

COMMERCIAL LEASES IN BANKRUPTCY

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Upon the filing of a petition pursuant to the Bankruptcy Code, 11 U.S.C. § 101, *et seq.*, the normal contract rights and obligations of landlords and tenants, as well as the remedies available to enforce such rights and obligations, can change dramatically. When a landlord or a tenant files a bankruptcy petition, the attorney for the non-filing party must know how the Bankruptcy Code will affect his or her client's rights and must move quickly to preserve those rights.

A. THE AUTOMATIC STAY CONSIDERATIONS

When a bankruptcy petition is filed, a body of assets known as the bankruptcy estate is created, which is broadly defined to include "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a). Section 362(a) of the Bankruptcy Code provides a stay of most action against the debtor and assets of the debtor's estate. Section 362(a)(3) specifically provides a stay for:

...any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.

While Section 362(a)(3) precludes recovery of possession by a landlord, 11 U.S.C. § 362(b) sets forth exceptions to the general stay provisions of section 362(a) and provides in subsection 10 that the automatic stay does not apply to:

...any act by a lessor to the debtor under a lease of

nonresidential real property that has terminated by the expiration of the stated term of the lease before the commencement of or during a case under this title to obtain possession of such property.

This section goes hand in hand with 11 U.S.C. § 541(b) (2) which provides that property of the bankruptcy estate does not include:

any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease before the commencement of the case under this title, and ceases to include any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease during the case.

Additionally, section 365(c)(3) provides that "...[t]he trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if...

Such lease is of nonresidential real property and has been terminated under applicable non-bankruptcy law prior to the order for relief.

As will be discussed in Section B, the issue as to whether a lease has expired and/or whether it has terminated has far reaching consequences for a tenant's ability to remain in possession after the filing of a bankruptcy petition.

B. ASSUMPTION AND REJECTION OF LEASES

In accordance with 11 U.S.C. §365(a), a bankruptcy trustee "...subject to the court's approval, may assume or reject...an unexpired lease of the debtor." Pursuant to 11 U.S.C. §1107 a debtor in possession in a Chapter 11 case (the "DIP") also has the authority to assume or reject a lease. The Bankruptcy Code does not contain an express standard for the assumption or rejection of a lease that is not in default.

Assumption or rejection of a lease must satisfy the business judgment test. A debtor's decision to assume or reject is generally accorded a high degree of deference by the courts.

Importantly, only an "unexpired" lease may be assumed or rejected. Additionally, section 365(c) (3) precludes a trustee or a DIP from assuming or assigning a nonresidential lease which "...has been terminated under applicable non-bankruptcy law prior to the order for relief." So, in the context of a nonresidential lease, the lease must be both "unexpired" and must not have been terminated to permit the trustee or DIP to assume. New Jersey Bankruptcy Judge Judith H. Wizmur in the context of a residential lease defined "expired" and "terminated" in In re DiCamillo, 206 B.R. 64 (Bankr. D.N.J. 1997):

...the word 'expired' denotes the natural or inevitable end to a contract or lease by lapse of time, while the word 'terminated' denotes the unnatural or premature end to a contract or lease as the result of breach of forfeiture. Id. at 68.

The New Jersey Bankruptcy Court has concluded that a nonresidential lease terminates upon entry of a judgment for possession rather than upon entry of a warrant of removal. In re Seven Hills, Inc., 403 B.R. 327, 331 (Bankr. D.N.J. 2009); In re Great Feeling Spas, Inc., 275 B.R. 476, 477 (Bankr. D.N.J. 2002). Therefore, once a judgment for possession is entered, the lease cannot be assumed by the trustee or DIP. In Seven Hills, however, Judge Michael B. Kaplan concluded that a consent judgment for possession which provides a cure mechanism does not equate to a judgment for possession thereby permitting assumption of a commercial lease. Judge Kaplan found that the consent judgment in that case provided the tenant, "with an interest in the

property, albeit only a ‘possessory nexus or toehold in the property.’” Id. at 332. This “toehold” was enough to allow the tenant to assume the lease and remain in the property. Additionally, Judge Kaplan concluded that a tenant/debtor may exercise an option to renew a lease, notwithstanding the fact that a condition for renewal (no default on payments) was not satisfied. Id. at 335.

The conditions by which a trustee may assume a lease where there exists a pre-petition default are identified in §365(b)(1) which requires the curing or “...assurance that the trustee will promptly cure...” such monetary default. The cure includes paying all amounts due under the lease, which may include obligations for taxes, insurance, CAM, utilities, repairs, clean-up costs, late charges, interest and other monetary obligations. See In re Network Access Solutions, Corp., 330 B.R. 67, 76 (Bankr. D. Del. 2005); In re Crown Books Corp., 269 B.R. 12, 15 (Bankr. D. Del. 2001). The Court in In re DiCamillo, 206 B.R. at 72, explains what “promptly” means (and what it does not mean) in the cure context:

The term “promptly” under §365(b)(1) is not defined. The term probably suggests a shorter period of time than the “reasonable time” to cure defaults in a long-term debt under 11 §1322(b)(5). KEITH M. LUNDIN, CHAPTER 13 BANKRUPTCY, §4.89 AT 4-191 (2D Ed. 1994). Whether a cure is prompt must be determined on the facts and circumstances of each case. The courts have consistently held that a proposed cure over a period of two years or more was not “prompt” for purposes of §365(b)(1). See, e.g., In re Flugel, 197 Bankr. 92, 97 (Bankr. S.D. Cal. 1996) (proposed cure over 10 years not prompt); In re Embers 86th St., Inc., 184 Bankr. 892, 901-02 (Bankr. S.D.N.Y. 1995) (29 months); In re Liggins, 145 Bankr. 227 (Bankr. E.D. Va. 1992) (48-60 months); In re Lloyd, 1992 Bankr. LEXIS 988, No. 92-12508 S, 1992

WL 167047 (Bankr. E.D.Pa. July 6, 1992) (3-5 years); In re Yokley, 99 Bankr. 394 (Bankr. M.D. Tenn. 1989) (2 years). Footnotes omitted.

Title 11 U.S.C. §365(d) sets forth the time period by which a lease must be assumed or rejected. Section 365(d)(4)(A) provides:

Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of – (i) the date that is 120 days after the date of the order for relief; or (ii) the date of the entry of an order confirming a plan.

Section 365(d)(4)(B) provides that the period may be extended for an additional ninety (90) days for cause, prior to the expiration of the 120 days and thereafter only with the consent of the landlord.

The Bankruptcy Code provides additional protections for landlords of commercial shopping centers. Since shopping centers require a unique blend of tenants intended to cover a broad range of the retail spectrum, these leases usually contain tenant mix provisions, as well as use and exclusivity restrictions. Unlike other lease provisions that the Code disregards, 11 U.S.C. § 365(b)(3)(D) specifically protects a landlord from an assumption or assignment that will “disrupt any tenant mix or balance in such shopping center.” Additionally, section 365(b)(3)(C) allows a landlord to enforce lease restrictions relating to use, exclusivity, and radius.

Moreover, shopping center landlords receive a heightened standard for adequate assurance of future performance. Section 365(b)(3)(A) requires the financial condition and operating performance of the remaining tenant (whether the debtor or an assignee)

meet the level of the debtor, “as of the time the debtor became the lessee under the lease.” Under section 365(b)(3)(A) the shopping center lessee must also demonstrate that the percentage rent due under the lease, “will not decline substantially.” These provisions give shopping center landlords great control and bargaining power in the bankruptcy process.

When a landlord files a bankruptcy petition and rejects a lease, 11 U.S.C. § 365(h) provides that, if the lease term has commenced, a tenant may retain its rights under the lease. If the landlord-debtor sells the commercial property in the bankruptcy proceeding, the purchaser must allow the tenant to remain. See IDEA Broadwalk, LLC v. Revel Entertainment Group, LLC (In re Revel AC, Inc.), 532 B.R. 216, 227 (Bankr. D.N.J. 2015).

1. PRE-PETITION DAMAGES

Title 11 U.S.C. §365(g) provides that, if a lease has not been assumed, the rejection of a lease constitutes a breach of the lease immediately before the date of the filing of the petition, thereby giving to the lessor a claim for pre-petition damages. Section 365(h) addresses the circumstances where the debtor is the landlord of a lease rejected by the trustee, in which case the tenant can treat the lease as terminated if under the lease the rejection constitutes a breach. In this case the tenant also has a claim for damages. Alternatively under section 365(h) the tenant may retain its rights, see above, and offset any damages it has by reason of the rejection against rents reserved under the lease but will have no claim for further damages against the estate or the debtor.

2. POST-PETITION RENT

Title 11 U.S.C. §365 offers a number of protections to a landlord, for the period before the trustee assumes or rejects the lease and after assumption of a lease to assure payment of post-petition rents. Section 365(d)(3) addresses the period before the trustee assumes or rejects a lease and provides:

The trustee shall timely perform all the obligations of the debtor...arising from and after the order for relief under any unexpired lease of non-residential real property until such lease is assumed or rejected... The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period.

Section 365(d)(3) is intended to protect the landlord from prejudice during the period the trustee is deciding whether to assume or reject the lease.

The “obligations” referenced in section 365(d)(3) are obligations that become due under the terms of the lease after the petition date, regardless of when the obligation accrued. Centerpoint Properties v. Montgomery Ward Holding Corp., 268 F.3d 205, 208-09 (3d Cir. 2001). The landlord may also make a claim under section 503(b)(1) for the use and occupancy of the leased premises for the period from the petition date to the time the first rent payment is due under the lease post-petition. In re Goody’s Family Clothing, Inc., 610 F.3d 812, 818 (3d Cir. 2010).

3. CAPPING A LANDLORD’S CLAIM

As discussed, upon rejection of a lease, the landlord has a claim for damages as if the breach occurred immediately before the filing of the bankruptcy. Additionally, if

the lease has been terminated (thereby precluding assumption or rejection of the lease) the landlord will also have a claim for damages. Calculation of the landlord's claim is established pursuant to section 502. See 11 USC § 502(g)(1). A cap on the landlord's claim is established in section 502(b)(6) which precludes recovery to the extent such claim exceeds:

(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of –
(i) the date of the filing of the petition; and
(ii) the date on which such lessor repossessed or the lessee surrendered the leased property; plus

(B) any unpaid rent due under such lease, without acceleration, or the earlier of such dates...

As an example, assume a ten year lease with monthly rent payments of \$1,000 beginning 1/1/10. The lease includes a simple acceleration clause. Default occurs 1/1/12, with eight years remaining in the term, and landlord recovers possession on 1/1/13, with seven years remaining in the term. The tenant files for bankruptcy on 1/1/14. Without consideration of section 502(b)(6), the landlord's damages for rent would be \$96,000.00 (\$1,000 x 96 months). Under section 502(b)(6), the landlord's damages are capped. In our example, date for calculating the cap is the date the landlord recovered the property, 1/1/13, because that is earlier than the petition date. On that date, 15% of the remaining term is 12.6 months (15% x 84 months), so the damages under section 502(b)(6)(A) are \$12,600 (\$1000 x 12.6 months). Adding the

unpaid rent from 1/1/12 to 1/1/13 of \$12,000 under section 502(b)(b)(B) provides a capped claim of \$24,600.

The capped amount established under §502(b)(6) must be reduced by a security deposit retained by the landlord or any drawdown on a letter of credit. Solow v. PPI Enterprises (U.S.), Inc. (In re PPI Enterprises (U.S.), Inc.), 324 F.3d 197, 208-10 (3d Cir. 2003). The landlord may not apply a security deposit or proceeds of a letter of credit first and then calculate its capped claim. While Section 502(b)(6) caps the landlord's claims it does not address the landlord's obligation to mitigate damages by re-letting the leased premises to a new tenant. The Third Circuit in In re PPI Enterprises, addressed the issue:

The landlord retains a duty to mitigate the tenant's breach, but any mitigation of damages secured by reletting the premises will offset only the landlord's overall potential recovery and does not affect the §502(b)(6) cap. The 'overwhelming majority of courts' have held that the §502(b)(6) statutory cap is not reduced by any amount a landlord has received by reletting the leased premises and mitigating its damages. Id at 208, fn 17.

Title 11 U.S.C. § 503(b)(7) also grants a landlord an administrative claim (and accordingly a higher priority) when a lease is assumed and then later rejected. It provides that a landlord shall have an administrative claim:

with respect to a nonresidential real property lease previously assumed under section 365 and subsequently rejected, a sum equal to all monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty

provision, for the period of two years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor, and the claim for remaining sums due for the balance of the term of the lease shall be a claim under Section 502(b)(6).

C. BREACH ISSUES

Whether there exists a breach under a lease prior to the filing of a bankruptcy filing could have significant effects upon the tenant/debtor's ability to reorganize because the breach may allow the landlord to treat the lease as terminated thereby precluding assumption. The terms of the lease will set forth circumstances by which the lease is terminated. Given the significant consequences of a termination the Bankruptcy Court may be required to conduct a hearing on the terms of the lease and under what terms the lease may be terminated. See, Family Kingdom, Inc. v. EMIF New Jersey Limited Partnership (In re Family Kingdom, Inc.) 225 B.R. 65 (D.N.J. 1998).

Certain provisions in a lease allowing for termination, however, are not enforceable in the bankruptcy context. Title 11 U.S.C. §365(e)(1) provides:

Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is

conditioned on –

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

Additionally, while the trustee may have an obligation to provide “adequate assurance” of the ability to cure a monetary default before assuming a lease under section 365(b)(1) the trustee will not be required to cure a non-monetary default as a condition for assuming a lease.

D. CLAIM AND COLLECTION ISSUES

Because section 365 gives the trustee or DIP a period of time to assume or reject a lease, a landlord may not know the extent of its damages until such time that the lease is rejected. Once a lease is rejected the court will set a time by which the landlord is to file its proof of claim. See Federal Rule of Bankruptcy Procedure 3002(a)(4). At that point, the landlord will be treated as a general unsecured creditor. If the landlord is paid in full under a plan of reorganization, the landlord’s claim will not be considered impaired. The landlord’s claim is not impaired simply because it is capped. See In re PPI Enterprises, 324 F.3d at 204-05. If a landlord’s claim is not impaired, the landlord cannot vote on the plan.

If the landlord’s claim is impaired, the debtor in a Chapter 11 case cannot have a plan confirmed unless it is accepted by one impaired class. Title 11 U.S.C. § 1129(a)(10). While it is a relatively straight forward to determine if a landlord is

impaired (i.e., not paid in full) for monetary defaults, non-monetary default creates a more complicated scenario. Section 1124(1)(D) explains that a non-monetary default, other than a default arising from failure to operate a nonresidential real property lease subject to section 365(b)(1)(A), is not considered an impairment if the plan compensates the holder of such claim for any actual pecuniary loss incurred by such holder as a result of such failure.

As with any bankruptcy filing, a landlord is precluded from collecting on any claim for unpaid rent from the debtor by reason of the automatic stay of section 362. Once a lease is rejected the landlord will have a claim for damages, but will be precluded from collecting beyond the amount permitted under a Chapter 11 plan of reorganization. The landlord, however, retains the right to proceed against non-debtor guarantors absent a specific discharge of non-debtor guarantors. See Title 11 U.S.C. §524(e). The Circuits are split as to whether a plan of reorganization may release non-debtors. In Gillman v. Continental Airlines (In re Continental Airlines), 203 F.3d 203 (3rd Cir. 1999) the Third Circuit considered the issue without deciding it, concluding that the Debtor's plan of reorganization providing for the third party releases:

...does not pass muster under even the most flexible tests for the validity of non-debtor releases. The hallmark of permissible non-consensual releases – fairness, necessity to the reorganization and specific factual findings to support these conclusions –are all absent here. Id. at 214.

While the issue remains open it is clear that the landlord is free to proceed against guarantors after a bankruptcy filing by the debtor.