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## Finger on the Trigger

Los Angeles lawyer Ashley B. Jordan provides an overview of the key insurance issues in recent state and federal court decisions concerning construction defect liability

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## FROM THE CHAIR

**B**ecause real estate plays a key role in our community, *Los Angeles Lawyer* follows its 33-year-old tradition of dedicating the first issue of the new year to matters affecting those practicing in this field. The tug of war that can occur between landlords and tenants over property rights

in a bankruptcy proceeding is the focus of Gary F. Torrell's article. In a recent case, the Ninth Circuit reconciled two seemingly contradictory provisions in the Bankruptcy Code: One statute allows tenants to remain in possession if they satisfy the lease obligations while another allows a landlord or trustee to sell property free and clear of all liens and interests, including leases. Although the court upheld the trustee's sale of the affected land free and clear of the tenants' leases, the tenants could have mitigated their losses had they asserted their rights to "adequate protection," which they failed to do.

Preservation of California's pristine beaches is covered in Angela Howe's article on the California Supreme Court's decision in *Lynch v. California Coastal Commission*. This opinion may be more significant for the issue the court did not address than the one it decided. The justices narrowly focused their unanimous opinion on actions taken by bluff-top homeowners in rejecting their objections to the Coastal Commission's approval of a seawall. Unlike the court of appeals, the supreme court did not cover the more significant environmental issues presented by the homeowners' challenge to the Commission's permit conditions.

Construction and insurance law attorneys will find Ashley B. Jordan's article to be instructive on coverage issues for latent construction defect claims arising under commercial general liability (CGL) policy terms. Jordan reviews recent federal and state decisions on whether faulty work constitutes an "occurrence" within the terms of current CGL policies, how courts have interpreted the phrase "trigger of coverage" despite the absence of this phrase in CGL policies or the Insurance Code and insurers' response to that interpretation, and whether "business risk" or "ongoing operations" work exclusions constitute grounds for insurers to deny coverage.

Author Gary A. Meyer notes that Southern California commercial and industrial properties have frequently been used for various operations that result in these properties' becoming contaminated with chemicals now regulated by strict environmental laws. Meyer examines the regulatory issues sellers and buyers may encounter in the purchase and sale of contaminated land, the resources available to determine the source and level of contamination, and whether any remediation has occurred. He then recommends strategies each side can follow in protecting their interests when environmental conditions arise. Landlords and tenants are also provided a similar analysis.

Finally, Rena E. Kreitenberg covers a topic potentially affecting any attorney: whether obtaining security from a client for future payment of legal fees, such as a real property lien, is voidable as a fraudulent transfer when the client subsequently files for bankruptcy. As Kreitenberg explains, attorneys can retain this security if their fee arrangements satisfy certain criteria. ■



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## Owner vs. Tenant Rights in a Property in Bankruptcy

**RENTAL PROPERTY OWNERS IN BANKRUPTCY** and bankruptcy trustees want to sell properties free of leases to maximize sale proceeds. Tenants, however, want bankrupt landlords to honor the leases to avoid disrupting, if not terminating, their businesses. On its face, the U.S. Bankruptcy Code seems to take two contradictory approaches to reconciling these conflicting interests. One code provision says tenants of bankrupt owners can stay in possession for the term of their lease if they pay rent when due and honor other lease terms.<sup>1</sup> However, another provision allows a bankrupt owner or trustee to sell property free and clear of all liens and interests.<sup>2</sup> Many bankruptcy courts interpret the latter statute to allow a tenant's leasehold interest to be extinguished in approving a sale.

The U.S. Court of Appeals for the Ninth Circuit recently interpreted these statutes to determine if a conflict truly existed between them.<sup>3</sup> This decision involved related debtors, the primary being Spanish Peaks Holdings, LLC, which owned Big Sky Resort, a 5,700-acre property in Big Sky, Montana. James J. Dolan ran Spanish Peaks Holdings, and Spanish Peaks Holdings signed two long-term leases with related company tenants at monthly rents below market. Dolan also was an officer of both tenants and signed the leases for both the landlord and two tenants. The Ninth Circuit ruled the chapter 7 trustee could sell the real property free and clear of the lease interests over the tenants' objections.

As developer of the resort property, Dolan planned to build a ski and golf resort, restaurant, and other facilities. One lease, for restaurant space, was made in 2006 between Spanish Peaks Holdings as landlord and Spanish Peaks Development, LLC, with rent charged at \$1,000 per month. A year later, the parties replaced the lease with a new version between Spanish Peaks Holdings and an entity called the Pinnacle Restaurant at Big Sky, LLC (Pinnacle), a company that Dolan controlled, for a term of 99 years and with the rent reduced to \$1,000 per year. The resort's general manager later told the bankruptcy court he had negotiated numerous leases and that he believed a fair market rent for the restaurant was \$40,000 to \$100,000 per year. Dolan also signed a 60-year lease with Montana Opticom, LLC (Opticom), of which he was the sole officer, for three cellphone tower locations, with the rent being only \$1,285 per year.

In October 2011, facing multiple lawsuits and unable to sell the resort, Spanish Peaks Holdings and two related companies also controlled by Dolan—The Club at Spanish Peaks, which managed the resort facilities, and Spanish Peaks Lodge, LLC, which managed real estate sales—filed chapter 7 bankruptcy in Delaware. The cases were consolidated a few months later and, at the request of certain parties, the Delaware court transferred the cases to the bankruptcy court in Montana. The bankruptcy court appointed a trustee that, with the agreement of the senior lender holding a mortgage totaling more than \$122 million,

retained a real estate agent to find qualified buyers for the resort.

The trustee prepared a term sheet for the proposed sale, which provided that, "Pursuant to Section 363(f) of the Bankruptcy Code, all of the Debtors' right, title and interest in and to the Property will be transferred free and clear of all liens, claims, encumbrances and other interests in the Property," other than some permitted encumbrances. In addition, it said, "Any other perfected, enforceable, valid liens, claims, interests and encumbrances (if any) will be discharged by the order approving the sale."<sup>4</sup>

The bankruptcy court commented that "[t]hroughout the sales process, the Trustee did not give a lot of thought" to the restaurant and cell tower leases, because the trustee's financial advisor felt "the status of the Leases" made them immaterial to the sale.<sup>5</sup>

In response to the auction sale, Pinnacle and Opticom (along with Spanish Peaks Holdings acting for the tenants) asked the bankruptcy court to affirm that they "could avail themselves, by separate motion, to any rights they might have under 11 U.S.C. § 365(h)" to remain in possession of the leased properties. The court denied their motion without explanation. The trustee then filed a motion rejecting the restaurant and cell tower leases because "the estate no longer possesses the property that is the subject of the Leases." The debtor and two tenants did not respond, and the court granted the motion.<sup>6</sup>

By failing to respond, the tenants made a critical mistake because they did not exercise their right under Bankruptcy Code Section 363 to request "adequate protection"<sup>7</sup> of their leasehold interests in connection with (and prior to the court's approval of), the sale of the resort.<sup>8</sup>

After the bankruptcy court approved the sale, the court conducted a hearing on what rights, if any, the two tenants retained. The court applied what it called a "case-by-case, fact-intensive, totality of the circumstances, approach,"<sup>9</sup> and relied on several factors in making its determination on these rights. First, the restaurant tenant had not operated the restaurant for over six years.<sup>10</sup> Second, the rent was far below fair market.<sup>11</sup> Third, the leases were signed at a time when the landlord and both tenants were controlled by the same person. Fourth, the leases were subject to a bona fide dispute. Finally, under state law if the bank with a lien on the property foreclosed, it would wipe out the leases (created after the bank's lien), and the trustee could use such state law in bankruptcy to avoid the leases when selling the property.<sup>12</sup>

Based upon these findings, the bankruptcy court ruled the sale could proceed free and clear of the leases.<sup>13</sup> The U.S. District Court affirmed the bankruptcy judge's rulings and this decision was appealed to the Ninth Circuit.

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The appellate court acknowledged the potential tension between Bankruptcy Code Section 363, which authorizes a trustee to sell property free and clear of all liens and interests, and Section 365(h) which supposedly protects a tenant when a bankrupt landlord “rejects” the lease and gives the tenant an option to remain in possession of the leased premises for the balance of the lease term.

The Ninth Circuit noted a “majority” of courts, when trying to reconcile the apparent conflict between these two statutes, ruled a tenant’s rights under Section 365 supersede those conferred on a trustee or debtor under Section 363 to sell property free and clear of leases. The appellate court stated “several bankruptcy courts have held that sections 363 and 365 conflict when they overlap,” because “each provision seems to provide an exclusive right that when invoked would override the interest of the other.”<sup>14</sup>

The Ninth Circuit judges also commented that several courts that have decided the issue have applied “the canon of statutory construction that ‘the specific prevails over the general’”<sup>15</sup> and, thus, Section 365 takes precedence over Section 363. In addition, the majority reasoned that “the legislative history regarding section 365 evinces a clear intent on the part of Congress to

protect a tenant’s estate when the landlord files bankruptcy.”<sup>16</sup>

Despite these precedents, the Ninth Circuit decided to follow a different legal analysis from the U.S. Court of Appeals for the Seventh Circuit, which ruled in *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, that Sections 363 and 365 “themselves do not suggest that one supersedes or limits the other.”<sup>17</sup> Section 363, the Seventh Circuit reasoned, confers a right to sell property free and clear of “any interest,” including leases entitled to protections under Section 365.<sup>18</sup> In contrast, it noted that Section 365 has a more “limited scope.” Specifically, Section 365(h) “focuses on a specific type of event—the rejection of an executory contract by the trustee or debtor-in-possession—and spells out the rights of parties affected by that event. It says nothing about sales of estate property, which are the province of section 363.”<sup>19</sup>

As the Seventh Circuit pointed out, Section 363(e) entitles tenants to seek “adequate protection,” in connection with a sale of the underlying property. This means tenants “are therefore not without recourse in the event of a sale free and clear of their interests,” because they have the right to seek protection under Section 363(e),” and if they do so, “the bankruptcy court is obligated to ensure that their interests are

adequately protected.”<sup>20</sup>

If the property is not sold and the trustee or debtor (acting for the bankruptcy estate) retains ownership but chooses to reject the lease, Section 365(h) gives the tenant the right to remain in possession under the terms of its lease. Understood this way, the Seventh Circuit said, “both provisions may be given full effect without coming into conflict with one another and without disregarding the rights of lessees.”<sup>21</sup>

The Ninth Circuit noted that even with the analysis provided by the Seventh Circuit, a significant issue remains; that is, whether a trustee has “rejected” the lease. The Ninth Circuit acknowledged that the Bankruptcy Code does not define a “rejection,” but said the term “is universally understood as an affirmative declaration by the trustee that the estate will not take on the obligations of a lease or contract made by the debtor.”<sup>22</sup> A sale of property free and clear of a lease “may be an effective rejection of the lease in some everyday sense,” but it is “not the same thing as the ‘rejection’ contemplated by section 365.”<sup>23</sup>

The Ninth Circuit’s interpretation of the statutes was that “section 363 governs the sale of estate property, while section 365 governs the formal rejection of a lease. Where there is a sale, but no rejection (or

a rejection, but no sale), there is no conflict.”<sup>24</sup> However, circumstances exist when a trustee’s failure to act would be considered a rejection. For example, failing to assume or reject a residential lease within 60 days in a chapter 7 liquidation, or within 120 days for a nonresidential lease if the debtor is the lessee, is deemed to be a rejection.<sup>25</sup> However, in *In re Spanish Peaks Holdings II, LLC*, all parties agreed the restaurant and cell tower leases were not formally rejected prior to sale of the underlying real property. Because no leases had been formally rejected, the Ninth Circuit reasoned that Section 365 was not triggered.<sup>26</sup>

In addition to the Seventh Circuit’s analysis of the statutory language, the Ninth Circuit identified other reasons why Sections 363 and 365 do not necessarily conflict: “First, we note the mandatory language of section 363(e). 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.”<sup>27</sup> The term “adequate protection” can include any relief (other than compensation as an administrative expense) that will “result in the realization by such entity of the indubitable equivalent” of the interest that will be terminated.<sup>28</sup>

Because the tenants in *Spanish Peaks* failed to request adequate protection before the property was sold, the Ninth Circuit was not required to decide what “adequate protection” the bankruptcy court could or should have awarded to them. “Still,” the Ninth Circuit said, “we think it worth mentioning that the broad definition of adequate protection makes it a powerful check on potential abuses of free-and-clear sales.”<sup>29</sup> In addition, the Ninth Circuit said, “[We] emphasize that section 363(f) authorizes free-and-clear sales only in certain circumstances.” One of these circumstances is that “applicable nonbankruptcy law permits sale of such property free and clear of such interest.”<sup>30</sup>

The Ninth Circuit acknowledged that under Montana law, if a lender with a lien on real property forecloses and the lien is recorded before the leases were created, the foreclosure would terminate the leases and all other junior liens or property interests.<sup>31</sup> A trustee in bankruptcy can use this state law—even when the lender does not foreclose—to sell property free and clear of junior liens and leases, driving up the sale price since any prospective buyers would prefer acquiring real property unencumbered by two long-term and below-market leases.

The court said that while Section 365(h) is designed to protect tenant rights in the

property owner’s bankruptcy, it is not designed to enhance those rights beyond what the tenant retains under state law.<sup>32</sup> Therefore, the *Spanish Peaks* bankruptcy “proceeded, practically speaking, like a foreclosure sale,” the Ninth Circuit said, which is not surprising since the largest creditor was the holder of the mortgage on the property.<sup>33</sup> “Indeed, had SPH [Spanish Peaks Holdings] not declared bankruptcy, we can confidently say that there would have been an actual foreclosure sale,” the court stated, and this sale would have terminated the leases.<sup>34</sup>

The Ninth Circuit cited the *Dishi & Sons* case in which the U.S. District Court for the Southern District of New York held that Section 363(f)(1) “refers not to foreclosure sales, but rather only to situations where the owner of the asset may, under nonbankruptcy law, sell an asset free and clear of an interest in such asset.”<sup>35</sup> The Ninth Circuit said that Section 365 recognizes rights conferred by a lease “to the extent that such rights are enforceable under applicable nonbankruptcy law,” which would include the law governing foreclosure sales. The court concluded that the “clear intent” of the statute is “to protect lessees’ rights outside of bankruptcy, not an intent to enhance them.”<sup>36</sup>

The Ninth Circuit noted that its analysis “highlights a limitation inherent in the ‘majority’ approach taken by other courts.”<sup>37</sup> Section 365 reflects the intent of Congress to protect lessees. “But that intent is not absolute; it exists alongside other purposes and sometimes conflicts with them,” the court said.<sup>38</sup> In some circumstances, protecting a lessee can reduce the value of the estate if the terms of a lease favorable to that lessee makes the property less desirable to a buyer. That would be contrary to the goal of “maximizing creditor recovery,” which is a key objective of the Bankruptcy Code, it noted.<sup>39</sup> “The statutory text is the best assurance we have that we are balancing competing purposes in the way Congress intended,” it added.<sup>40</sup>

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. (Most bankruptcy sales are structured to offer the property free and clear of all encumbrances to increase the sale price.) On the other hand, more bankrupt companies and trustees may use the holding in *Spanish Peaks* to sell rental property free and clear of leases and thereby increase the sale proceeds. These “sold out” tenants may file a claim for

damages, but the recovery can be little and worth far less than the right to continue using the rental property. Tenants facing these circumstances should consult with experienced bankruptcy counsel and discuss various forms of “adequate protection” they should request as a condition to a court’s approval of a trustee (or chapter 11 debtor’s) request to sell property free and clear of the tenant leases. ■

<sup>1</sup> 11 U.S.C. §362.

<sup>2</sup> 11 U.S.C. §363.

<sup>3</sup> *In re Spanish Peaks Holdings II, LLC*, 862 F. 3d 1148 (9th Cir. 2017).

<sup>4</sup> *In re Spanish Peaks Holdings II LLC*, 2014 Bankr. LEXIS 913 (Bankr. D. Mont., Mar. 10, 2014).

<sup>5</sup> *Id.* at 21.

<sup>6</sup> *Id.*

<sup>7</sup> As explained in *Pinnacle Rest. at Big Sky, LLC v. CH SP Acquisitions, LLC* (*In re Spanish Peaks Holdings*), 862 F. 3d 1148, 1156 (9th Cir. 2017), amended by 872 F. 3d 892 (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. Moreover, “adequate protection” includes any relief—other than compensation as an administrative expense—that will “result in the realization by such entity of the indubitable equivalent” of the terminated interest. 11 U.S.C. §361(3).”

<sup>8</sup> *Pinnacle Rest.*, 862 F. 3d at 1153.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 1152.

<sup>11</sup> *Id.* at 1153.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 1151.

<sup>14</sup> *Id.* at 1154 (citing *In re Churchill Props.*, 197 B.R. 283, 286 (Bankr. N.D. Ill. 1996); *In re Haskell, L.P.*, 321 B.R. 1, 8–9 (Bankr. D. Mass. 2005); *In re Taylor*, 198 B.R. 142, 164–66 (Bankr. D.S.C. 1996); and *In re LHD Realty Corp.*, 20 B.R. 717, 719 (Bankr. S.D. Ind. 1982)).

<sup>15</sup> *Pinnacle Rest.*, 862 F. 3d at 1154–55 (quoting *In re Churchill Props.*, 197 B.R. at 288).

<sup>16</sup> *Pinnacle Rest.*, 862 F. 3d at 1155 (quoting *In re Taylor*, 198 B.R. at 165).

<sup>17</sup> *Precision Ind., Inc. v. Qualitech Steel SBQ, LLC* (*In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.*), 327 F. 3d 537, 547 (7th Cir. 2003).

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Pinnacle Rest.*, 862 F. 3d at 1155 (quoting *Precision Ind.*, 327 F. at 548).

<sup>21</sup> *Id.*

<sup>22</sup> *Pinnacle Rest.*, 862 F. 3d at 1155–56.

<sup>23</sup> *Id.* at 1156.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> 11 U.S.C. § 361(3).

<sup>29</sup> *Pinnacle Rest.*, 862 F. 3d at 1156.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* at 1157.

<sup>33</sup> *Id.* at 1156.

<sup>34</sup> *Id.* at 1157.

<sup>35</sup> *Dishi & Sons v. Bay Condos, LLC*, 510 B.R. 696, 704 (S.D. N.Y. 2014).

<sup>36</sup> *Pinnacle Rest.*, 862 F. 3d at 1157.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*