50735, 2007 WL 4162918, at *5 (Bankr. E.D. Ky. Nov. 21, 2007) (determining the lessee "has rights under Bankruptcy Code section 365(h)").

[38] *See, e.g.,* Nancy A. Peterman, Ryan A. Wagner, and Kai Zhu, *The Interplay of Sections 363(F) and 365(H): Can These Provisions of the Bankruptcy Code Be Reconciled?*, 28 NORT. J. BANKR. L. & PRAC. (2019) (citing *Qualitech* as "arguably the most oft-cited decision in favor of the 'minority' position"); Jackson & Bambrick, *supra* note 10, at 92 (concluding "the backlash against *Qualitech* is a tempest in a teapot").

[39] *See* Baxter, *supra* note 22, at 500–01 ("The Seventh Circuit's decision in *Precision Industries v. Qualitech Steel* is wrongly decided and should not be followed."); Ferretti, *supra* note 22, at 746 ("[A]nalysis of the text of [sections 363(f) and 365(h)(1)(A)], which clearly conflict, do[] not support the *Precision Industries* holding.").

grounds.[40] It was not until 2017 that another circuit court addressed the issue in *In re Spanish Peaks Holdings II*.[41] The Ninth Circuit Court of Appeals addressed the same issue as *Qualitech*, but the *Spanish Peaks* facts contain a problematic new wrinkle.

C. The Ninth Circuit Adopts the Minority Approach

Spanish Peaks Holdings ran a 5,700-acre ski resort in Montana that contained a ski club, golf course, residential property, and other commercial property.[42] Spanish Peaks Holdings—a limited liability company—decided to lease two properties to develop the resort.[43] Spanish Peaks granted the first lease to Spanish Peaks Development and the second lease to Montana Opticom, which were both separate, independent limited liability companies.[44] James J. Dolan, Jr. was an officer of Spanish Peaks Holdings, Spanish Peaks Development and Montana Opticom.[45]

The first amended lease between Spanish Peaks Holdings and Spanish Peaks Development contained an initial term of ninety-nine years with the lessee paying $1,000 per month, and the lessor—Spanish Peaks Holdings—agreed to pay "all real and personal property taxes, and for paying all utilities and services when due, and was required to maintain the Leased Premises in a clean and orderly condition."[46] The first lease was granted to establish a restaurant adjacent to the ski resort on Spanish Peaks.[47] The manager at Big Sky Resort—who had extensive experience negotiating leases—testified that the value of this first amended lease between Spanish Peaks Holdings and Spanish Peaks Development was between $40,000 and $100,000 per year.[48] James J. Dolan signed the lease as Manager of Spanish Peaks Development; James J. Dolan was also the manager of Spanish Peaks Holdings at the time.[49] The second lease was granted to Montana Opticom by Spanish Peaks Holdings for $1,285

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[40] *See In re* Revel AC, Inc., 802 F.3d 558, 575 (3d Cir. 2015) (finding that the lessor was "prohibit[ed] . . . from invoking § 363(f)[,]" and therefore avoiding any conflict between section 363(f) and 365(h)). In *Revel*, the Third Circuit Court of Appeals denied a stay pending appeal of a 363(f) sale involving a lease holding that the factors to grant a stay pending appeal favored not granting the stay. *Id.*

[41] *See generally* Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 872 F.3d 892, 898 (9th Cir. 2017) (identifying the Seventh Circuit as the only other circuit court to consider the issue). The Fifth Circuit Court of Appeals denied mandamus relief to an insider lessee seeking either adequate protection under section 363I or rejection of the leases. *In re* Royal St. Bistro, L.L.C., 26 F 4th 326, 327 (5th Cir. 2022).

[42] *In re* Spanish Peaks Holdings II, 872 F.3d at 894.

[43] *Id.* at 894–95.

[44] *Id.*

[45] *Id.*

[46] *In re* Spanish Peaks Holdings II, LLC, No. 12-60041-7, 2014 WL 929701, at *3 (Bankr. D. Mont. Mar. 10, 2014), *aff'd*, *In re* Spanish Peaks Holdings II, LLC, No. BR 12-60041, 2015 WL 3767099 (D. Mont. June 16, 2015), *aff'd sub nom.* Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 862 F.3d 892 (9th Cir. 2017), *opinion amended and superseded*, 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).

[47] *See id.* at *4.

[48] *Id.*

[49] *Id.*

per year and lasted through 2068.[50] The second lease was granted to establish telecommunication towers on Spanish Peaks so that residents could have telephone service.[51] James J. Dolan signed the lease for Montana Opticom while he was also the Manager of Spanish Peaks Holdings.[52] Spanish Peaks Holdings and Spanish Peaks Development were both listed at the same address.[53]

Spanish Peaks Holdings filed for bankruptcy under chapter 7 of the Bankruptcy Code.[54] The chapter 7 trustee and the senior secured lender agreed on a plan to liquidate substantially all of the Spanish Peaks' real and personal property at an auction with a minimum bid of twenty million dollars.[55] The Trustee's proposed sale order provided that the property be sold free and clear all liens, claims, encumbrances and other interests in the property pursuant to section 363(f).[56] The procedure of the sale was convoluted, but the lessees objected to the proposed bid procedures and the sale order stating the lessees would elect to retain their rights pursuant to section 365(h).[57] Eventually, the sale occurred and the new owner of Spanish Peaks sought a determination from the court that the sale occurred free and clear of the two leases pursuant to section 363(f).[58] The Ninth Circuit Court of Appeals—like the Seventh Circuit in *Qualitech*—held that section 363(f) and section 365(h) do not conflict and section 365(h) is only triggered when a lease is affirmatively rejected.[59] Thus, the new owners of Spanish Peaks were successful in obtaining Spanish Peaks free and clear of the two leases.[60]

D. The Spanish Peaks *Insider Lease Wrinkle*

The Ninth Circuit in *Spanish Peaks* decided the same legal question as *Qualitech*, but the important new wrinkle of a self-dealing lease granted by insiders cannot be ignored. The Ninth Circuit even acknowledged the significance of the self-dealing transaction.[61] The insiders attempted to use the bankruptcy case to retain the inequitable terms of their leases obtained through self-dealing.[62]

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[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] *Id.* at *3.

[54] Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 872 F.3d 892, 895 (9th Cir. 2017).

[55] *Id.*

[56] *In re* Spanish Peaks Holdings II, LLC, 2014 WL 929701, at *6. The list of permitted encumbrances did not include either of the leases. *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 895.

[57] *In re* Spanish Peaks Holdings II, LLC, 2014 WL 929701, at *6. The court used the phrase "Debtor – Affiliates" which include James J. Dolan, Pinnacle Restaurant At Big Sky, LLC, Spanish Peaks Development LLC, and Montana Opticom, LLC. *Id.* at *1.

[58] *See id.* at *13.

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

[60] *See id.* at 901.

[61] *See id.* at 894.

[62] *See id*. at 894–95 ("A collection of interrelated entities owned the resort and managed its . . . residential and commercial real-estate sales and rentals.").

The insiders were likely aware that section 365 provides protections for lessees, and that they would lose their equity interest in the company to the senior secured lenders in the event of a bankruptcy. To shield themselves from complete loss, the insiders became lessees of their own property to take advantage of those protections.[63] If the new owners of Spanish Peaks were able to successfully turn the business around, the lessees would be able to continue to profit off of their leases or the lessees could assign the lease back to the new owners of Spanish Peaks for a fair market rate, which is much more than they were paying for the lease. The insiders sought to retain a ninety-nine-year lease for $12,000 per year when an expert testified that the current value of the lease was between $40,000 and $100,000 per year.[64] One could imagine this Spanish Peaks insider lease scheme on an even larger scale.[65] The Ninth Circuit was able to prevent the insiders from retaining their leases by holding that section 363 applied and the properties could be sold free and clear of the leases.[66]

II. INSIDER LEASES UNDER SECTION 363

The Ninth Circuit was aware of the self-dealing insider leases in *Spanish Peaks*, which might have motivated their holding that section 365 is not triggered unless a contract is explicitly rejected.[67] In fact, Bradford Barnhardt noted that the court mentioned Timothy Blixseth—who spent fourteen months in solitary confinement for contempt of court—as one of the visionaries of the Spanish Peaks project and Blixseth's involvement provided further motivation to prevent the insiders from retaining the lease.[68] Barnhardt approved of the Ninth Circuit's holding as the best way to prevent these self-dealing lease transactions from taking advantage of the Bankruptcy Code.[69] However, as the Ninth Circuit in *Spanish Peaks* and Barnhardt

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[63] *See id.* at 894 ("In 2006, Spanish Peaks Holdings, LLC ('SPH'), leased restaurant space to Spanish Peaks Development, LLC ('SPD'), for $1,000 per month. Dolan was an officer of both companies, and signed the lease for both lessor and lessee.").

[64] *See In re* Spanish Peaks Holdings II, LLC, No. 12-60041-7, 2014 WL 929701, at *3–4 (Bankr. D. Mont. Mar. 10, 2014), *aff'd*, *In re* Spanish Peaks Holdings II, LLC, No. BR 12-60041, 2015 WL 3767099 (D. Mont. June 16, 2015), *aff'd sub nom.* Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 862 F.3d 892 (9th Cir. 2017), *opinion amended and superseded*, 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).

[65] *Cf. In re* Royal St. Bistro, L.L.C., 26 F.4th 326, 327–28 (5th Cir. 2022) (per curiam) (denying a writ of mandamus in a case with insider leases).

[66] *See In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 901 ("Since the trustee did not reject the leases, section 365 was not implicated.").

[67] *See id.* at 899 (finding "a 'rejection' is universally understood as an affirmative declaration by the trustee that the estate will not take on the obligations" of a debtor's lease or contract).

[68] *See* Bradford N. Barnhardt, *Closing the Loophole in Commercial Landlord Bankruptcies: Why the Ninth Circuit Made the Right Decision in* Matter of Spanish Peaks Holdings II, LLC, 35 EMORY BANKR. DEVS. J. 191, 210 (2019). Timothy Blixseth was held in contempt of court for disobeying a court order to not sell a resort in Mexico. *Id.* Creditors in another bankruptcy case "claim he borrowed $375,000,000 for the Yellowstone Club development and then pocketed much of the loan." *Id.* at 210–11.

[69] *See id.* at 223 ("[T]he minority approach provides judges with a way to deter developers from attempting to exploit the loophole in the Bankruptcy Code.").

both acknowledge, the court would not have been able to approve the sale free and clear of the insider leases had the lessees timely requested adequate protection under section 363(e),[70] and the insiders would have been successful in retaining some undeserved value in the bankruptcy.[71]

A. Adequate Protection Saves Insiders

The Ninth Circuit's solution of using section 363 to prevent insiders from reaping the benefit of insider leases in the future will not be successful, as future insiders will now be on notice that they must timely seek adequate protection and make sure their leases are properly recorded.[72] Barnhardt's solution to this problem is for bankruptcy courts to place a low value on these insider leases, and then grant adequate protection in the form of a lien on property of the debtor instead of continued possession.[73] The problem with Barnhardt's solution is that the adequate protection standard in section 361(3) requires that adequate protection be the "indubitable equivalent."[74]

The indubitable equivalent of possession of property in a lease will still be continued possession of the property under the lease despite a lower valuation of that lease.[75] Barnhardt's noble solution attempts to give the courts a method to protect the purchaser from the insiders, but unfortunately section 363(e) focuses on protecting the lessee's interest, not the purchasers.[76] The Southern District of New York in *Dishi & Sons v. Bay Condos LLC* observed that the particular leases in that case were difficult to value and other forms of adequate protection—specifically a lien on proceeds from the sale—would not preserve any value for the lessees because the lessees were unlikely to receive any compensation from a lien on proceeds from the sale.[77] However, the absence of those specific facts may not stop courts in the future from holding that the indubitable equivalent is continued possession. Even if bankruptcy courts limited continued possession as adequate protection to cases where there are secured lenders that would collect all or most of the proceeds from the sale, that would not be much of a safeguard because cases with senior secured lenders

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[70] *See id.* at 214 ("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."); *In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 898.

[71] *See In re* Spanish Peaks Holdings II, LLC, 872 F.3d at 899–00; *cf. id*. at 900–901 ("To some extent, protecting lessees reduces the value of the estate . . . and is therefore contrary to the goal of 'maximizing creditor recovery,' another core purpose of the Code.") (citation omitted).

[72] *See id.* at 898; *see also* Jackson & Bambrick, *supra* note 10, at 92 ("Had the lessee in *Qualitech* objected to the sale and sought adequate protection of its possessory interest . . . the *Qualitech* lessee could not have satisfied its burden of establishing that its leasehold estate . . . was valid and entitled to protection.").

[73] *See* Barnhardt, *supra* note 68, at 215–16.

[74] *See* 11 U.S.C. § 361(3) (2018).

[75] *See* St. James, *supra* note 22, at 254 n.42; Jackson & Bambrick, *supra* note 10 at 90–91.

[76] Dishi & Sons v. Bay Condos LLC, 510 B.R. 696, 711 (S.D.N.Y. 2014) ("§ 363(e) is focused upon protecting the entity whose interest is threatened, not other creditors or the purchaser.").

[77] *See id.* at 711–12.

occur frequently.[78] Bankruptcy judges must ignore this plain language of section 363(e) and section 361 in order to hold the indubitable equivalent is not continued possession because the lease has a lower value.[79] Although bankruptcy courts are courts of equity, judges may not be willing to ignore plain language in order to reach the most equitable result.

Barnhardt brings up another possible problem to relying on section 363 to sell property free of leases in Subordination, Non-disturbance, and Attornment agreements ("SNDA agreements").[80] SNDA agreements are contracts between the lessee of the property and the lessor's mortgage lender.[81] SNDA agreements usually state that in the event of foreclosure, the lessee will recognize the mortgage holder as the new landlord and the landlord will allow the lessee to remain in possession.[82] SNDA agreements may make it harder to deny the lessee of the right to continued possession in bankruptcy since they have an agreement with the senior secured lender—who often becomes the new owner—that the lessee has the right to continued possession.[83]

However, at least one court held that the lack of a non-disturbance agreement was fatal to the lessee's request for adequate protection.[84] The Eastern District of Louisiana in *In re Royal Alice Properties, LLC* reasoned that because there was no non-disturbance agreement—guaranteeing the lease would continue—and the property could have been sold free and clear of their lease pursuant to section 363(f)(1), the lessees had no interest in the property to protect.[85] According to the court, the most common form of adequate protection is a lien attaching to the proceeds of the sale, but since the senior secured lender was also entitled to adequate protection, and the proceeds from the sale would all go to the senior secured lender, the lessee has no value to protect.[86] The court also rejected the lessee's argument for adequate protection in the form of the indubitable equivalent—meaning continued possession—because the court believed the lessees had no value to protect because the sale was authorized by section 363(f)(1).[87]

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[78] *See, e.g., id.*; *see also In re* Haskell L.P., 321 B.R. 1, 10 (Bankr. D. Mass. 2005).

[79] *See* Dishi & Sons v. Bay Condos LLC, 510 B.R. 696, 711 (S.D.N.Y. 2014) ("Absent any authority to the contrary, the Court must follow the plain language of the Code, which requires the bankruptcy court to provide 'adequate protection,' which may include the indubitable equivalent of the interest, namely, continued possession.").

[80] *See* Barnhardt, *supra* note 68, at 218.

[81] *See id.*

[82] *See id.*

[83] *See id.* at 219 ("[T]he bankruptcy judge would have had tremendous difficulty depriving them of continued possession.").

[84] *See In re* Royal Alice Props., LLC, 637 B.R. 465, 483 (Bankr. E.D. La. 2021) ("The Court observes that none of the Leases here contain nondisturbance clauses that would ensure that the Leases between the Lessees and the Debtor would continue under any circumstances . . . ."), *appeal dismissed sub nom. In re* Royal St. Bistro, LLC, No. 21-2285, 2022 WL 6308294 (E.D. La. Sept. 23, 2022).

[85] *See id.* at 483–84.

[86] *Id.* at 484.

[87] *See id.* ("But offering such adequate protection to creditors with no interests to protect 'would catapult [those creditors] ahead of [their] position behind secured, administrative, and priority unsecured creditors . . . .'").

The problem with the *Royal Alice Properties* court's creative approach to preventing an insider lessee[88] from retaining its lease in bankruptcy is that it ignores the first premise of section 363(e), which states, "Notwithstanding any other provision of this section . . . ."[89] The court disregards that first premise and applies section 363(f)(1) to limit a lessee's right to adequate protection under section 363(e).[90]

This new reading of section 363(e) is at odds with the idea of adequate protection as a safeguard to protect the rights of lessees in the minority approach posited by *Qualitech* and cited by *Spanish Peaks*.[91]

B. Section 363(f) Conditions for Sale

In addition to requesting adequate protection, an insider lessee seeking to preserve the value of its beneficial lease can object to the sale and argue that none of the conditions for a sale under section 363(f) were present.[92] A sale pursuant to section 363(f) can only occur if one of five conditions is met, which Professor Robert Zinman refers to as the gate keeper protection for lessees.[93] Section 363(f)(1) permits a sale if "applicable nonbankruptcy law permits sale of such property free and clear of such interest . . . ."[94] Under state law, an unrecorded lease is often unenforceable against a good-faith purchaser of the property.[95] Zinman opined that the sale of the leases in *Qualitech* may have been based on section 363(f)(1) because the leases were not recorded.[96] Alternatively, the sale may have been permissible under section 363(f)(1) because a mortgage encumbered the property prior to the lease, and state foreclosure law may permit a foreclosure free of a subsequent lease.[97]

Section 363(f)(1) was the basis for the sale in *Spanish Peaks* because there was a senior mortgage, and under Montana state law a senior mortgage extinguishes inferior

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[88] The lessees in this case were also insiders. *Id.* at 474 (highlighting that of the two lessees, one lessee was the sole shareholder of the debtor, and the other lessee was the husband of the former and "designated representative of the estate.").

[89] 11 U.S.C. § 363(e) (2018).

[90] *See In re* Royal Alice Props., LLC, 637 B.R. at 478 (citing section 363(e) before stating "under § 363(f), the Trustee may not sell the Properties free and clear of all interests in the Properties . . ." and listing several scenarios).

[91] *See* Precision Indus., Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp.), 327 F.3d 537, 547–48 (7th Cir. 2003); *see also* Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 872 F.3d 892, 899–900 (9th Cir. 2017) ("A bankruptcy court *must* provide adequate protection for an interest that will be terminated by a sale if the holder of the interest requests it.") (emphasis in original).

[92] *See* Zinman, *supra* note 18, at 128.

[93] *See id.* (providing section 363(f) "may be referred to as the 'gate keeper'"); *see also* Asebedo, *supra* note 6, at 321–33 (analyzing the five conditions of section 363(f)).

[94] 11 U.S.C. § 363(f)(1) (2018).

[95] *See* Zinman, *supra* note 18, at 128–29 (noting a tenant who failed to record its lease was "subordinate to any subsequent bona fide purchaser"); *see also* Asebedo, *supra* note 6, at 323.

[96] Zinman, *supra* note 18, at 128–29.

[97] *See id.*

leases upon a foreclosure sale.[98] However, at least some courts have held that a trustee seeking to sell property under section 363(f)(1) may not stand in the shoes of the senior mortgage lenders; rather, the owner of the asset must be the one who may sell the property free and clear of the leasehold interest under applicable non-bankruptcy law.[99]

Section 363(f)(2) will not be the basis of a sale because an insider seeking to take advantage of the Bankruptcy Code will not consent to the sale occurring free and clear of its lease.[100] Section 363(f)(3) is not applicable to the sale of a property encumbered by a lease.[101]

Section 363(f)(4) permits a sale when "such interest is in bona fide dispute . . . ."[102] Most courts interpret this provision to mean that a sale is permitted when the validity of the interest itself is in dispute.[103] However, some courts have read the statute broader and held that a sale is permitted when any interest is in dispute, including a covenant in the lease.[104] Although it is probably not the intended reading,[105] courts that interpret 363(f)(4) more broadly will be in a better position to permit the sale of property free of a lease, preventing an insider from benefitting from the self-dealing lease.

If the other provisions fail, those seeking to sell the property may be saved by the "most enigmatic" of the provisions, section 363(f)(5).[106] Section 363(f)(5) permits a sale when "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[107] Both Zinman and Anthony Asebedo analyzed the numerous potential grounds that could meet the requirements of section 363(f)(5) including a cramdown under section 1129(b)(2), an eminent domain proceeding, and a foreclosure proceeding.[108] Whether section 363(f)(5) can be used as the basis for a sale hinges on exactly who can compel the legal or equitable

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[98] *See* Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 872 F.3d 892, 900 (9th Cir. 2017) (noting an actual or anticipated foreclosure sale is not required, but only that a foreclosure sale would be legally permissible).

[99] *See, e.g.*, Dishi & Sons v. Bay Condos LLC, 510 B.R. 696, 709–10 (S.D.N.Y. 2014) (finding a narrow interpretation of 363(f)(1) does not authorize the sale "free and clear" of the tenant's lease if it is sold by a trustee); *In re* Jaussi, 488 B.R. 456, 458 (Bankr. D. Colo. 2013). *But see In re* Southland Royalty Co. LLC, 623 B.R. 64, 97–98 (Bankr. D. Del. 2020) (finding section 363(f)(1) is not limited to only "situations where the owner of the asset may, under nonbankruptcy law, sell the asset free and clear").

[100] *See* 11 U.S.C. § 363(f)(2) (2018).

[101] *See* Zinman, *supra* note 18, at 132.

[102] 11 U.S.C. § 363(f)(4).

[103] *See* Zinman, *supra* note 18, at 133; *see, e.g., In re* Stroud Wholesale Inc., 47 B.R. 999, 1002 (E.D.N.C. 1985) ("[Section 363(f)(4)] is merely a codification of long-standing law that allows property to be sold free and clear of a lien if there is a dispute concerning the validity of that lien.").

[104] *See* Zinman, *supra* note 18, at 134; *see, e.g., In re* Bedford Square Assocs., 247 B.R. 140, 145 (Bankr. E.D. Pa. 2000) (finding a lease provision was likely avoidable under section 544(a)(3), and thus was enough to create a "bona fide dispute").

[105] *See* Zinman, *supra* note 18, at 133 (highlighting that the "fuzzy language [of section 363(f)] raises some concern that a dispute arising with the interest" may be enough to permit a free and clear sale).

[106] Asebedo, *supra* note 6, at 326 (quoting Zinman, *supra* note 18, at 134).

[107] 11 U.S.C. § 363(f)(5).

[108] *See* Zinman, *supra* note 18, at 134–39; Asebedo, *supra* note 6, at 326–33.

proceeding.[109] Some courts reject the broad reading of section 363(f)(5) and require that the debtor or trustee compels the sale and not some hypothetical third party.[110] Other courts read section 363(f)(5) broadly to include proceedings brought by a hypothetical third party.[111] Although there is no limitation on who may compel this legal or equitable proceeding in the text of the statute, this broad reading has been criticized for "swallow[ing] the rest of the section."[112]

The broad reading of section 363(f)(5) swallows the rest of the section because certain proceedings—like eminent domain—will always exist rendering the rest of the conditions for a sale under 363(f) superfluous.[113] Zinman calls for an alternative interpretation of section 363(f)(5) that "appl[ies] only to an actual right the debtor might have to force the holder of the interest in the property the debtor wishes to sell to accept a money satisfaction."[114] However, this interpretation is not supported by the current language of the statute,[115] and the literal language of the statute takes priority in statutory interpretation.[116] Although a section 363(f) sale is contingent, this limitation is hardly helpful for lessees attempting to prevent a sale because the conditions are so broad.[117]

C. Section 363 is Not an Adequate Solution

A trustee seeking to sell property free and clear of an insider's leasehold interest will benefit from a broad reading of the conditions of section 363(f) consistent with the language of the statute.[118] However, a section 363 sale is not a sufficient solution to prevent insiders from taking advantage of the Bankruptcy Code because the insiders still have the ability to request adequate protection under section 363(e).[119] The clearest form of adequate protection of a leasehold interest under section 363(e) and section 361(3) is the right to continued possession.[120] Although insiders have failed to take the initiative and timely request adequate protection in the past,[121]

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[109] *See* Asebedo, *supra* note 6, at 326–27.

[110] *See, e.g., In re* Haskell L.P., 321 B.R. 1, 9 (Bankr. D. Mass. 2005); *In re* Patriot Place, Ltd., 486 B.R. 773, 816 (Bankr. W.D. Tex. 2013).

[111] *See, e.g., In re* Hunt Energy Co., 48 B.R. 472, 485 (Bankr. N.D. Ohio 1985) (approving proceedings brought by a third party as "in the best interest of the estate"); *In re* Terrace Chalet Apartments, Ltd., 159 B.R. 821, 829 (N.D. Ill. 1993).

[112] St. James, *supra* note 22, at 250.

[113] *See id.*; *see also* Ferretti, *supra* note 22, at 711.

[114] Zinman, *supra* note 18, at 140 (emphasis omitted).

[115] *See id.*

[116] *See* Asebedo, *supra* note 6, at 331 (quoting United States v. Ron Pair Enters., 489 U.S. 235, 242 (1989)).

[117] *See generally* Zinman, *supra* note 18; Asebedo, *supra* note 6.

[118] *See supra* text accompanying notes 104–17.

[119] *See* 11 U.S.C. § 363(e) (2018).

[120] *See supra* notes 74–76 and accompanying text. If a court instead grants some other form of adequate protection like a claim in the estate, then equitable subordination may be used to subordinate the claim below legitimate creditors. *See infra* Section III(B).

[121] *See* Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 872 F.3d 892, 900 (9th Cir. 2017).

debtor's counsel should not assume that insiders will continue to make the same mistake by neglecting to request adequate protection for their legal rights.[122] Thus, insider-lessees will be able to take advantage of the Bankruptcy Code if the minority approach is adopted as long as the insider timely requests adequate protection because the court must grant the insider lessee adequate protection.

III. INSIDER LEASES UNDER SECTION 365

A. Rejection is Not Recission

A majority of courts hold that when a debtor/lessor attempts to sell property encumbered by a lease, that lease must first be rejected pursuant to section 365(h).[123] Section 365(h) governs when a debtor/lessor rejects a lease.[124] Section 365(h) protects the tenant's rights under state law by providing that the tenant may retain its rights under the lease including the right to continued possession.[125] The debtor benefits by rejecting a lease because it no longer has to perform its obligations under the lease agreement, but the rejection of the lease is not a rescission of the lease requiring the tenant to vacate the premises.[126]

The tenant retains its rights under the lease, and the tenant is entitled to any damages that it incurs as a result of the debtor no longer performing its obligations under the lease.[127] The tenant's claim for damages is a pre-petition claim, which is ordinarily only paid "cents on the dollar."[128] These rules apply equally to insider leases, which makes it difficult—if not impossible—to argue against the insider/lessee's right to continued possession in majority jurisdictions.

B. Equitable Subordination of Damages Claim

Although it does not seem possible to prevent insiders from retaining their right to continued possession under the majority approach, there is a method to prevent a recovery on their claim for damages. The doctrine of equitable subordination can be used to subordinate the claims of insiders in bankruptcy.[129] Equitable subordination allows a bankruptcy court to subordinate "all or part of an allowed claim to all or part

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[122] *See In re* Royal Alice Props., LLC, 637 B.R. 465, 476 (Bankr. E.D. La. 2021) (potentially learning from previous lessees, the tenants in *Royal Alice Properties* submitted a timely motion for adequate protection).

[123] *See In re* Spanish Peaks Holdings, LLC, 872 F.3d at 898 (discussing the majority approach).

[124] *See* 11 U.S.C. § 365(h).

[125] *See id.* § 365(h)(1)(A)(ii).

[126] *See generally id.* § 365(h)(1); *see also* Mission Prod. Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1661 (2019) ("Rejection of a contract—any contract—in bankruptcy operates not as a rescission but as a breach."); Gulfport Energy Corp. v. Federal Energy Regulatory Commission, 41 F.4th 667, 672 (5th Cir. 2022) ("Rejection does not change or cancel a contract; it breaches that contract . . . .") (emphasis omitted).

[127] *See Tempnology, LLC,* 139 S. Ct. at 1658 ("As both parties here agree, the counterparty thus has a claim against the estate for damages resulting from the debtor's nonperformance.").

[128] *Id.* at 1662.

[129] *See* 11 U.S.C § 510(c); *see also Equitable Subordination of a Claim Depends on Insider Status, Conduct of the Claimant, and if There was Harm*, 14 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 32 (2022).

of another allowed claim . . . ."[130] A court may equitably subordinate a claim when three elements are met: "(1) '[t]he claimant must have engaged in some type of inequitable conduct;' (2) '[t]he misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant;' and (3) '[e]quitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy [Code].'"[131] Courts apply heightened scrutiny to insiders when determining if there was inequitable conduct.[132] Inequitable conduct for insiders includes "(1) fraud, illegality, and breach of fiduciary duties; (2) undercapitalization; or (3) claimant's use of the debtor as a mere instrumentality or alter ego."[133]

An insider lease well below market value—like the one in *Spanish Peaks*—is ideal evidence of a claimant/lessee using the debtor/lessor as a mere instrumentality or alter ego because the purpose of an insider transaction is to shield the property from creditors without paying the fair market rate for the lease.[134] An insider lease in bankruptcy harms the other creditors because the property is worth less encumbered by a below market lease. [135] The first two elements of equitable subordination should not be difficult to prove given the nature of insider leases, and the third element would not prohibit a court from subordinating the claim for damages of an insider/lessee.[136] Equitable subordination can at least be used in courts that adapt the majority approach to subordinate an insider lessee's claim for damages resulting from the rejection of the contract under section 365(h).

IV. FIDUCIARY DUTY SUITS TO PREVENT INSIDER LEASES

Neither the majority approach nor the minority approach to the sale of property encumbered by a lease present an adequate solution to prevent insiders from taking advantage of the Bankruptcy Code by leasing their property to themselves for below market rates. In majority jurisdictions the best solution is to subordinate the lessee's claim for damages after the lease is rejected under section 365(h).[137] In minority

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[130] 11 U.S.C. § 510(c).

[131] Schubert v. Lucent Techs. Inc. (*In re* Winstar Commc'ns, Inc.), 554 F.3d 382, 411 (3d Cir. 2009) (quoting Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692, 699–700 (5th Cir. 1977)).

[132] *See, e.g., In re* Winstar Commc'ns, Inc., 554 F.3d at 412; Boyajian v. DeFusco (*In re* Giorgio), 862 F.2d 933, 939 (1st Cir. 1988) (noting most "'equitable subordination' [claims] also involve corporate insiders or fiduciaries who have obtained unfair advantages over other creditors").

[133] *In re* Mid-Am. Waste Sys., Inc., 284 B.R. 53, 70; *see also* Fabricators, Inc. v. Tech. Fabricators, Inc. (*In re* Fabricators, Inc.), 926 F.2d 1458, 1467 (5th Cir. 1991).

[134] *See* Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 872 F.3d 892, 896 (9th Cir. 2017).

[135] *See id.* at 900–01.

[136] United States v. Noland, 517 U.S. 535, 539 (1996) (quoting Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417, 428 (1985)) ("This last requirement has been read as a reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable.").

[137] *See, e.g., In re* Haskell L.P., 321 B.R. 1, 7 (Bankr. D. Mass. 2005).

jurisdictions the best solution is to hope the insider lessee fails to timely request adequate protection under section 363(e).[138] However, a proactive debtor seeking to unwind insider leases prior to a sale has two additional theories upon which it can seek relief. Prior to bankruptcy, insider leases for below market value are prevented by the fiduciary duty of loyalty.

A. Fiduciary Duty Lawsuits Prior to Bankruptcy

The fiduciary duty of loyalty "proscribes a fiduciary from any means of misappropriation of assets entrusted to his management and supervision."[139] The fiduciary duty of loyalty applies to corporate officers,[140] including the president of a limited liability company.[141] Putting self-interest ahead of the corporation's best interest is a clear breach of the fiduciary duty of loyalty.[142] An insider lease for below market value harms the lessor corporation because it relinquishes property rights for less than adequate consideration.[143] If the corporate officer of the lessor-corporation is also a corporate officer of the lessee, it is clearly a self-interested transaction that benefits the officer to the detriment of the lessor corporation.[144] Standing can be a problem preventing those harmed by the misappropriation of assets from bringing a breach of fiduciary duty lawsuit.

Standing requires an actual or imminent injury that is concrete and particularized, which is "fairly . . . trace[able] to the challenged action of the defendant, and not . . . th[e] result [of] the independent action of some third party not before the court."[145] In a large publicly traded corporation, the corporation itself and its shareholders have standing to bring a breach of fiduciary duty lawsuit against officers of the corporation.[146] Shareholders have standing through a derivative action because they have equity in the company, which will be financially harmed if the company is

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[138] *See, e.g.*, Precision Indus., Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp.), 327 F.3d 537, 548 (7th Cir. 2003).

[139] Metro Storage Int'l LLC v. Harron, 275 A.3d 810, 848 (Del. Ch. 2022) (quoting U.S. West, Inc. v. Time Warner Inc., No. 14555, 1996 WL 307445, at *21 (Del. Ch. June 6, 1996)).

[140] *See* Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009).

[141] *See Metro Storage Int'l LLC*, 275 A.3d at 839.

[142] *See id.* at 843 ("[O]fficers have a duty to act 'loyally by trying to do their job for proper corporate purposes in good faith,' rather than disloyally by in bad faith putting other interests, such as the self-interest of a superior, ahead of the corporation's best interest.").

[143] *See* Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC) 872 F.3d 892, 896 (9th Cir. 2017).

[144] This is exactly what happened in Spanish Peaks. *Id.* at 894 (9th Cir. 2017) ("Dolan was an officer of both companies, and signed the lease for both lessor and lessee.").

[145] Lujan v. Defs. of Wildlife, 504 U.S. 555, 560–61 (1992) (quoting Simon v. E. Ky. Welfare Rts. Org., 426 U.S. 26, 41–42 (1976)).

[146] *See In re* Tyson Foods, Inc., 919 A.2d 563, 588–90 (Del. Ch. 2007) (holding plaintiff-shareholders' claim that defendant-directors breached fiduciary duties survives defendant-directors' motion to dismiss); *see also* General Rubber Co. v. Benedict, 109 N.E. 96 (N.Y. 1915) (holding that defendant-director was liable directly to the company).

transferring value to another company for the benefit of an insider.[147] Creditors generally do not have standing to bring a lawsuit for the breach of the fiduciary duty of loyalty.[148] Shareholders bringing a breach of the fiduciary duty of loyalty lawsuit prior to bankruptcy for a self-dealing transaction is one solution to prevent a self-dealing transaction.

However, sometimes there are no shareholders or members incentivized to bring the breach of fiduciary duty lawsuit. This appears to be the case in *Spanish Peaks*—a small private limited liability company—where the manager of the limited liability company was on both sides of the transaction.[149] Even if there were members incentivized to bring the lawsuit, Delaware law permits limited liability companies to limit or eliminate their fiduciary duties.[150] This lack of duty or lack of standing problem for creditors results in secured lenders having no ability to prevent self-dealing transactions from transferring value away from the debtor in limited liability companies or closely held corporations.[151]

B. Fiduciary Duty Lawsuits in Bankruptcy

Creditor's options to prevent self-dealing change once a debtor files for bankruptcy. A debtor has a fiduciary duty to the bankruptcy estate whether a trustee is appointed or the debtor remains in possession.[152] A debtor in possession's duties include "a restriction against self-dealing, a prohibition against conflicts of interest, and a restriction against activity that appears improper, even though no actual impropriety has taken place."[153]

However, the debtor in possession is not breaching any duties by seeking a sale under section 363(e) or rejecting the contract under section 365(h) prior to selling the

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[147] *See* Schoon v. Smith, 53 A.2d 196, 202 (Del. 2008) ("[C]ourts have consistently recognized this nature of the derivative suit. . . . As we have acknowledged, '[t]he right of a stockholder to . . . litigate corporate rights is . . . solely for the purpose of preventing injustice where it is apparent that material corporate rights would not otherwise be protected.'") (footnote omitted) (citation omitted).

[148] *See* Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992) ("[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms . . . .'") (citations omitted).

[149] *See In re* Spanish Peaks Holdings II, LLC, No. 12-60041-7, 2014 WL 929701, at *5 (Bankr. D. Mont. Mar. 10, 2014), *aff'd*, *In re* Spanish Peaks Holdings II, LLC, No. BR 12-60041, 2015 WL 3767099 (D. Mont. June 16, 2015), *aff'd sub nom.* Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 862 F.3d 892 (9th Cir. 2017), *opinion amended and superseded*, 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).

[150] Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. 3658, 2009 WL 1124451, at *8 (Del. Ch. Apr. 20, 2009) ("The Delaware LLC Act gives members of an LLC wide latitude to order their relationships, including the flexibility to limit or eliminate fiduciary duties.").

[151] *See* CML V, LLC v. BAX, 28 A.3d 1037, 1043 (Del. Ch. 2011) ("Therefore, [the Delaware LLC Act] precludes [the creditor] from suing derivatively . . . .").

[152] Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985) ("[I]f a debtor remains in possession—that is, if a trustee is not appointed—the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession.").

[153] Daniel B. Bogart, *Liability of Directors of Chapter 11 Debtors in Possession: "Don't Look Back–Something May Be Gaining on You"*, 68 AM. BANKR. L.J. 155, 217 (1994).

property because the sale will bring in value to the bankruptcy estate.[154] The problem arises when the lessee—who happens to be controlled by the same person as the debtor—requests adequate protection under 363(f) or retains its rights under the lease under section 365(h) because those actions decrease the value of the property that is being sold.[155] Creditors will be unable to prevent this loss of value because creditors are only owed fiduciary duties upon insolvency.[156] The debtor's breach of fiduciary duty occurred pre-bankruptcy and pre-insolvency by leasing the property for below market value.[157] Therefore, you must have standing to sue the debtor for a pre-bankruptcy breach in order to prevent the self-dealing transaction.

If a debtor chooses to liquidate under chapter 7 of the Bankruptcy Code, a trustee will be appointed; a trustee has the same standing in a bankruptcy case as a debtor in possession.[158] A trustee can bring claims against insider-directors or insider-members just like a debtor in possession could bring those claims.[159] The trustee in *Spanish Peaks* brought fraudulent and preferential transfer claims against the corporation, and the trustee sued James J. Dolan—as a corporate officer—for breaching his fiduciary duty.[160] The claims in *Spanish Peaks* ultimately settled, which resulted in money being brought back into the estate.[161] If a debtor files for relief under chapter 11 of the Bankruptcy Code, the debtor remains in possession and there is no trustee appointed.[162]

It appears that the lack of standing problem will make it more difficult to bring the breach lawsuit because the debtor in possession—if still run by the insiders—will not sue itself. However, depending on where the bankruptcy is filed, some jurisdictions grant creditors' committees derivative standing to bring certain claims against a debtor.

1. Derivative Standing Jurisdictions

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[154] *See In re* Chrysler LLC, 405 B.R. 84, 96 (Bankr. S.D.N.Y.) ("A debtor may sell substantially all of its assets *as a going concern* . . . .") (emphasis added).

[155] *See* Barnhardt, *supra* note 68, at 223 (noting that a section 363 free and clear sale can prevent this insider exploitation).

[156] *See* Prod. Res. Grp., v. NCT Grp., 863 A.2d 772, 790–91 (Del. Ch. 2004) ("When a firm has reached the point of insolvency, it is settled that under Delaware law, the firm's directors are said to owe fiduciary duties to the company's creditors.") (footnote omitted).

[157] *In re* Spanish Peaks Holdings II, LLC, No. 12-60041-7, 2014 WL 929701, at *18 (Bankr. D. Mont. Mar. 10, 2014) (finding the lease was listed "far below fair market rental rates" for the area in question).

[158] *See* Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991) ("Under the Bankruptcy Code the trustee stands in the shoes of the bankrupt corporation and has standing to bring any suit that the bankrupt corporation could have instituted had it not petitioned for bankruptcy."); *see also* 11 U.S.C. § 1107(a) (2018).

[159] *See In re* Spanish Peaks Holdings II, LLC, 2014 WL 929701, at *9.

[160] *Id.*

[161] *Id.*

[162] *See* 11 U.S.C. § 1101(1).

Derivative standing allows a third party to sue on behalf of the debtor or trustee when the debtor or trustee is unable or unwilling to sue.[163] Derivative lawsuits provide "redress not only against faithless officers and directors but also against third parties who had damaged or threatened the corporate properties . . . ."[164] A creditors' committee or an individual creditor can use derivative standing in a chapter 11 bankruptcy to sue the debtor's officers responsible for the insider leases.[165] However, some courts decline to grant derivative standing to a creditor.[166] In jurisdictions that allow derivative standing, a court will grant standing if a creditor can show:

> (1) it petitioned the trustee to bring the claims and the trustee refused; (2) its claims are colorable; (3) it sought permission from the bankruptcy court to initiate an adversary proceeding; and (4) the trustee unjustifiably refused to pursue the claims.[167]

A creditor or creditors' committee seeking to establish derivative standing may find it difficult to establish the last element that the trustee—or debtor in possession—unjustifiably refused to pursue the claims.[168] The last element is difficult to meet because it requires a cost-benefit analysis.[169] A creditor must show that it has a good chance of legal success that results in a financial recovery that is not outweighed by the costs of litigation and the delay in the bankruptcy case to meet the cost benefit

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[163] *See Granting Derivative Standing to a Creditors' Committee*, 14 ST. JOHN'S BANKR. RESEARCH LIBR. No. 20 (2022) ("[A] bankruptcy court may grant derivative standing to a creditors' committee or similar body, rather than the bankruptcy estate itself, to bring a claim on behalf of a debtor's estate."); *see also* Off. Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 569 (3d Cir. 2003).

[164] Ross v. Bernhard, 396 U.S. 531, 534 (1970).

[165] *Cf. In re* Pursuit Cap. Mgmt., 595 B.R. 631, 658 (Bankr. D. Del. 2018) ("I conclude that *Cybergenics II* can be extended to cases under chapter 7 and that individual creditors may be permitted to assert avoidance actions in appropriate circumstances with court approval.").

[166] *See, e.g., In re* SRJ Enters., 151 B.R. 189, 196 (Bankr. N.D. Ill. 1993); Surf N Sun Apts., Inc. v. Dempsey, 253 B.R. 490, 494–95 (M.D. Fla. 1999) (describing that the authority to grant derivative standing upon the creditors rests with Congress, not the bankruptcy court).

[167] PW Enters. v. N.D. Racing Comm'n (*In re* Racing Servs.), 540 F.3d 892, 900 (8th Cir. 2008); *see also* Fogel v. Zell, 221 F.3d 955, 965 (7th Cir. 2000); *In re* Pursuit Cap. Mgmt., 595 B.R. at 663. *But see* Commodore Int'l Ltd. v. Gould (*In re* Commodore Int'l Ltd.), 262 F.3d 96, 100 (2d Cir. 2001) (providing an alternative basis for derivative standing based on the trustee's consent). Derivative standing based on consent is not likely to solve our insider lease problem because it is not likely the debtor in possession would consent to a lawsuit against the insider lessee.

[168] The court wrote:

> We expect in most cases creditors will readily satisfy the first three elements without much difficulty—petitioning the trustee and bankruptcy court ought to be mere formalities. And a creditor's claims are colorable if they would survive a motion to dismiss. The real challenge for the creditor will be to persuade the bankruptcy court that the trustee unjustifiably refuses to bring its claims.

In re Racing Servs., 540 F.3d at 900.

[169] *See id.* at 901.

analysis.[170] The trustee in *Spanish Peaks* noted the settlement of the fiduciary duty and fraudulent transfer claims was beneficial to the estate because the estate did not have to spend money litigating.[171] If a creditor insists on bringing a breach of fiduciary duty lawsuit, it can help sway the cost-benefit analysis in its favor by offering to cover the costs of the litigation.[172]

Derivative standing is an even less attractive solution to the insider lease problem because of the cost-benefit analysis. Even if a creditor is successful on the merits of the claim, the creditor is not guaranteed the ideal remedy of rescission of the insider lease.[173] Rescission is the ideal remedy because the property will no longer be encumbered by the below market value lease.[174] However, compensatory damages are generally preferred over the more extreme remedy of rescission.[175] Therefore, even if a creditor succeeds on the merits of the fiduciary duty lawsuit, it may still be unsuccessful in the ultimate goal of preventing the insider lessee from retaining its right to possession via the court awarding compensatory damages instead of rescission.

2. Non-derivative Standing Jurisdictions

Creditors are not granted derivative standing in some jurisdictions.[176] Creditors inthose jurisdictions can hope for a chapter 7 case because a trustee still has standing to bring the breach of fiduciary duty lawsuit.[177] If the case is filed under chapter 11, the creditors will have to either convince the debtor in possession to bring the lawsuit

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[170] *See id.*

[171] *See In re* Spanish Peaks Holdings II, LLC, No. 12-60041-7, 2014 WL 929701, at *9 (Bankr. D. Mont. Mar. 10, 2014) ("[T]he revised damage estimate of $660,000.00, as discussed earlier is 'pretty close to what we had gotten [in the settlement] without having to expend significant capital to either litigate it, hire experts to prove market value of the services, and removing all of the collection risk. So from our perspective, there is a lot of benefits to having brought the settlement forth.'"), *aff'd*, *In re* Spanish Peaks Holdings II, LLC, No. BR 12-60041, 2015 WL 3767099 (D. Mont. June 16, 2015), *aff'd sub nom.* Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 862 F.3d 1148 (9th Cir. 2017), *opinion amended and superseded*, 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).

[172] *See* Unsecured Creditors Comm. of Debtor STN Enters. v. Noyes (*In re* STN Enters.), 779 F.2d 901, 906 (2d Cir. 1985).

[173] *See* Croce v. Kurnit, 565 F. Supp. 884, 894 (S.D.N.Y. 1982), *aff'd*, 737 F.2d 229 (2d Cir. 1984) (holding that the claim was meritorious, but not granting recission as the remedy).

[174] *See* Mission Prod. Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1657–58 (2019) ("A rejection breaches a contract but does not rescind it. And that means all the rights that would ordinarily survive a contract breach, including those conveyed here, remain in place.").

[175] *See* Strassburger v. Earley, 752 A.2d 557, 579 (Del. Ch. 2000) ("Rescissory damages is an exception to the normal out-of-pocket measure."); *see also Croce*, 565 F. Supp. at 894.

[176] *See* United Phosphorus, Ltd. v. Fox (*In re* Fox), 305 B.R. 912, 914 (B.A.P. 10th Cir. 2004) ("The core issue is whether creditors may bring derivative suits on behalf of the bankruptcy estate. We agree with Judge Flannagan that the Bankruptcy Code does not allow such suits.").

[177] *See* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 354 (1985) ("[I]f a debtor remains in possession—that is, if a trustee is not appointed—the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession.").

or appoint a trustee in the chapter 11 case.[178] A trustee may be appointed after notice and a hearing under chapter 11 for cause, which includes "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management."[179] Any party in interest may seek the appointment of a trustee,[180] but the burden is on the moving party to show cause for the trustee's appointment.[181] The appointment of a trustee is considered to be an extraordinary remedy and the presumption is against removing the debtor in possession.[182]

Although the burden is on the party seeking the trustee's appointment, an insider lease is at least some evidence of mismanagement of the affairs of the debtor by the insider.[183] Courts will consider the totality of the circumstances in a motion to appoint a trustee under section 1181(a) and the creditor/lessee would be given an opportunity to explain the below market value lease.[184] Even if the party seeking the appointment of a trustee is successful, it will once again be a costly solution because that party will have to pay lawyers to argue at the hearing and litigate the fiduciary duty lawsuit.[185]

V. FRAUDULENT TRANSFERS AND PREFERENCES TO PREVENT INSIDER LEASES

Fiduciary duty lawsuits are an imperfect solution because of the cost and uncertainty of litigation, but there may be a better and easier to prove solution in fraudulent transfers. Section 548(a)(1) of the Bankruptcy Code authorizes a trustee—or debtor in possession—to avoid any transfer of an interest in the debtor's property if certain conditions are met.[186] Section 548(a)(1)(B) provides the trustee with the power to avoid the claim as a fraudulent transfer if the debtor received less than reasonably equivalent value for the transfer and the transfer was made for the benefit of an insider.[187] Reasonably equivalent value is "value that is substantially comparable to the worth of the transferred property."[188] An insider lease—especially one similar to the lease in *Spanish Peaks*[189]—is not transferred for reasonably

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[178] *See* Off. Comm. of Equity Sec. Holders of Adelphia Commc'ns Corp. v. Off. Comm. of Equity Unsec. Creditors of Adelphia Commc'ns Corp. (*In re* Adelphia Commc'ns Corp.), 544 F.3d 420 (2d Cir. 2008) (explaining that, with limited exceptions, "[t]he Bankruptcy Code does not expressly authorize [creditors]—in contrast to trustees and debtors-in-possession—to sue on behalf of the estate").

[179] 11 U.S.C. § 1104(a)(1) (2018).

[180] *Id.* at 1104(a).

[181] *See, e.g.*, *In re* Colorado-Ute Elec. Ass'n, 120 B.R. 164, 173 (Bankr. D. Colo. 1990) ("The burden is on the movant to show by clear and convincing evidence that there is cause to appoint the trustee.").

[182] *In re* Ionosphere Clubs, Inc., 113 B.R. 164, 167 (Bankr. S.D.N.Y. 1990).

[183] *See, e.g.*, Pinnacle Rest. At Big Sky, LLC v. CH SP Acquisitions, LLC (*In re* Spanish Peaks Holdings II, LLC), 872 F.3d 892, 896 (9th Cir. 2017).

[184] *See In re* López-Muñoz, 866 F.3d at 497–98.

[185] The appointment of a trustee can only occur after notice and a hearing. 11 U.S.C. § 1104(a).

[186] *See id.* § 548(a)(1).

[187] *See id.* § 548(a)(1)(B).

[188] BFP v. Resol. Tr. Corp., 511 U.S. 531, 548 (1994).

[189] *See supra* notes 62–64 and accompanying text.

equivalent value given the large difference in the worth of the transferred property and the amount the debtor received.[190] Fraudulent transfers are easier to prove than a breach of a fiduciary duty or inequitable conduct warranting equitable subordination due to section 548(a) directly including the transfer of property to an insider for the benefit of an insider as a fraudulent transfer.[191]

Although fraudulent transfers are the ideal solution to unwind insider leases, section 548(a) is limited to transfers made within two years of the bankruptcy filing.[192] Fraudulent transfers will not be an option if the debtor files for bankruptcy more than two years after the insider lease was signed.[193] Like fraudulent transfers, preferences under section 547 could be used to unwind insider leases, but section 547 is even more limited to transfers that occurred within one year of the bankruptcy petition.[194] The one-year limitation on preferences makes the practical use of section 547 limited given the long-term nature of insider leases.[195]

The two-year limitation on fraudulent transfers is not the only problem of avoiding leases as fraudulent transfers. Like fiduciary duty lawsuits, fraudulent transfers are often litigated,[196] which is costly to the estate. Litigating a fraudulent transfer lawsuit of an insider lease requires proving the lease was made to an insider and it was leased for less than reasonably equivalent value, which would likely require expert testimony.[197] The trustee in *Spanish Peaks* was motivated to settle due to the high costs to the estate in litigating fiduciary duty and fraudulent transfer claims.[198] The settlement brought in money for the estate, but ultimately it was the court's approval of the sale of the property free and clear of the lease that prevented the insiders from retaining the insider lease.[199]

If the debtor filed under chapter 11, a creditor will have to convince the debtor in possession to bring the avoidance action—an unlikely event—attempt to obtain derivative standing to bring the fraudulent transfer action, or move to appoint a trustee under section 1104.[200] The remedy for an avoidance action of a fraudulent lease can be to unwind the lease.[201] Unlike a breach of fiduciary duty lawsuit, the remedy for a

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[190] *See supra* note 64 and accompanying text.

[191] *See* 11 U.S.C. § 548(a)(1)(B)(ii)(IV).

[192] *See id.* § 548(a)(1).

[193] *See id.*

[194] *See id*. § 547(b)(4)(B).

[195] *See supra* note 46 and accompanying text.

[196] *See, e.g.*, *In re* PSN USA, Inc., 615 F. App'x 925, 927 (11th Cir. 2015) (per curiam); Jalbert v. Wessel G m b H (*In re* La. Pellets, Inc.), 838 F. App'x 45, 48 (5th Cir. 2020) (per curiam).

[197] *See supra* note 64, 171 and accompanying text.

[198] *See* Bogart, *supra* note 153, at 234 n.418 ("Posner argues that the 'nontrivial' threat of bankruptcy helps keep managers in line. This is true because the filing of a petition in bankruptcy, including chapter 11, is the public admission of failure of a company and its managers. Posner says, 'bankruptcy may reveal managerial shortcomings that a merely lackluster corporate performance might not, and therefore it will increase the cost of those shortcomings to the managers.'"); *supra* note 171 and accompanying text.

[199] *See supra* note 58, 171 and accompanying text.

[200] *See supra* Part IV Section B.

[201] *In re* Empire Interiors, Inc., 248 B.R. 305, 309 (Bankr. N.D. Ohio 2000) (holding a pre-petition assumption and assignment of a lease is set aside as a constructively fraudulent transfer).

fraudulent transfer seems to be more clear. Therefore, as long as the lease was signed within the preceding two years of the bankruptcy filing, fraudulent transfers are the preferred proceeding to unwind the insider lease.

CONCLUSION

Under the current Bankruptcy Code, it is difficult to prevent diligent insiders from retaining undervalued leases. A court adopting the majority approach will be limited to equitably subordinating the lessees claim for damages if another creditor brings an adversary proceeding to equitably subordinate the damages after the sale.[202] A court adopting the minority approach—assuming the court recognizes the indubitable equivalent of a lease is the right to continued possession under the lease—will be limited to hoping the lessee fails to timely request adequate protection.[203] Under either approach a court may adopt, a debtor or potential purchaser of land encumbered with an insider lease should be proactive by seeking to unwind the lease before the sale of the property. A proactive approach will put the insider lease issue before the bankruptcy judge earlier in the process, giving the judge more time to hear evidence of the insider transaction prior to ruling on the eventual sale.

A proactive debtor or purchaser/creditor can bring breach of fiduciary duty and fraudulent transfer claims, but both of those remedies have their shortfalls.[204] A breach of fiduciary duty claim may not result in the desired remedy of recission of the lease,[205] and a fraudulent transfer claim is limited to leases signed within two years of the bankruptcy.[206] Both breach of fiduciary duty and fraudulent transfer claims are expensive to litigate, which further reduces the value of the bankruptcy estate.[207] An amendment to the Bankruptcy Code is required to solve the insider lease problem in all cases without requiring expensive litigation. An amendment that states "Section 365(h) is not applicable to insider leases for less than reasonably equivalent value, but all other leases must be rejected pursuant to Section 365(h) prior to any sale under Section 363" would be the easiest solution to the problem. The amendment should also grant any party in interest standing to challenge a lease as an insider lease, which would alleviate creditor's concerns of obtaining derivative standing. The current Bankruptcy Code makes no distinction between leases and insider leases in section 363 or section 365; a future amendment should make that distinction in order to preserve the equitable nature of bankruptcy.

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[202] *See supra* Part III.
[203] *See supra* Part II.
[204] *See supra* Part IV & V.
[205] *See supra* Part IV.
[206] *See supra* Part V.
[207] *See supra* Part IV & V.