

Lessor update: what commercial landlords need to understand about bankruptcy

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Lease agreements are subject to special treatment in bankruptcy cases that is often contrary to the terms of the lease itself or relevant non-bankruptcy law. Thus, a tenant's filing of a bankruptcy case presents myriad issues for a commercial landlord. This chapter discusses several of the most important matters affecting a landlord in the case of its tenant's bankruptcy, including:

- the tenant's assumption, rejection or assignment of a lease;
- lease obligations pending assumption, rejection or assignment;
- deadlines for assuming, rejecting or assigning a lease; and
- the treatment of claims arising from the assumption, rejection or assignment of a lease.

This chapter focuses on bankruptcy law provisions unique to non-residential real property leases, which are of the greatest interest to most commercial landlords.

Sections 365 and 502 of the Bankruptcy Code are the primary statutes governing the treatment of leases in bankruptcy. Section 365 provides for the assumption, rejection and assignment of unexpired leases. Assumption is akin to ratification of a lease, while rejection is effectively an anticipatory repudiation of a lease. Section 365 deals with a tenant's obligations under a non-residential real property lease pending assumption, rejection or assignment, as well as containing specific provisions for "shopping center" leases. Section 502 deals with the treatment of claims arising from the breach of a lease, including limitations on claims arising from the rejection of a lease.

It is important to remember that the express language of the Bankruptcy Code only goes so far, and that it is up to the courts to interpret the provisions of the code and thereby articulate and refine various principles necessary to implement the code's provisions. There is a large body of reported case law interpreting key provisions of the Bankruptcy Code and it is not always consistent, so for any particular issue there is not always a uniform principle or rule of decision. The volume and variety of reported decisions in bankruptcy cases are largely explained by the fact that while the Bankruptcy Code is a uniform federal law, it is applied by a federal court system divided into 12 regional circuits, each with its own court of appeals, and that is then further subdivided into trial-level district courts for most civil and criminal cases and specialised bankruptcy courts (which are units of the district courts) for bankruptcy cases.

To complicate matters further, first-level appeals from a bankruptcy court go either to the district court or a special bankruptcy appellate panel for the circuit and then, if further appealed, to the court of appeals for the circuit, so there is the possibility of written opinions on any specific bankruptcy issue from any number of bankruptcy courts, district courts, bankruptcy appellate panels or courts of appeal. Sitting above all these courts is the US Supreme Court, with its reported decisions constituting precedent that is binding on all lower courts. However, because the Supreme Court takes on relatively few cases and therefore issues relatively few decisions, few issues regarding non-

residential real property leases have been addressed and decided by the Supreme Court; therefore, most of the applicable precedent is found in lower court decisions.

The final complication in understanding the significance of the welter of published decisions on many bankruptcy issues is that there are less-than-clear principles regarding which decisions are binding on which courts in subsequent cases. For example, it is universally recognised that a circuit court of appeals decision constitutes binding precedent for all district courts and bankruptcy courts located in that circuit, but not for any other circuit court of appeals or lower courts in any other circuit. While a written decision by a bankruptcy appellate panel or a district court sitting in an appellate capacity in a bankruptcy matter will always govern the bankruptcy court below in that case, there is a split of opinion as to whether the decision is binding on district courts and bankruptcy courts in regard to the same issue in any other case. A written decision that is not binding precedent is at best “persuasive authority” that can be followed or rejected by the judge in the subsequent bankruptcy case.

This means that the same issue can produce different results and outcomes in different circuits, and often within the same circuit if there is not binding authority at Supreme Court level or from the circuit court of appeals in that circuit. Accordingly, for the purpose of this chapter’s overview of issues regarding non-residential real property leases in bankruptcy, terms such as ‘the majority view’, ‘generally’ or ‘some courts’ are used where appropriate to signal that there are a range of views and outcomes in the reported case law on various Section 365 issues. Some comfort can be drawn from the fact that because bankruptcy law is part of US federal law, expert US bankruptcy lawyers are well versed in any inconsistencies in case law and generally can advise on substantive bankruptcy matters without regard to the location of the bankruptcy case within the United States.

Debtor’s lease obligations pending assumption or rejection of a non-residential real property lease

Section 365(d)(3) of the Bankruptcy Code requires a debtor-tenant to continue to perform its post-petition (ie, post-bankruptcy) obligations under a non-residential real property lease until it is assumed, rejected or assigned pursuant to Section 365(a). If unpaid, such obligations give rise to an administrative expense claim (which are entitled to payment priority over virtually all other unsecured

claims), generally in the amount provided in the lease, regardless of the actual value of the lease to the bankruptcy estate.

Authority is split regarding whether a debtor is obligated to pay all amounts arising from its post-petition lease obligations under Section 365(d)(3) where there may be insufficient funds to satisfy other administrative expense claims. The conflict centres around whether such claims should effectively receive a super-priority, such that they are fully paid even if so doing will prevent other administrative expense claims from being paid. The cases can generally be divided into three groups. The plurality, if not the majority, of cases hold that obligations under Section 365(d)(3) effectively do not give rise to a super-priority administrative claim and should not be paid until it is determined that there are sufficient funds in the bankruptcy estate to pay all administrative claims in full (eg, see *In re Bryant Universal Roofing, Inc*, 218 BR 948 (Bankr D Ariz 1998)). By contrast, a substantial minority of courts have ruled that obligations arising under Section 365(d)(3) give rise to a super-priority administrative claim which must be timely paid regardless of the bankruptcy estate’s ability to pay other administrative claims (eg, see *In re New Almac’s, Inc*, 196 BR 244 (Bankr NDNY 1996)). Finally, a substantial number of cases effectively take an approach midway between those two lines of cases, holding that the bankruptcy estate should pay all obligations under Section 365(d)(3), subject to later disgorgement if it turns out that there are insufficient funds in the bankruptcy estate to pay all administrative claims in full (eg, see *In re PYXSYS Corp*, 288 BR 309 (Bankr D Mass 2003)).

Section 365(d)(3) and interpretive case law establish the scope of a debtor’s post-petition lease obligations. Most courts have ruled that Section 365(d)(3) encompasses post-petition obligations for taxes, insurance, common area maintenance, utilities, repairs, clean-up costs, late charges, interest and other monetary obligations (eg, see *In re Cukierman*, 265 F3d 846 (9th Cir 2001)). However, a few courts have held that a debtor’s post-petition failure to comply with maintenance responsibilities and obligations to restore the premises to their pre-lease condition gives rise to an unsecured claim deemed to arise pre-petition, rather than to a post-petition administrative claim, because such obligations do not accrue until the lease is rejected (eg, see *In re TreeSource Industries, Inc* 363 F 3d 994 (9th Cir 2004)). Further, there is a split in the case law regarding whether Section 365(d)(3) requires a debtor to pay the attorney’s fees incurred post-

petition by a landlord seeking to enforce the debtor's lease obligations, with a majority permitting such recovery to the extent allowed under the lease (compare *In re Midway Airlines Group*, 406 F 3d 229 (4th Cir 2005) with *In re Pudgies Dev of New York, Inc*, 202 BR 832 (Bankr SDNY 1996)).

Certain types of post-petition lease obligation specified in Section 365(b)(2) are expressly excluded from the debtor's performance duties under Section 365(d)(3). These include penalty rates or provisions arising from the debtor's failure to perform non-monetary obligations, as well as so-called *ipso facto* provisions that impose obligations or penalties based on:

- the commencement of a bankruptcy case by or against the debtor;
- the financial condition of the debtor; or
- the appointment of a trustee in bankruptcy case or a custodian prior to the commencement of a bankruptcy case.

There is a split in the case law regarding the extent of a debtor's obligations under Section 365(d)(3) where a portion of an obligation falling due post-petition accrued during the pre-petition period. Most courts hold that where obligations falling due post-petition include amounts accruing pre-petition, the debtor must pay a *pro rata* amount under Section 365(d)(3) based on the proportion that the post-petition period bears to the entire period to which the payment relates (eg, see *In re Handy Andy Home Improvement Centers, Inc*, 144 F 3d 1125 (7th Cir 1998)). Similarly, several courts have required *pro rata* payment under Section 365(d)(3) of lease obligations attributable to the post-petition period even where the payment fell due (and was not made) pre-petition (eg, see *In re Victory Markets, Inc*, 196 BR 6 (NDNY 1996)).

By contrast, a substantial minority of courts have ruled that obligations falling due post-petition that include amounts accruing pre-petition must be fully paid under Section 365(d)(3) without proration (eg, see *In re Montgomery Ward Holding Corp*, 268 F 3d 205 (3d Cir 2001)). Similarly, some courts have ruled that a debtor need not pay any portion of rent falling due pre-petition even if it relates to post-petition occupancy (eg, see *In re Appletree Markets, Inc*, 139 BR 417 (Bankr SD Tex 1992)).

Deadlines to assume or reject a non-residential real property lease

Pursuant to Section 365(d)(4) of the Bankruptcy Code, a debtor's lease of non-residential real

property is deemed rejected if it is not assumed or rejected within the earlier of 120 days following the debtor's bankruptcy petition or the date of entry of an order confirming a reorganisation plan, in either case unless the court extends the time for assumption or rejection before such period expires. The statute authorises the bankruptcy court to extend the 120-day period, for cause shown, for up to an additional 90 days, but conditions any further extensions on the lessor's consent.

Although the Bankruptcy Code does not provide a standard for determining whether there is cause for granting an extension of the time to assume or reject a lease, courts typically consider a number of factors in determining whether to grant an extension, including whether:

- the lease is the primary asset of the debtor;
- the lessor continues to receive rental payments;
- the case is exceptionally complex and involves a large number of leases;
- the decision to assume or reject the lease would be central to any plan of reorganisation;
- there is a reasonable possibility that the debtor will submit a plan capable of being confirmed;
- the debtor has had the time necessary to appraise its financial situation and the potential value of its assets in terms of the formulation of a plan;
- the lessor will be subject to damages beyond compensation available under the Bankruptcy Code due to the debtor's continued occupation;
- the lessor has a reversionary interest in the building built by the debtor on the lessor's land;
- the property remains vacant, thereby affecting neighbouring tenants; and
- any other facts exist bearing on whether the debtor has had a reasonable amount of time to decide whether to assume or reject the lease.

Courts have adopted various procedures to protect the interests of a landlord during the extension of the time for the debtor to assume or reject a lease. These include:

- granting an extension conditioned on the debtor's continued compliance with its post-petition lease obligations under Section 365(d)(3);
- requiring the debtor to continue operating for a certain period of time (eg, keeping a retail store open through the Christmas shopping season), even if it would otherwise elect to reject the lease sooner; and
- requiring the debtor to continue making rental

payments beyond the time when the debtor would otherwise elect to reject the lease (eg, see *In re Pacific Sea Farms, Inc*, 134 BR 11 (Bankr D Haw 1991)).

At least one court has granted an extension under Section 365(d)(4) to allow a third-party purchaser of the debtor's assets to determine whether to assume or reject leases (*In re Ernst Home Center, Inc*, 209 BR 974 (Bankr WD Wash 1997), appeal dismissed 221 BR 243 (BAP 9th Cir 1998)).

In addition, a debtor may be authorised to renew a lease pending assumption or rejection despite uncured defaults, even where the lease makes renewal conditional on the absence of any defaults. However, the bankruptcy court has discretion regarding whether to allow a tenant in default to exercise its renewal option after considering the scope of the default, the causes of the default, any subsequent cure and the significance of the lease to the tenant's ability to reorganise, and then balancing these factors against the policy of Section 365(d)(3) to provide the landlord with the right to timely post-petition payments (eg, see *In re Leisure Corp*, 234 BR 916 (BAP 9th Cir 1999) and *In re Fifth Taste Concepts Las Olas, LLC*, 325 BR 42 (Bankr SD Fla 2005), requiring the debtor to assume lease and cure defaults as a condition to exercising renewal option).

Rejection of an unexpired lease in bankruptcy

The business judgement rule is the standard that governs a bankruptcy court's approval of a debtor's decision to reject an unexpired lease. Under this rule, the debtor's determination that rejection of the lease will benefit the bankruptcy estate will be accepted by the court unless shown to be manifestly unreasonable. Generally, the potential damages to the non-debtor party resulting from rejection are irrelevant to the court's analysis, although the court may refuse to authorise rejection of a lease where the lessor would suffer disproportionate damage (eg, where most of the benefit of rejection would be captured by a third party rather than the bankruptcy estate).

Assumption of an unexpired lease in bankruptcy

As with lease rejection, the business judgement rule is the standard that governs the court's approval of a debtor's decision to assume an unexpired lease. Pursuant to Section 365(b)(1) of the Bankruptcy Code, if there has been a default under a lease, in

order to assume such lease the debtor must:

- cure (or provide adequate assurance of prompt cure of) pre and post-petition defaults;
- compensate (or provide adequate assurance of prompt compensation of) all pecuniary loss resulting from pre and post-petition defaults; and
- provide adequate assurance of future performance under the lease.

In general, all monetary defaults must be cured in order for a debtor-tenant to assume a lease under Section 365(b)(1). This may include a landlord's recovery of its attorney's fees in enforcing the lease. To recover attorney's fees, generally a lessor must establish that the lease specifically provides for recovery of such fees and that the attorney's fees were reasonably incurred (eg, see *In re Crown Books Corp*, 269 BR 12 (Bankr D Del 2001)). The lease must be construed as a whole to determine the scope of the lessor's contractual right to attorney's fees. Thus, standard lease language may not encompass attorney's fees incurred by a landlord in enforcing its lease rights and participating in a tenant's bankruptcy case (eg, see *In re Westside Print Works, Inc*, 180 BR 557 (BAP 9th Cir 1995), denying recovery of attorney's fees where the lease provided for attorney's fees only in connection with recovery of premises). Lease provisions that provide for recovery of attorney's fees by the 'prevailing party' with respect to a disputed matter may also be interpreted to limit a landlord's recovery of attorney's fees in connection with a landlord's objection to assumption or assignment.

Pursuant to Section 365(b)(2) of the Bankruptcy Code, certain defaults are excluded from the defaults that must be cured by the debtor in order to assume a lease. These exceptions include defaults related to *ipso facto* provisions and penalty rates or provisions, consistent with the obligations excluded from a debtor's post-petition lease obligations pursuant to Section 365(d)(3). In addition, the debtor need not cure non-monetary defaults under a real property lease that are impossible to cure by performing non-monetary acts (eg, violation of a prohibition against 'going dark'), although to the extent that such defaults arise from a failure to operate in accordance with the terms of a non-residential real property lease, such defaults must be prospectively cured at the time of lease assumption and the lessor must be compensated for any pecuniary loss resulting from the prior defaults.

With respect to the third prerequisite for

assuming a lease (ie, adequate assurance of future performance), Section 365(b)(3) contains special requirements for the debtor's assumption of a lease in a shopping centre, mandating that the debtor demonstrate adequate assurance:

- of the source of rent and other consideration due under the lease;
- that any percentage rent due under the lease will not decline substantially;
- of compliance with all lease provisions, including those regarding radius, location, use and exclusivity, as well as compliance with such provisions in other shopping centre leases, financing agreements and master agreements relating to the shopping centre; and
- of no disruption of tenant mix or balance in the shopping centre.

These and other special provisions regarding shopping centre leases were added to Section 365 in the 1980s following intensive lobbying of Congress by shopping centre owners, which perceived the general conditions of assumption and assignment under Section 365 to have particular risks and downsides for owners of shopping centres and their non-bankruptcy tenants because of the synergistic mix of tenants and uses that shopping centres must maintain for their economic health. While a detailed consideration of the special Section 365 principles applicable to shopping centre leases is beyond the scope of this chapter, the term 'shopping centre' is not defined in the Bankruptcy Code and has therefore been fleshed out by case law. Although there are up to 15 different factors that courts consider in determining whether a non-residential real property lease is in a shopping centre for the purpose of Section 365, as a general principle it appears that the most important characteristics of a shopping centre are a combination of leases on contiguous spaces held by a single owner/landlord, leased to commercial distributors of goods or services, with the presence of a common parking area.

Assumption and assignment of an unexpired lease in bankruptcy

Pursuant to Section 365(f)(1) of the Bankruptcy Code, a debtor may assign a lease in accordance with Section 365(f)(2), notwithstanding lease provisions that purport to prohibit, restrict or condition assignment. Assignment under Section 365(f)(2) requires assumption of the lease pursuant to Section 365(a) and a showing of adequate

assurance of future performance under the lease by the proposed assignee, even if there have been no defaults under the lease. Pursuant to Section 365(l), the landlord may require a deposit or other security from the assignee comparable to what the landlord would have required upon the initial leasing to a similar tenant. The assignment of a lease, like the assumption of a lease, must be approved by bankruptcy court order.

Just as the assumption of a shopping centre lease is subject to special lessor-friendly provisions as discussed in the preceding section, the assignment of a shopping centre lease is subject to additional requirements pursuant to Section 365(b)(3) of the Bankruptcy Code, including a showing of adequate assurance that the financial condition and operating performance of the assignee (and its guarantors, if any) is similar to the financial condition and operating performance of the debtor (and its guarantors, if any) as of the time the debtor became the lessee under the lease. In assessing the financial condition and operating performance of a proposed assignee without an established track record, courts have looked at such factors as the business experience of the principals of the assignee (eg, see *In re Service Merchandise Co, Inc*, 297 BR 675 (Bankr MD Tenn 2002).

Pursuant to Section 365(k) of the Bankruptcy Code, the assignment of a real property lease pursuant to Section 365(f) relieves the bankruptcy estate of all claims resulting from a subsequent breach of the lease. Since landlords often make various year-end accounting adjustments with their tenants (eg, to reflect the difference between actual expenses for certain items and the estimated amount previously charged to tenants), it is prudent for a landlord to obtain a carve-out for certain post-assignment adjustments for a specified period in the order authorising assignment of the lease.

Claims arising from rejection of a lease in bankruptcy

A landlord's claim arising from the debtor-tenant's rejection of a lease is treated as a pre-petition unsecured claim under Sections 365(g) and 502(g) of the Bankruptcy Code, even though the rejection actually occurs post-petition. The calculation of a claim arising from lease rejection is based on the terms of the lease and relevant non-bankruptcy law, with certain adjustments required by bankruptcy law.

As lease rejection claims pertaining to long-term real property leases can be very large relative to the

other unsecured claims against a bankruptcy estate, in order to mitigate the risk that one or more large lease rejection claims will dominate a bankruptcy case Section 502(b)(6) limits the maximum recovery for a landlord's claim arising from termination of a real property lease to any unpaid rent owed under the lease, plus a portion of the remaining future rent, equal to the rent reserved in the lease for the greater of one year or 15 per cent (not to exceed three years) of the remaining term of the lease. Authority is split as to whether the 15 per cent should be calculated based on the time remaining or the rent remaining under the lease (see *In re Connectix Corp*, 372 BR 488 (Bankr ND Cal 2007), collecting cases holding that the reference to 15 per cent in Section 502(b)(6) refers to the time remaining on the lease and cases holding that the 15 per cent refers to the aggregate rent due under the remainder of the lease). This cap on damages is applied after calculating the total damages arising from rejection of the lease, after taking account of any mitigation (eg, see *In re Highland Superstores, Inc*, 154 F 3d 573 (6th Cir 1998)). In addition, relevant case law generally requires that the landlord's total damages arising from lease rejection be discounted to present value before applying the Section 502(b)(6) cap (see *In re Merry-Go-Round Enterprises, Inc*, 241 BR 124 (Bankr D Md 1999)).

One of the most difficult issues in calculating the Section 502(b)(6) cap on a lease termination claim is determining what amounts are considered as 'rent reserved' under the cap formula. Some courts have established a three-factor test for ascertaining whether charges owed by a debtor-tenant under a lease constitute 'rent reserved' for purposes of calculating the limitation on lease rejection damages under Section 502(b)(6):

- The charge must be either designated as 'rent' or 'additional rent' in the lease or provided as the tenant's obligation in the lease;
- The charge must be related to the value of the property or the lease; and
- The charge must be properly classifiable as rent because it is fixed, regular or periodic (eg, see *In re JSJF Corporation*, 344 BR 94, 100 (BAP 9th Cir 2006)).

Although the relevant case law is not uniform, it reveals certain general principles regarding the types of charge that are generally included or excluded from the determination of rent reserved pursuant to Section 502(b)(6). Charges generally treated as rent reserved include minimum rent, real estate taxes, insurance, common area maintenance

charges and annual capital improvement fees. Charges typically excluded from rent reserved include utility charges, maintenance and repair expenses, remodelling and reconstruction costs, service charges, re-letting fees, attorney fees, janitorial expenses, liquidated damages and interest (see cases collected in *In re McSheridan*, 184 BR 91, 97-99 (BAP 9th Cir 1995), overruled on other grounds by *In re El Toro Materials Company, Inc*, 504 F 3d 978 (9th Cir 2007)). Other ancillary damages associated with breach of a lease that have been held not to be subject to the Section 502(b)(6) cap include expenses resulting from a debtor's failure to comply with its obligations to maintain the premises and to restore them to the condition they were in at commencement of the lease, and construction allowances payable by the debtor upon an event of default (eg, see *In re El Toro Materials Company, Inc*, 504 F 3d 978 (9th Cir 2007)).

Under an emerging majority view, once the Section 502(b)(6) cap is calculated any security deposit (whether in the form of cash or a letter of credit) securing the debtor-tenant's lease obligations must be deducted in determining the landlord's maximum allowable claim for lease termination damages (eg, see *In re AB Liquidating Corp*, 416 F 3d 961, 963-64 (9th Cir 2005)). This means that the landlord holding a security deposit generally cannot apply such security deposit to the excess (ie, beyond the capped) amount of its claim resulting from rejection of the lease, and must instead credit such security deposit to the capped amount, thus reducing the amount of the capped claim. As yet there is little case law on whether a third-party guaranty in favour of a landlord will be treated the same as a letter of credit for purposes of determining whether any recovery on such a guaranty must be applied against the landlord's capped claim. Many bankruptcy lawyers and commentators believe that it will be difficult to distinguish a third-party guaranty from a letter of credit as a form of lease deposit and/or lease credit support, and that therefore a guaranty may be subject to the same treatment as a letter of credit.

However, in most jurisdictions a security deposit may also be applied against any of the landlord's other pre-petition unsecured claims (ie, a pre-petition claim for rent unpaid as of the bankruptcy filing, for damage to the premises as of the bankruptcy filing or other unsecured claims that do not arise from rejection of the lease), but not against the lessor's administrative claim for unpaid post-petition rent and other obligations (eg, see *In re Far West Corp of Shasta County*, 120 BR 551, 553 (Bankr

ED Cal 1990)). After such application, any excess proceeds from the security deposit must be refunded to the extent it exceeds the lease damages cap (eg, see *In re Builders Transport, Inc*, 471 F 3d 1178, 1191 (11th Cir 2006), cert den 127 S Ct 112 (2007)).

In view of the foregoing array of principles regarding the requisite application of security deposits in the bankruptcy context and the still-emerging case law, it may be prudent for a landlord at the outset of the lease to seek one security deposit for potentially capped lease termination damages and one or more additional security deposits for other uncapped claims. Although this does not guarantee that the landlord will be able to apply the security deposit(s) in the way most advantageous to it, it may give the landlord more flexibility and more arguments, particularly in jurisdictions where the courts have not fully articulated or developed the rules regarding application of security deposits.

Claims arising from breach of a previously assumed lease

Under Section 365(g)(2) of the Bankruptcy Code, the rejection of a previously assumed lease is deemed a post-petition breach of such lease (in contrast to Section 365(g)(1), which provides that the rejection of an unassumed lease is deemed to be

a pre-petition breach). In general, a landlord's entire claim resulting from the debtor's breach of a previously assumed lease is entitled to administrative expense priority treatment under Section 503(b). However, pursuant to Section 503(b)(7) a landlord's administrative claim for damages resulting from the rejection of a previously assumed non-residential real property lease is limited to all monetary obligations (excluding those arising from a failure to operate or a penalty provision) for a period of two years following the later of the rejection date or the date of turnover of the premises, without reduction or set-off, except for amounts received from a third party (eg, a guarantor). Any remaining amounts due for the balance of the lease term are treated as a general unsecured claim subject to the limitations of Section 502(b)(6).

Conclusion

The filing of a bankruptcy case by a tenant presents a number of challenges for a commercial landlord, based on various provisions of the Bankruptcy Code that may change the parties' otherwise applicable rights and obligations pursuant to the terms of the lease and applicable non-bankruptcy law, and the non-uniform interpretation of these provisions by the courts.