THERE THEY GO AGAIN! ANOTHER MODIFICATION OF LESSEE RIGHTS IN BANKRUPTCY WITH QUESTIONABLE NOTICE[*]

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In 2003, the Seventh Circuit in *Precision Industries, Inc. v. Qualitech Steel SBQ*,[1] permitted the sale of real property free and clear of a lessee's interest under section 363(f) of the Bankruptcy Code,[2] and held inapplicable the lessee's right to remain in possession of a rejected real property lease under section 365(h).[3] Although this decision has sparked controversy concerning its interpretation of the interplay between sections 363(f) and 365(h),[4] in an article for both the NABT and the ABI, I complained about the inadequacy of the notice given to the lessee.[5] In particular, I noted that the lessee was never specifically informed that, as a consequence of the proposed sale, its lease was proposed to be forfeited – not rejected, but

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1 327 F.3d 537 (7th Cir. 2003).

2 11 U.S.C. § 363(f).

3 11 U.S.C. § 365(h).

4 *See* Robert N. Zinman, Precision *in Statutory Drafting: The* Qualitech *Quagmire and the Sad History of Section 365(h) of the Bankruptcy Code,* 38 JOHN MARSHALL L. REV. 97 (2004); Michael St. Patrick Butler, *Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in* Precision Industries v. Qualitech Steel, 59 BUS. LAW. 475 (2004).

5 Alec P. Ostrow, Qualitech *and Sales Free and Clear of Leasehold Interests: Bankruptcy Process and Due Process*, 7 ANNUAL CONVENTION OF NAT'L ASS'N OF BANKR. TRUSTEES 7 (2003) and 2003 WINTER LEADERSHIP CONFERENCE OF AM. BANKR. INST. 353, *reprinted in* NABTALK vol. 19, no. 4 at 14 (2004).

forfeited. This lack of specific notice may have resulted in the inability of the lessee to protect its rights, an issue not addressed by the decision itself.[6]

In September of this year, the Eleventh Circuit in *Finova Capital Corp. v. Larson Pharmacy Inc. (In re Optical Technologies, Inc.)*,[7] dealt a similar blow to lessees in a completely different context. It rejected on *res judicata* grounds a post-confirmation challenge to a plan provision that modified – not just assumed, but modified – the leases.[8] What makes this case alarmingly similar to the *Qualitech* result is the deplorable lack of notice given to the lessees that a plan that proposed the modification of their leases was being considered for confirmation. And although the Eleventh Circuit squarely addressed the due process arguments raised by the lessees, the quality of the notice given was, once again, only cursorily examined.

In *Optical Technologies* the debtors leased electronic kiosks that displayed advertising to pharmacies and health care providers. The debtors sold advertising on these kiosks and agreed to pay a portion of the advertising revenue to the lessees. It was contemplated that the lessees' share of the advertising revenue would more than compensate them for their rental payments to the debtors. The debtors then assigned the leases to several finance companies, including Finova. When the debtors ran into financial difficulties a few years later, they stopped forwarding the lessees' share of the advertising revenue. The lessees then stopped paying rent and sued. This forced the debtors to file chapter 11, but significantly, in two stages.[9]

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[6] *Id.*

[7] 425 F.3d 1294, 2005 U.S. App. LEXIS 20095 (11th Cir. Sept. 20, 2005). Because the Federal Reporter page citations were not available to the author, this article will use the LEXIS page citations.

[8] 2005 U.S. App. LEXIS at *15, *34.

[9] *Id.* at *1-*5.

In the debtors' third amended plan, the original debtors proposed to modify some of the kiosk leases, in particular those assigned to Finova, by, among other things, extending their terms. The lessees in question received a copy of the plan, but the debtor-related entities with whom these lessees had contracted had not yet filed for chapter 11. Because not all the relevant entities were in bankruptcy at the time, the bankruptcy court rejected the plan. Shortly thereafter, a fourth amended plan, which included the newly-filed debtors, was proposed, and hearings were promptly scheduled. The lessees in question were not served with the fourth amended plan, but instead were served with a summary highlighting the differences between the third and fourth amended plans. Because the lease modification provisions were unchanged, they were not mentioned in the summary. In addition to the summary, the lessees received a copy of the order that rescheduled the confirmation hearing. The lessees did not appear at the rescheduled confirmation hearing, and the bankruptcy court confirmed the plan.[10]

After the confirmation order became final and nonappealable, Finova sent to the lessees statements of the revised leases with their extended terms. The lessees objected, and Finova brought an adversary proceeding in the bankruptcy court to declare that the leases had indeed been modified by the confirmed plan. The bankruptcy court held for the lessees. As to those with leases that had expired before the second round of filings, the court held that the plan could not have permissibly modified leases that were no longer in effect. As to the other lessees, the court held that they had not been given adequate notice of the modification, and therefore the court lacked jurisdiction to modify the leases. The district court, however, reversed. Although the court acknowledged that the lease extension provisions may not have been proper, the

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[10] *Id.* at *3-*5 & nn.6-7.

lessees' defenses to Finova's adversary proceeding were impermissible collateral attacks on the confirmation order, the issuance of which did not violate the lessees' due process rights.[11]

The Eleventh Circuit affirmed the district court. After rejecting the lessees' arguments that the plan's lease extension provisions were inapplicable to their leases,[12] the court stated that the lessees were bound by the plan unless the confirmation order could be set aside as to them.[13] The relevant ground was Rule 60(b)(4) of the Federal Rules of Civil Procedure, that "the judgment is void."[14] "Void" did not mean a mere error in the exercise of jurisdiction.[15] Citing a 1940 Supreme Court decision,[16] the court held that the lessees had to demonstrate a constitutionally defective failure of process.[17] The lessees did not argue such a failure, and the court held – without analysis – that the notice that had been given satisfied the constitutional standard.[18] Instead, the lessees argued for the bankruptcy court's continuing authority to revisit its own jurisdiction, and delete from the plan provisions that are jurisdictionally improper. The court rejected these arguments, and held the lessees bound by the plan.[19]

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[11] *Id.* at *6-*10.

[12] *Id.* at *15-*28.

[13] *Id.* at *28.

[14] FED. R. CIV. P. 60(b), which is made applicable in bankruptcy cases by FED. R. BANKR. P. 9024.

[15] 2005 U.S. App. LEXIS at *29.

[16] Chicot County Drainage Dist. v. Baxter State Bank, 308 U.S. 371, 376 (1940).

[17] 2005 U.S. App. LEXIS at *30.

[18] *Id.*

[19] *Id.* at *31-*34.

As is the case with *Qualitech*, it is difficult to find fault with the reasoning of the court of appeals in *Optical Technologies*, especially when the lessees conceded the central due process argument. What is particularly frustrating about this case, like *Qualitech*, is what little it allows to pass for due process in bankruptcy cases concerning the rights of lessees. In *Qualitech* the lessee received a notice of sale "free and clear of all liens, claims, encumbrances, and interests" and was expected to understand that its real property lease was just such an "interest."[20] In *Optical Technologies* the lessees received a third amended plan concerning debtors with whom they had no privity, and a summary of a fourth amended plan, which did concern a debtor with whom they had privity, but failed to mention the very provisions, retained from the third amended plan, that affected their rights.[21] Yes, the lessees got sets of papers with notices of hearings and opportunities to object. But the first set of papers, which provided the information on how their rights might be affected, did not apply to them. And the second set of papers, which did apply to them, did not tell them that their rights were being affected.

It must be remembered that due process is more than the mere receipt of a notice that a motion is being made, or a plan is being considered for confirmation, and the recipient has the opportunity to object. The notice must be "a reliable means of acquainting interested parties of the fact that their rights are before the courts."[22] I submit that the lessees were well within their rights to throw away the first set of papers, because the parties with whom they contracted were not then debtors and thus, the notice did not concern their lessees. If that is right, how could the

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[20] *See* 327 F.3d at 541.

[21] 2005 U.S. App. LEXIS at *4-*5 & nn.6-7.

[22] Mullane v. Central Hanover Bank & Tr. Co., 339 U.S. 306, 315 (1950); *see also* Grannis v. Ordean, 234 U.S. 385, 392 (1914) (to satisfy due process the objectant, "upon receiving the notice, would be sufficiently warned that it affected his interest").

second set of papers, standing by itself, have reliably acquainted the lessees of the fact that in the new hearing their leases were proposed to be modified?

In my article on *Qualitech*, I pointed out that the notice to the lessee not only raised due process concerns, it failed to comply with the relevant bankruptcy rules requiring motions to sell free and clear to "state with particularity the grounds therefor, and . . . set forth the relief or order sought."[23] Unfortunately, these rules do not apply to confirmation of plans, and there is no similar requirement.[24] The disclosure statement may be justly regarded as a more than adequate substitute, but not for lessees. Disclosure statements are for the purpose of soliciting votes,[25] which is necessary only when there are impaired classes that receive some distribution.[26] The "adequate information" required to be contained in disclosure statements is for the benefit of the creditor or interest holder with a right to vote.[27] Therefore, neither the Bankruptcy Code nor Rules protect the lessee's interest in receiving adequate notice of the provisions in a plan that affect its rights. The lessee's only protection is in the Constitution itself. If the Constitution does not require the plan's proponent to give the lessee specific notice of what the plan coming up for confirmation proposes to do to its lease – or stated differently, if the Constitution requires the lessee to read the plan to figure out for itself what the plan proposes to do to its lease when it

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[23] FED. R. BANKR. P. 9013 (stating the requirement of a "motion," which is required to obtain an order to sell free and clear under Rules 6004(c) and 9014).

[24] *See* FED. R. BANKR. P. 3017(d) (procedure for transmittal of plan and disclosure statement after approval of disclosure statement), 3020(b)(1) (making an objection to confirmation a contested matter under Rule 9014). Nothing in these or any other rules requires the making of a "motion" to obtain confirmation.

[25] 11 U.S.C. §§ 1125(b), 1126(b)(2).

[26] 11 U.S.C. § 1126(f)-(g).

[27] 11 U.S.C. § 1125(a).

receives a notice of a confirmation hearing, then, at a minimum, the lessee should be given the plan to read at that time. That was not done in *Optical Technologies.*

This case is another disturbing example of the need for lessees to be especially vigilant in protecting their rights. So long as confirmed plans with improper provisions are afforded *res judicata* effect, special care must be taken to make sure these provisions are ferreted out before the plans are confirmed. So far, neither Congress nor the rule-makers require the highlighting of plan provisions that affect the rights of lessees in ways other than the standard assumption, rejection and assignment of their leases.[28] It is submitted that, to the extent the Due Process clause[29] does not require that explanations of extraordinary provisions in plans be provided to the parties affected by them, then the bankruptcy courts should use their authority to regulate notices[30] to accomplish the same result. Those concerned with the integrity of the bankruptcy process should strive to reduce the number of instances in which a party can justly complain that he found out too late what preventable thing had been done to him.

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[28] *See* 11 U.S.C. §§ 365(a)-(b), 365(f), 1123(b)(2).

[29] U.S. CONST. amend. V ("No person shall . . . be deprived of life, liberty, or property, without due process of law . . . .").

[30] FED. R. BANKR. P. 9007.