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Bankruptcy Issues for Landlords and Tenants

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Editors' Note: In this month's column, we address bankruptcy issues of concern to real estate landlords and tenants.

Consider DebtorCo, which filed for relief under chapter 11. DebtorCo owns a concrete-block office building that it leases to TenantCo. DebtorCo also occupies a factory building under a five-year lease from LandCo. DebtorCo is, therefore, both a landlord and a tenant. DebtorCo's chapter 11 calls both these relationships into question. Must DebtorCo continue to pay rent to LandCo? May LandCo evict DebtorCo? May TenantCo walk away from its lease? May DebtorCo evict TenantCo?

The Bankruptcy Code addresses these questions in §365. The core rule of §365 is deceptively simple: The debtor may assume (elect to retain) or reject (elect to terminate) any unexpired lease. But this is only the beginning. Taken as a whole, §365 is one of the most complicated sections in the Code, replete with special-interest provisions and exceptions to the general rules.¹

¹ Although this column focuses on real estate leases, we note that §365 also covers leases of *personal* property as well as other “executory contracts.” For a discussion on one of the interesting exceptions to the rule, see the article on p. 24 of this issue.

The Basic Rules

Section 365 says the debtor “may assume or reject” an unexpired lease. A motion to assume or reject requires court approval, but in practice the standard is a fairly deferential one—most often articulated as a “business judgment test.”

Assumption of the lease is, essentially, a decision to retain the lease. Rejection of the lease is essentially a decision to terminate the lease. If the debtor-tenant rejects the lease, the landlord may assert a “rejection damage” claim.

If the debtor is in default at the time of filing, the debtor may not assume the lease unless it can cure defaults and provide adequate assurance of future performance under the lease.

Assumption or rejection is one issue. A less obvious wrinkle is that the debtor who can *assume* a lease may also be able to *assign* it (transfer it to a third party). See §365(f). This right will override an anti-assignment provision in the lease. And that is not all: Unlike an ordinary assignment, a bankruptcy assignment will terminate the obligation of the original assignor. See §365(k).

A debtor-landlord may also assume or reject a lease, but there are special provisions (discussed below) to protect tenants under such circumstances.

What Leases Are Governed by Bankruptcy Code §365?

Bankruptcy Code §365 refers to “unexpired leases.” Thus, in order to fall within the scope of this section, the transaction must be both a “lease” and “unexpired.”

You may think the issue of whether a transaction is a lease is beyond dispute. Landlord rents space to tenant for a term of years, with periodic payment of rent under a document entitled “lease”—end of question. Right? Usually yes—but not always. Look out for those agreements denominated as leases that are subject to “recharacterization” as something else—perhaps a sale of the property dressed up as a lease, or a secured lending transaction. Bankruptcy courts are not bound to treat a transaction as a “lease” just because it says it is one.

What about the “unexpired” question? The problem tends to arise when the debtor is a tenant and is trying to hold onto the leased property. If the debtor files while the lease is “unexpired,” then the bankruptcy court can deal with it; otherwise, it can't. If a lease has terminated by its terms before the bankruptcy filing, then there is nothing to assume (or reject). But suppose we are in the fourth year of a 10-year lease. The tenant is behind on the rent. The landlord has declared a default and sent a notice of termination. Is that notice sufficient to “terminate the lease” so that there is nothing left to assume? This question will be governed by the terms of the lease and state law. For example, in some states there is a “redemption period” that allows the tenant to cure defaults even after a notice of default (or acceleration or termination) of the lease is sent. And some courts have held that until this period expires, the debtor retains an interest in the lease. All such issues go to the question of whether the lease is “unexpired.” These are questions (though they arise under state law) to be decided by the bankruptcy judge.

Time for Assumption or Rejection When Debtor Is Tenant

Consider this case: DebtorCo is a lessee and files for chapter 11 with a lease still “unexpired.” The debtor may (with the approval of the court) either assume or reject. Which should it do? The stakes are easy to define. If it “assumes,” then the debtor may remain in possession of the property, but the lease becomes a post-petition liability, with all its conditions, and the landlord has a kind of first-priority claim. If the debtor rejects, it has to turn back the property, and the landlord has no more than an unsecured claim for any shortfall (maybe not even that; a discussion of the damage cap follows).

The practical answer is that the debtor will want to do whatever maximizes the value of the estate. The problem debtors often face is that they don't know what decision will maximize value until well into the chapter 11 case, and yet the deadline to assume or reject comes early in the case.

A debtor must assume or reject a lease of nonresidential real property, under which the debtor is the tenant, within 60 days after the

entry of an order for relief (in a voluntary case, that's the petition date). If the debtor fails to assume or reject within that period, the lease is deemed rejected. The 60-day period may be extended, and it often is extended—sometimes for a long time—in order to allow the debtor enough time to make an informed decision about whether to assume or reject. But the extension is not automatic. The debtor must obtain an order granting the extension, and the extension order must be entered before the period for assumption or rejection expires.

It used to be that lawyers would sometimes think it good enough to file the extension motion before the period expires, but some courts have held that is not sufficient—with terrible consequences for the debtor—so these days, debtors' lawyers usually try to obtain an extension order before the period expires, even if that requires obtaining a "bridge order" on an expedited basis to tide the debtor over until a hearing can be conducted on the merits of a proposed extension. To avoid having to deal with many emergency requests for bridge orders, some courts have enacted local rules explicitly providing that the filing of a motion to extend serves as a bridge order.

The extension can be important for the debtor. A debtor often wants to wait to see how its case will turn out before making the assumption or rejection decision. If it will end up in liquidation, it will probably want to reject its leases. If it is going to reorganize, it will likely want to keep its leases, unless the lease is above market or its post-reorganization business plan does not require this space. If it is going to do a going-concern sale, it may want to be able to offer the lease to its buyer. And even in a liquidation, depending on the market, the debtor may be able to sell ("assume and assign") a lease it has no need for. The debtor is usually able to make a better-informed decision after some time passes and it sees in what direction its case is headed. And there are adverse consequences for making the wrong decision. Reject too soon, and you will have lost the lease. Assume too soon (and then decide in retrospect that you should have rejected), and you can still reject, but the landlord's claims will have administrative priority rather than general unsecured status. For these reasons, courts are often willing to extend the debtor's time to assume or reject. Exceptions to this include situations where the landlord can show prejudice as a result of the delay that outweighs the debtor's need for an extension, or cases where the debtor is not making progress in its reorganization process. The landlord is free to move the court at any time to set a deadline for

assumption or rejection of the lease. Such a motion is probably most commonly granted when the debtor tenant is in post-petition default under the lease, but there are other situations where the landlord may be able to demonstrate that the debtor's failure to make a prompt decision would prejudice the landlord. The 60-day time limit and extensions are governed by §365(d)(4).

Obligations Pending Assumption or Rejection

The debtor-tenant must comply with its obligations under the lease pending assumption or rejection. *See* §365(d)(3). The court *may* grant the debtor temporary deferral of its obligations under the lease during the first 60 days of the case, but the court may not defer those obligations past the 60th day.

The landlord also must comply with its obligations under the lease. A failure to do so could be a breach of contract and/or possibly a violation of the automatic stay.

Assumption

If the debtor wants to retain the lease, it will move to assume it. In order to assume the lease, the debtor must cure any defaults or provide assurance that it will promptly do so.² The debtor must also compensate the landlord for "any actual pecuniary loss" resulting from the debtor's breach. *See* §365(b)(1)(B). And the debtor must "provide adequate assurance of future performance." *See* §365(b)(2)(C).

Rejection

If the debtor does not want to retain the lease, then it may reject the lease. If the debtor rejects the lease, it must vacate the space.³ If the debtor-tenant rejects the lease, the landlord may assert a "rejection damage" claim, which (unless the lease was previously assumed) will be a pre-petition unsecured claim—sharing *pro rata* with other general unsecured creditors. However, unlike other rejection damage claims, the landlord's rejection damage claims are capped by §502(b)(6). The cap is the greater of (1) one year's rent or (2) the rent for 15 percent, not to exceed three years, of the remaining term of the lease. Keep in mind that this is just a cap; the landlord is not automatically entitled to these damages, and in some cases it will not be entitled to any claim at all (for example, if it is able to re-lease the space at a rent that will cover all of its losses resulting from rejection).

² *See* §365(b)(1)(A). This is at least true with respect to monetary defaults. There is a split in the case law as to whether non-monetary defaults must be cured in order to assume a lease (or other executory contract).

³ This sometimes leads to issues about what the debtor tenant can take with it and what it must leave (this issue is beyond the scope of this column, but you should be aware of it), which is often resolved with reference to state law.

The cap applies only to *future* rent that would have been due but for rejection. Any unpaid pre-petition rent would be a claim in addition to the capped amount, and any unpaid post-petition rent would be an administrative priority claim (again, in addition to the capped rejection damage claim).

Assumption and Assignment

A final option available to a debtor is to "assume and assign a lease." Assume the following: The debtor has a warehouse lease in Los Angeles with a 10-year remaining term, at \$6 per square foot. The market rate for comparable space is \$11 per square foot. The debtor's business strategy is to stop doing business on the West Coast, so the debtor does not need the Los Angeles warehouse space. It could, of course, reject the lease. That would make the landlord happy, since it could re-lease the space for \$5 per square foot more. But the debtor can also "assume and assign," or sell, the lease to another tenant. The other tenant may pay substantial amounts to purchase the below-market lease. This presents an opportunity for the debtor to make some money from a lease that it doesn't need. (The possibility to do this also sometimes results in an agreement between the debtor and landlord, whereby the landlord would pay the debtor to reject the lease; the landlord is then free to re-lease the space to a tenant of its choice).

The debtor can make this assignment despite the anti-assignment provision that the lease may contain. In order to assume and assign, the debtor (and assignee) must cure defaults and provide adequate assurance of future performance by the assignee. The Code permits the landlord to require a deposit or other security from the assignee equal to what it would have initially required from a similar tenant at the time it entered into the lease. *See* §365(l).

What if the Debtor Is the Landlord?

The debtor-landlord also has the right to assume or reject a lease, but the Code contains a special protection for non-debtor tenants, so that a debtor landlord is unable to "reject the tenant out onto the street."

Section 365 provides that if the debtor-landlord rejects a real estate lease, the non-debtor tenant has two choices—treat the lease as terminated, or remain in possession and retain its rights under the lease. If the tenant elects to remain in possession, it must continue to pay rent pursuant to the lease. If the landlord has failed to perform its obligations under the lease, the debtor tenant may offset any damages it has incurred as a result of such non-performance against the rent, but other than

such offset the tenant is precluded from asserting claims against the debtor-landlord (that is the trade-off for the right to, in effect, ignore the debtor-landlord's rejection of the lease).

Special Provisions for Shopping Center Leases

Shopping center lessors have some additional protections that other lessors don't have. These provisions, found in §365(b)(3), provide that "adequate assurance of future performance" of a shopping center lease will include (1) assurance that the reorganized debtor (or assignee of the lease, if the lease is to be assumed and assigned) will have at least the same ability to pay the rent as the initial lessee, (2) any "percentage rent" will not decline substantially (shopping center leases often provide that a part of the rent is dependent on the tenant's revenues), (3) assumption of the lease will be subject to requirements in the lease concerning matters such as radius requirements, use of the premises and exclusivity provisions—common provisions in shopping center leases—and will not breach any other lease, financing agreement or master agreement relating to the same shopping center, and (4) assumption or assignment of the lease will not disrupt any tenant mix or balance in the shopping center.

These provisions are justified in part because of the impact on other tenants. What goes on in one store in a shopping center may well affect the other surrounding stores. For example, let's say one tenant in a shopping center is an ice cream parlor. The ice cream parlor's lease may prevent the landlord from leasing other space in the same shopping center to a competing ice cream parlor. It may also prevent the landlord from leasing space to an adult entertainment business (mom and dad won't want to take the kids to the ice cream parlor if it is right next door to the X-rated theater).

Maybe the shop next door is a sporting-goods shop. That would be okay with the ice cream tenant. But if the sporting goods store files bankruptcy and tries to assign the lease to another ice cream shop, or an X-rated theatre, the tenant next door will be harmed, and the landlord will find himself involuntarily in breach of the ice cream parlor's lease. This is the sort of thing §365(d)(3) is meant to prevent.

There is a mix of case law on the issue of how strictly the courts must, or should, enforce these provisions. On the one hand, many courts will feel bound by the law as written, and in any event will appreciate the impact that loose enforcement of these provisions may have on landlords and other

tenants. On the other hand, sometimes modest leeway is necessary in order for the debtor to realize substantial value, particularly where granting such leeway will not have any significant impact on the landlord or any other tenant. So courts may show some modest flexibility here, depending on whether the harm complained of by the landlord seems real or, on the other hand, just seems like an effort to gain some leverage over the debtor or its proposed assignee.

Can a Landlord Protect Itself?

Much has been written about ways that a landlord can try to protect itself against the risk of rejection by a debtor-tenant. We have space here for only a few thoughts. First, landlords will often require security deposits. This will make the landlord a secured creditor in the tenant's bankruptcy case (to the extent of the deposit) and improve the landlord's recovery, although courts have held, based on the legislative history of Code §502(b)(6), that if a lease is rejected the landlord's security deposit will protect it only to the extent of the capped claim amount.

Another option is to require the tenant to post a letter of credit. This may be even better than a security deposit, from the landlord's perspective, since nearly all courts that have addressed the issue have held that a landlord may draw down a letter of credit, on the terms provided for in the lease and the letter of credit, without regard to the automatic stay, since letters of credit are not property of the debtor's bankruptcy estate (this is sometimes referred to as the "independence principle," since the obligation of the issuing bank to honor its letter of credit is independent of the agreement between the account party and the beneficiary—*i.e.*, the tenant and the landlord).⁴

Another option is to obtain a guarantee of the lease by a third party. That will give the landlord someone else to look to if the tenant files bankruptcy, and courts have held that if the guarantor is not in bankruptcy, the landlord's claim against the guarantor will not be capped by §502(b)(6), even though its claim against the bankrupt tenant is so capped.

Some landlords also try to define in the lease what would be required for a tenant to demonstrate "adequate assurance of future performance" under a lease, in the event that the tenant becomes subject to bankruptcy proceedings and seeks to assume (or assume

and assign) the lease. It is not clear that this will work: The bankruptcy court may not feel bound by the parties' pre-petition agreement regarding what constitutes adequate assurance (particularly if the requirements are onerous), but reasonable requirements agreed to in advance in the lease may at least be persuasive to the judge in a subsequent dispute over adequate assurance.

Once the tenant is already in bankruptcy, the landlord will want to monitor the tenant's compliance with the lease terms carefully. If the tenant commits a post-petition breach of the lease, the landlord may want to seek relief from the automatic stay to terminate the lease and/or ask the court to fix a prompt deadline for the debtor to assume or reject the lease. ■

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⁴ Some issues relating to the use of letters of credit to protect landlords were addressed in a recent article, White, B. and Medford, W., "Securing Payment of Rent: Are Letters of Credit Still a Viable Mechanism?" (*ABI Journal*, July/August 2004); see, also, Berman, G., Gilhuly, P. and Roth, S., "Landlords Use Letters of Credit to Bypass the Claim Cap of §502(b)(6)" (*ABI Journal*, December/January 2002) (discussing the interplay between letters of credit and the §502(b)(6) cap).