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Seventh Circuit Ruling on Sale of Bankrupt's Assets Eliminates Rights of Lessee–Decision May Have Implications for Rights of IP Licensees

The Seventh Circuit ruled recently that a debtor's court-approved sale of property "free and clear of all liens, claims, encumbrances and interests" pursuant to 11 U.S.C. § 363(f) eliminates the rights of a lessee under 11 U.S.C. § 365(h) to retain the benefits—including continued possession—of a lease rejected by a debtor. In addition to potentially changing the balance between lessors and lessees of real property, this decision, *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 2003 WL 1918405 (7th Cir., Apr. 23, 2003) (*Precision Industries*), calls into question commonly held assumptions about certain other rights under the Bankruptcy Code. In particular, the decision may impair the rights of a licensee of intellectual property under 11 U.S.C. § 365(n) to retain the benefits of an intellectual property license if the underlying intellectual property is sold by the debtor.

Background

The debtor in *Precision Industries*, Qualitech Steel, operated a steel mill in Pittsboro, Indiana. Qualitech agreed to lease a portion of its property to Precision, one of its suppliers, for $1 per year over a ten-year period. In a related transaction, Precision agreed to construct a warehouse on the property and to give Qualitech the right to purchase the warehouse for $1 at the end of the ten-year lease, as long as Qualitech had not defaulted under either agreement. In the event of a default, Precision was to have the right to remove all improvements and fixtures from the property.

Soon after the execution of the lease, Qualitech filed for bankruptcy. Five months later, the bankruptcy court entered an order pursuant to § 363(f), approving the sale of substantially all of Qualitech's assets "free and clear of all liens, claims, encumbrances and interests." Precision, which had notice of the sale hearing, made no objections to the sale order. The sale order preserved Qualitech's right to assume and assign all executory contracts—presumably including the Precision lease—to the buyer. Negotiations between Precision and the buyer regarding the assignment of the Precision lease ultimately failed, the lease was rejected and, by December 3, 1999, Precision had vacated and padlocked the warehouse. Soon afterwards, the buyer changed the locks, asserting ownership of the warehouse "free and clear" of any rights of Precision.

Precision challenged the buyer's right to the warehouse and property by filing a complaint with the federal district court alleging the buyer's trespass and asserting other related claims. The complaint was ultimately referred to the bankruptcy court. The buyer requested a determination that the sale order had extinguished Precision's interest in the property. The bankruptcy court found that, pursuant to § 363(f) and the terms of the sale order, the buyer had indeed

> The *Precision Industries* decision could change the balance between lessors and lessees, and raises questions about the rights of a licensee of intellectual property under 11 U.S.C. § 365(n).

acquired the real property from Qualitech free and clear of any rights of Precision. The district court reversed. Finding a conflict between § 363(f) and § 365(h), the district court ruled that the more specific provisions of § 365(h), which governs rejected leases and allows tenants to remain in possession of the premises for the balance of the lease term, trumped the general language of § 363(f), which governs asset sales.

The Seventh Circuit's Opinion

As an initial matter, the Seventh Circuit agreed with the district court and determined that, despite Precision's failure to object at the sale hearing, its further failure to appeal the sale order, and its failure to challenge the sale order until months later when the buyer had prevented its entry into the warehouse, the issues raised by the appeal were properly before the court, as they involved the bankruptcy court's interpretation of its own sale order. In all other respects, the Seventh Circuit reversed the decision of the district court, emphasizing that courts are obligated to construe statutes in a way that avoids potential conflicts whenever able to do so reasonably.

In reaching its decision, the Seventh Circuit determined that there are three reasons why § 365(h) does not conflict with § 363(f). First, there was no suggestion in either statute that one was to supersede or limit the other, even though both statutes contained cross-references to other statutes affecting their operations. Second, the "plain language" of § 365(h) indicated that its operation is limited to situations in which the debtor has rejected a lease; "nothing in the express terms of section 365(h) suggests that it applies to any and all events that threaten the lessee's possessory rights." *Precision Industries*, 2003 WL at *8. Third, to the extent that Precision's right to possession as a tenant was an "interest" subject to being divested under § 363(f), § 363 provides a mechanism for protecting the rights of lessees, in that § 363(e) directs the bankruptcy court, "on the request of any entity with *an interest* in the property to be sold, to 'prohibit or condition such… sale… as is necessary to provide adequate protection of such interest.'" *Id.* (emphasis added).

Thus, the Seventh Circuit held that Precision's rights to continued possession of the property under § 365(h) were "interests" that were extinguished by the sale. Although the Seventh Circuit did not address the issue, Precision's rights to adequate protection of its interest presumably also were extinguished because Precision did not object to the sale at the time the bankruptcy court approved the sale. The Seventh Circuit did not consider what adequate protection would have been appropriate had Precision objected to the sale in a timely manner, nor whether the bankruptcy court could have approved the sale over Precision's objection under § 363(f). *Id.* It is also worth noting that Precision did not raise on appeal the issue of whether its consent to the sale was required under § 363(f). The Seventh Circuit concluded by stating that its interpretation was consistent with the process of marshaling the estate's assets for the twin purposes of maximizing creditor recovery and rehabilitating the debtor.

Ruling Generates Uncertainty for Intellectual Property Licensees

Prior to the *Precision Industries* decision, many practitioners assumed that the rights of intellectual property licensees were protected from any impairment if the licensor entered bankruptcy because of § 365(n), which provides that if a debtor-licensor rejects an intellectual property license, the licensee may elect to nonetheless retain its rights to use the intellectual property for the duration of the license term.

The *Precision Industries* decision casts doubt on that assumption. Not only is the structure of § 365(n) similar to that of § 365(h), but the legislative history of § 365(n) indicates that it was modeled on § 365(h). *See* S. REP. NO. 100-505, at 4 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3203. Additionally, the policy concern voiced by

Previously, many assumed that the rights of intellectual property licensees were protected under § 365(n) from a licensor's bankruptcy. The *Precision Industries* decision now casts doubt on that assumption.

the Seventh Circuit in *Precision Industries*—that courts should construe statutes in a way that avoids conflict—and the Seventh Circuit's analysis of the relationship between § 365(f) and § 365(h), would each apply equally well to the interpretation of the interaction of § 363(f) and § 365(n).

Thus, licensees should no longer assume that their interests will pass through bankruptcy unscathed. If the debtor proposes to sell its intellectual property assets, the battle may now shift from preservation of defined rights under § 365(n) to a far more uncertain issue of adequate protection under § 363.

It is difficult to know so soon after this Seventh Circuit decision whether a license or lease can be protected from a sale under § 363(f). However, some of the pitfalls of the *Precision Industries* decision may be avoided if lessees and licensees are vigilant in objecting to a sale of assets that does not adequately protect their interests.

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