

THE CURRENT DELUGE: TENANT AND LANDLORD BANKRUPTCIES

Stephen A. Bogorad
Richard E. Lear
Tara A. Scanlon
Holland & Knight LLP
2099 Pennsylvania Avenue, N.W.
Washington, DC 20004

Jo-Ann M. Marzullo
Posternak Blankstein & Lund LLP
800 Boylston Street, Suite 3200
Boston, MA 02199

I. Overview and Scope of Problem.

A. Impact of retail bankruptcy filings.

1. Cash flow problems for landlords with non-paying tenants or tenants who have rejected leases.
 - a. Could trigger defaults by landlords on secured loans.
 - b. Makes refinancing more difficult.
2. Rejected leases often trigger provisions in performing tenant leases allowing performing tenant to vacate or providing rent relief to performing tenant.
 - a. Dark spaces also decrease foot traffic and lead to lower revenue for other tenants which in turn leads to reduced percentage rent.
3. Even performing tenants in bankruptcy can impair ability of landlord to refinance.
 - a. Threat of rejection by a performing debtor tenant is often deemed tantamount to vacancy by prospective lenders.
4. Liberal rules for assignment of leases may result in "undesirable" tenants, but not undesirable uses of the space if the lease is in a shopping center. *See* 11 U.S.C. § 365(b)(3)(C).

B. Impact of bankruptcy filings by other commercial tenants.

1. Cash flow problems (same as for retail tenants)
 2. Impediment to refinancing (same as for retail tenants)
- C. Impact of Landlord Bankruptcies.
1. Landlord Right to Reject.
 2. Problems posed when premises have not yet been delivered.
 - a. Is debtor landlord required to timely perform under 365(d)(3)?
 - b. Can debtor landlord use bankruptcy to force tenant to await late delivery of space?
- II. Steps a Landlord May Take in Anticipation of a Tenant Bankruptcy.
- A. Common Red Flags.
1. Late or missing payments of rent or any other monetary obligations.
 2. Requests for payment or covenant waivers.
 3. Failure to comply with non-financial covenants.
 4. Slow reporting of financial information.
 5. Retail -- reduced foot traffic, staff reductions, reductions in inventory.
 6. Press reports.
- B. Determination of Landlord's Goals.
1. Is pre-petition termination of lease in landlord's best interests?
 - a. Does landlord really want space back?
 - b. Would landlord prefer to make concessions to preserve tenancy?
 - c. Effect of on-going refinancing? Does existing loan allow landlord to make concessions without obtaining lender's consent?
- C. Noticing Defaults

1. Need to carefully review lease to determine what notices must be sent as pre-requisite for exercising remedies under lease and applicable law.
 - a. May want to notice defaults even if landlord does not have present intention to exercise remedies before imposition of automatic stay under Bankruptcy Code.
 - i. Potential downside – some (probably slight) possibility that notices could trigger a bankruptcy that is otherwise avoidable.
 - ii. Bankruptcy may be advantageous because of statutory protections afforded to commercial landlords.
2. Should strictly comply with all notice provisions.
3. Consider nonconsensual pre-petition termination of lease.
 - a. Ability to terminate lease on nonconsensual basis as remedy for default is dependent on lease provisions and applicable state law.
 - b. Some states allow termination without judicial proceeding.
 - i. Some states allow self help.
 - c. Other states require judicial proceeding to terminate.
 - i. Some states require actual eviction to terminate tenant's rights.
 - d. If lease is effectively terminated before bankruptcy, it is not property of the estate.
 - i. But you may still need relief from the stay to effectuate an eviction.
4. Consider consensual pre-petition termination of lease.
 - a. Negotiated termination may make sense if landlord believes there is a market for the space.
 - b. May be able to negotiate agreeable lease termination payment and/or terms for payment.
 - c. But consensual termination can be subject to challenge in bankruptcy as a fraudulent conveyance, if tenant is deemed to have

had equity in lease. A transfer of property of the debtor for less than reasonably equivalent value within two years before the date of the filing of the petition may be subject to avoidance as a fraudulent conveyance. 11 U.S.C. § 548(a)(1)(B). The Bankruptcy Code also allows for actions to be filed by a debtor in bankruptcy under the applicable state fraudulent conveyance statutes, which typically longer reach-back periods. 11 U.S.C. § 544.

- d. Payments under lease termination agreement may also be subject to avoidance as a preference. Section 547 of the Bankruptcy Code provides that a transfer to a non-insider on or within ninety (90) days before the date of the filing of the bankruptcy petition may be subject to avoidance if all of the requirements of the statute are met. *See* 11 U.S.C. § 547(b).

5. Consider application of security for tenant's performance under lease.

III. Steps a Landlord Should Take Upon the Filing of a Tenant Bankruptcy.

A. First Day Motions.

1. What are they?
2. Things for landlords to watch out for in DIP financing motions and other first day orders.
 - a. Granting of liens on fixtures or property that belongs to landlords.
 - b. Granting of rights to enter/use premises.
 - c. Granting of priority over and above obligation to pay post-petition rent.
 - d. Permitting assignment of lease to DIP lender or anyone else.

B. Enforcement of Tenant's Obligation to Comply With Post Petition Obligations Under Lease.

1. Tenant is required to "timely perform" all post-petition, pre-rejection rent and other obligations under unexpired lease of nonresidential real property, although the time for performance may be extended for up to sixty (60) days after entry of the order for relief upon cause shown to the court. 11 U.S.C. § 365(d)(3).

- a. Does section 365(d)(3) create a special priority for payment of post-petition, pre-rejection lease obligations separate from the administrative expense priority provided under section 503(b)(1)(A)?
2. The Bankruptcy Code provides a creditor with an administrative expense claim for "the actual, necessary costs and expenses of preserving the estate". 11 U.S.C. § 503(b)(1)(A).
 - a. Section 503(b)(1)(A) provides for administrative expense claims in general and does not specifically refer to the post-petition, pre-rejection lease obligations. Consequently, courts have declined to characterize lease obligations under section 365(d)(3) as administrative expenses. *See, e.g., In re Child World, Inc.*, 150 B.R. 571, 576 (Bankr. S.D.N.Y. 1993); *In re Cardian Mortgage Corp.*, 127 B.R. 14, 15 (Bankr. E.D. Va. 1991).
 3. Depending on the circumstances, it may or may not be to the landlord's advantage to argue that post-petition, pre-rejection lease obligations are administrative expenses claims.
 - a. Section 365(d)(3) does not require that the lease obligations be actual and necessary cost of preserving the bankruptcy estate in order for the obligations to be paid.
 - b. However, in order to be confirmed, a plan of reorganization must provide for the payment of administrative expense claims in cash on the effective date of the plan. 11 U.S.C. § 1129(a)(9)(A).
 4. Stub rent.
 - a. There is a dispute between the circuits as to whether section 365(d)(3) requires that lease obligations due in advance on the first day of the month be paid on the billing date, or whether the payments should be prorated for the month when the order for relief is entered after the first of the month.
 - i. Section 365(d)(3) requires that lease obligations be paid on the billing date such that if the order for relief is not entered until after the first day of the month, the tenant is not required to pay the rent for that month. *See In re Montgomery Ward Holding Corp.*, 268 F.3d 205, 209-10 (3rd Cir. 2001); *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986, 989 (6th Cir. 2000).

- ii. Section 356(d)(3) requires that the payment of rent and other lease obligations be pro-rated such that the tenant is required to timely pay rent for the post-petition portion of the month in which the order for relief is entered. *In re Handy Andy Home Improvement Ctrs., Inc.*, 144 F.3d 1125, 1127 (7th Cir. 1998); *In re Ames Dep't Stores, Inc.*, 306 B.R. 43, 67-70 (Bankr. S.D.N.Y. 2004).

- b. Tenants are now not only challenging the timing of the payment of stub rent, immediate payments v. allowance of an administrative priority expense claim, but also, in one recent instance, appealing the allowance of stub rent as an administrative claim. *See In re Goody's Family Clothing, Inc.*, 392 B.R. 604 (Bankr. D. Del. 2008). During the pendency of the appeal, other retail debtors in Delaware were following Goody's lead and refusing to agree to allow stub rent administrative expense priority under section 503(b)(1)(A) unless their landlords would agree to a form of "Goody's appeal" discount. The issue has been resolved for the moment by the district court affirming the bankruptcy court decision, holding that the stub rent was entitled to the administrative priority because the debtor's actual occupancy and use of the landlords' premises constituted an actual expense necessary for the preservation of the debtor's estate. *In re Goody's Family Clothing, Inc.*, -- B.R. --, 2009 WL 903370 (D. Del. March 31, 2009).

5. Percentage rent.

- a. A specific approach has been developed to address application of section 365(d)(3) in the context of percentage or sales breakpoint rent. *See In re Petrie Retail, Inc.*, 233 B.R. 256, 260-61 (S.D.N.Y. 1999); *In re Kmart Corp.*, 286 B.R. 345, 351 (Bankr. N.D. Ill. 2002). Under this approach, if the sales breakpoint is exceeded after the petition date, all percentage rent owing under the lease is recoverable under section 365(d)(3), while if the breakpoint is exceeded pre-petition and the lease ends after the petition date, only the percentage rent from sales subsequent to the petition date is recoverable under section 365(d)(3).

- b. This sales breakpoint approach comports more closely to the accrual method rather than the billing method because it allocates the obligation among periods based on the reality of when during the lease year the obligation arises.

IV. Assumption, Assignment and Rejection of Leases.

A. A debtor in possession may elect, with bankruptcy court approval, either to "assume" or to "reject" an unexpired lease or executory contract. 11 U.S.C. § 365. In essence, the debtor gets to pick and choose which of its executory contracts and unexpired leases it wishes to honor, and which ones it wishes to walk away from. By contrast, the non-debtor party to the executory contract and unexpired lease is prohibited by the automatic stay from terminating the contract or lease, even if the debtor is defaulting on its obligations, unless the non-debtor party obtains relief from the automatic stay to do so. If the debtor rejects a lease of real property under which the debtor is the landlord, the tenant may elect to either treat the lease as terminated or to remain in possession of the premises and continue paying rent. 11 U.S.C. § 365(h)(1)(A).

1. "Executory Contract" Defined. Although not defined in the Bankruptcy Code, most courts define an executory contract as "a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that that the failure of either to complete the performance would constitute a material breach excusing the performance of the other." In re La Electronica, Inc., 995 F.2d 320, 322 n.3 (1st Cir. 1993) (quoting Vern Countryman, "Executory Contracts in Bankruptcy: Part I," 57 Minn. L.Rev. 439 (1973)). But, a few courts "hold that the determination whether a contract is 'executory' requires a more 'functional' approach," with an eye towards furthering the policies of the Bankruptcy Code." Id. (collecting cases).
2. Requirements for Assumption and Assignment of Executory Contract or Unexpired Lease. Pursuant to 11 U.S.C. § 365(b)(1), if there has been a default under an executory contract or unexpired lease of the debtor (other than a default of a provision relating to the financial condition of the debtor, the commencement of a bankruptcy case, the appointment of a trustee or receiver for the debtor, or the satisfaction of any penalty rate or provisions relating to a default arising from any failure to perform non-monetary obligations), the debtor-in-possession or trustee may not assume such lease or contract unless it:
 - a. Cures, or provides adequate assurance that it will promptly cure, such default;
 - b. Compensates, or provides adequate assurance that it will promptly compensate, the non-debtor party for any pecuniary loss incurred as a result of the default; and
 - c. Provides adequate assurance of future performance under the contract or lease.

- i. This third requirement – adequate assurance of future performance – provides the non-debtor party the best opportunity to oppose an assumption of the lease. Many courts will compare the financial condition of the debtor at the time the lease or contract was first entered into and the financial condition of the proposed assignee at the time of the hearing on the objection.
 - ii. Non-debtor parties can often extract additional security for future performance as a condition to withdrawing an objection based on the financial condition of assignee.
 - d. Adequate assurance of future performance – shopping center. The Bankruptcy Code conditions the assignment of shopping center leases on compliance with existing contractual "use" provisions, (*i.e.*, radius, location, use, exclusivity, etc.). 11 U.S.C. § 365(b)(3).
 - i. The general right of a debtor under section 365(f) of the Bankruptcy Code to assign a lease, notwithstanding a provision in the lease restricting or prohibiting such assignment, is specifically made subject to compliance with section 365(b), including the adequate assurance of future performance requirements under section 365(b)(3). 11 U.S.C. § 365(f)(1).
 - e. Anti-assignment Provisions. Provisions in executory contracts and unexpired leases that purport to prohibit, restrict or condition the assignment of such contracts or leases, or provisions that provide for the modification or termination of such contracts or leases upon assignment, are unenforceable against a debtor-in-possession or trustee in a bankruptcy case. 11 U.S.C. § 365(f)(1) and (3).
- 3. Effect of Rejection. If an executory contract or unexpired lease is considered burdensome, the debtor-in-possession or trustee can reject it. In most jurisdictions, the rejection is considered to be a breach of the contract (not a termination). The Bankruptcy Code allows the non-debtor to assert a pre-petition (usually unsecured) claim for damages flowing from the rejection of the executory contract or unexpired lease (in addition to any claim existing as of the petition date). 11 U.S.C. § 365(g). However, if an executory contract or unexpired lease is assumed by a chapter 11 debtor or trustee and is later rejected, after the case is converted to chapter 7, the claim for damages flowing from the rejection is afforded priority as a chapter 11 administrative expense. 11 U.S.C. § 365(g)(2).

- a. Claims arising from the rejection of unexpired leases of real property are capped at the greater of one year's rent or 15% of the remaining rent under the lease (not to exceed three years). 11 U.S.C. § 502(b)(6).
 - i. It may be possible for a landlord to recover more than the capped amount of a claim through use of a letter of credit to secure performance under the lease.
 - b. The claim may include damages not relating to rejection such as waste. *In re El Toro Materials Co., Inc.*, 504 F.3d 978 (9th Cir. 2007). The *El Toro* court stated that a "simple test" can be formulated to determine whether the damages were subject to the statutory cap, "A simple test reveals whether the damages result from the rejection of the lease: Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it. Here, Saddleback would still have the same it brings today had El Toro accepted the lease and committed to finish its term: The pile of dirt would still be allegedly trespassing on Saddleback's land and Saddleback still would have the same basis for its theories of nuisance, waste and breach of contract. *Id.* at 981.
4. Effect of Assumption. If an executory contract or unexpired lease is assumed by the debtor-in-possession or trustee, the debtor's obligations under such contract or lease become administrative obligations, which affords a significant priority of payment to the non-debtor party to the contract or lease. As a result, debtors-in-possession try to delay making decisions as to whether to assume or reject executory contracts and unexpired leases as long as possible. However, as a result of recent amendments to the Bankruptcy Code, if a lease of non-residential real property is assumed, but later rejected, the administrative claim arising from the rejection is capped at two years rent and other obligations under the lease, and the balance of the rejection claim is treated as an unsecured claim. 11 U.S.C. § 503(b)(7). The remainder of the damages claim resulting from such rejection is capped under 11 U.S.C. § 502(b)(6), discussed above.
 5. Timing of Assumption or Rejection of Unexpired Leases of Non-Residential Real Property. Unexpired leases of non-residential real property must be assumed or rejected within 120 days (or 210 days if the bankruptcy court finds cause exists for the additional 90 days), and if not timely assumed or rejected, they are deemed rejected. 11 U.S.C. § 365(d)(4).

- a. Any further extension of time to assume or reject an unexpired lease of non-residential real property, beyond 210 days, must be consented to by the lessor.
- b. This relatively short period (210 days) for assumption or rejection of leases of non-residential real property, adopted as part of the 2005 amendments to the Bankruptcy Code, has been criticized as making it virtually impossible for a retail debtor to reorganize.
 - i. But given today's real estate market, debtors may be successful in convincing landlords to consent to further extensions of time to assume or reject, as many landlords would be happy to have a debtor as a tenant for a prolonged period of time as long as the debtor is paying rent.

6. Effective Date of Rejection.

- a. General rule is that rejection is effective only upon court order approving rejection. 11 U.S.C. § 365(a).
- b. Growing number of courts are allowing "retroactive rejection" of leases.

V. Assertion of Claims Upon Rejection of Leases.

A. Claims by Landlord in Tenant Bankruptcy Upon Rejection of Lease.

- 1. General Rule. When a debtor rejects a lease of non-residential real property, the landlord will have a claim (deemed to be a pre-petition claim unless the lease was assumed prior to its rejection) that it may assert against the debtor's estate by filing a proof of claim. This claim, which is a claim for damages governed by applicable state law, is subject to a statutory cap that has two components:
 - 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 the 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, on the earlier of such dates."

11 U.S.C. § 502(b)(6).

- 2. Rejection Portion of Claim. The first component of the cap relates to damages suffered from the rejection of the lease. It consists of "rent reserved" for the greater of one year or 15% of the remaining term of the lease (not to exceed 3 years). Different courts calculate this component differently.
 - a. The method of calculating 15% is subject to different judicial interpretations.
 - i. Some courts have adopted a "rent measurement" approach under which the total rent due over the remaining lease term (taking into account free rent and escalators for the balance of the lease term) is multiplied by 15%. *See, e.g., New Valley Corp.*, No. 98-982, 2000 WL 1251858, U.S. Dist. LEXIS 12663; *In re Farley, Inc.*, 146 B.R. 739, 744-45 (Bankr. N.D. Ill. 1992); *In re Q-Masters, Inc.*, 135 B.R. 157, 160 (Bankr. S.D. Fla. 1991) This approach gives the landlord the benefit of rent increases over the balance of the lease term.
 - ii. Other courts have adopted a "term measurement" approach, under which the number of months remaining in the lease term is multiplied by 15%. *See, e.g., In re Iron-Oak Supply Corp.*, 169 B.R. 414 (Bankr. E.D. Cal. 1994); *Sunbeam-Oster Co. v. Lincoln Liberty Avenue*, 145 B.R. 823 (W.D. Pa. 1992). For example, if there are 180 months left on a lease, 15% would be 27 months, and the rejection claim would be calculated by determining the rent reserved during the next 27 months following rejection, taking into account free rent and rent escalators just for the next 27 months.
 - iii. The "rent measurement" approach is usually more favorable to the landlord because it provides the landlord with the benefit of future rent increases and provides a buffer in the event a lease is rejected during the free rent period.
 - b. The definition of "rent reserved" is also subject to judicial interpretation, and two different approaches have developed.

- i. One view, as exemplified by *Kiske v. McSheridan (In re McSheridan)*, 184 B.R. 91, 100-101 (BAP 9th Cir. 1995), is that a lease rejection claim only includes charges that meet the following three requirements (and that all other charges are not recoverable):
 - A. the charges must be designated as "rent" or "additional rent" in the lease or be the tenant's obligation under the lease;
 - B. the charges must be related to the value of the property or the lease thereon; and
 - C. the charges must be properly classified as rent because they are a fixed, regular or periodic charge.
- ii. Some courts, however, have rejected the *McSheridan* approach, and held that the cap on damages from a rejection claim only applies to damages that would have been avoided but for the rejection (*i.e.*, future rent), and that other damages are free from any cap or limit.. In *Best Products*, 229 B.R. 673 (Bankr. E.D. Va. 1998), the court ruled that a landlord could recover, as part of its lease rejection damages, the damages flowing from the tenant's failure to keep and maintain the premises in good repair, even though such damages do not fall within the definition of "rent reserved." The court found that section 502(b)(6) was only intended to limit rejection claims for prospective future rent, and that the claim for failure to maintain and repair the premises was therefore not subject to the cap. *Accord In re Atlantic Container Corp.*, 133 B.R. 980, 993 (Bankr. N.D. Ill. 1991) (holding that landlord's pre-petition claims for physical damage to premises and for repair and maintenance expenses were not subject to cap).
- c. There is also conflicting law as to whether a tenant's obligation to restore premises to pre-occupancy condition and remediate any environmental contamination may qualify as an administrative claim, arising pre-rejection.
 - i. In *In re National Refractories & Minerals Corp.*, 297 B.R. 614 (Bankr. N.D. Cal. 2003), the lease stated that the debtor was required "to restore the premises to a condition satisfactory to the lessor before abandoning the premises," and the bankruptcy court ruled that the landlord's costs of removing hazardous waste were recoverable and

entitled to administrative priority to the extent that the debtor first brought the hazardous materials onto the leased premises after the petition date.

- A. It is important that under the lease restoration of the premises was required "before" the lessor could abandon the premises, *and* that the hazardous materials were brought onto the premises post-petition.
 - ii. Similarly, in *In re Allied Container Corp.*, 133 B.R. 980, 992 (Bankr. N.D. Ill. 1991), the court held that the portion of a landlord's claim for physical damages that occurred post-petition was entitled to administrative priority.
 - iii. By contrast, in *In re Teleglobe Communications Corp.*, 304 B.R. 79 (D. Del. 2004), the lease provided that upon termination of the lease, the tenant was required to remove all of its property from the premises and repair damage caused by the removal, and the district court held that the damages arising from the failure to remove and repair was a rejection claim because the duty to remove and repair did not arise until rejection, and that it was therefore to be paid as a general unsecured claim.
 - iv. Drafting Tip. Landlords would be well served to include language in leases making repair and maintenance duties as on-going lease obligations and restoration requirements as conditions precedent to abandonment or termination of the lease, instead of having such obligations triggered by a termination of the lease or abandonment of the space.
3. Pre-petition Portion of Claim. In addition to the rejection portion of the claim discussed above, the cap on claims also includes any "unpaid rent" due under the lease, without acceleration, on the earlier of the petition date or the date on which the lessor repossessed, or the lessee surrendered, the premises. As in the case of the rejection portion of the claim, there are differing interpretations of "unpaid rent."
- a. Some courts hold that there is no limit on amounts owed under the lease as of the petition date, and that the landlord is entitled to all

monetary damages suffered pre-petition, regardless of whether the obligations are denominated as "rent" under the lease. *See e.g., In re Clements*, 185 B.R. 895 (Bankr. M.D. Fla. 1995); *In re Q-Masters, Inc.*, 135 B.R. 157 (Bankr. S.D. Fla. 1991).

- b. Other courts have held that the term "unpaid rent" should be construed in the same manner as "rent reserved" under section 502(b)(6)(A), and have adopted the definition of rent from the *McSheridan* case discussed above. *See e.g., Smith v. Sprayberry Square Holdings, Inc. (In re Smith)*, 249 B.R. 328 (Bankr. S.D. Ga. 2000) (disallowing free rent payable only on default and unamortized building expenses due only upon default); *In re Edwards Theatres Circuit, Inc.*, 281 B.R. 675 (Bankr. C.D. Cal. 2002) (disallowing damages from tenant's failure to construct a movie theater).

4. Security Deposits v. Letters of Credit. Many commercial leases provide for some form of security, usually in the form of a letter of credit or a cash security deposit, or some combination thereof.

a. Advantages of letter of credit. The primary advantage of a letter of credit in a tenant bankruptcy scenario is that the landlord is not precluded by the automatic stay from drawing down the letter of credit. A secondary advantage of a letter of credit is that under certain circumstances, it might enable the landlord to recover damages in excess of the statutory caps discussed above.

- i. While the automatic stay imposed by a tenant bankruptcy does not, in and of itself, stay the draw down of a letter of credit because the letter of credit is not deemed to be property of the estate, often times a notice of default is required as a prerequisite to drawing the letter of credit, and the automatic stay does prevent a landlord from issuing such a notice of default. Therefore, landlords should attempt to negotiate clean letters of credit that do not require the issuance of a notice of default prior to a draw.
- ii. Historically, many landlords chose letters of credit as the preferred form of security because they believed that in a future bankruptcy of the tenant, they may be permitted to draw down a letter of credit to compensate for damages in excess of the statutory cap. This rationale has proven to be unfounded, as most courts now hold that a letter of credit can only be used up to the amount of the statutory cap, and that any excess amount drawn down under the letter of credit must be returned to the debtor tenant. *See e.g.,*

Solow v. PPI Enterprises (U.S.), Inc. (In re PPI Enterprises (U.S.), Inc.), 324 F. 3d 197 (3d Cir. 2003).

- iii. However, in *In re Stonebridge Technologies, Inc.*, 430 F. 3d 260, 264 (5th Cir. 2005), the Fifth Circuit held that a landlord was entitled to draw down a letter of credit to compensate itself for damages in excess of the statutory cap because the landlord did not file a proof of claim in the debtor's bankruptcy case. The Court reasoned that the statutory cap applied only to "claims" and that since no such claim was filed, the cap did not limit the landlord's rights under the letter of credit.

Stonebridge also addressed the question of whether the draw down of the letter of credit was premature because the debtor tenant was only two months in arrears at the time. The Fifth Circuit held that the acceleration provision in the lease – which provided that upon a monetary default the landlord was entitled to accelerated rent minus the present value of the premises and anticipated costs of re-letting -- warranted the draw down of the letter of credit.

5. Application of Statutory Cap to Claims Against Guarantors. It is well settled that the section 502(b)(6) cap does **not** apply to claims against non-debtors who have guaranteed the obligations of a debtor under a lease of non-residential real property. See e.g., *Wainer v. A.J. Equities, Ltd.*, 984 F.2d 679 (5th Cir. 1993); *AI Kopolow v. P.M. Holding Corp. (In re Modern Textile, Inc.)*, 900 F.2d 1184 (8th Cir. 1990). But when both the tenant and the guarantor file for bankruptcy, the statutory cap applies to claims against both debtors. See *In re Loewen Group, Int'l, Inc.*, 274 B.R. 427, 442 (Bankr. D. Del. 2002). Moreover, a guarantor that files for bankruptcy should receive the benefit of the statutory cap even if the tenant has not also filed for bankruptcy protection. See *In re Farley, Inc.*, 146 B.R. 739, 745 (Bankr. N.D. Ill. 1992).

- a. Drafting tip. In many instances, the likelihood of a bankruptcy by the tenant is much greater than the likelihood of a bankruptcy by the guarantor. In those cases, if a letter of credit in excess of one year's rent is being provided, it may make sense to have the letter of credit issued as security for the guarantor's performance, as this will increase the likelihood that the landlord can draw down the letter of credit to satisfy damages in excess of the statutory cap.

6. Rejection claims when lease has previously been assumed. As a result of amendments to the Bankruptcy code in 2005, there is now a cap on a landlord's administrative claim arising from the rejection of a lease that was previously assumed under section 365. Pursuant to 11 U.S.C. § 503(b)(7), the landlord's administrative claim is capped at "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 2 years following the later of the rejection date or the date of actual turnover of the premises."
 - a. The claim for the remaining sums due under the previously assumed lease is subject to the cap of 11 U.S.C. § 502(b)(6).

VI. GOB Sales.

A. Motion for Sale of Business as a Going Concern and/or Via Store Closing Sales.

1. A debtor may use, sell or lease property out of the ordinary course of business upon notice and with bankruptcy court approval. 11 U.S.C. § 363(b)(1).
2. A sale out of the ordinary course of business may be approved by the bankruptcy court if a sound business purpose exists for doing so. *In re Martin*, 91 F.3d 389, 395 (3d Cir. 1996); *In re Lionel Corp.*, 722 F.2d 1063, 1070-71 (2d Cir. 1983).
3. When a valid business justification exists, there is a strong presumption that the debtor "acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company." *In re Integrated Res., Inc.*, 147 B.R. 650, 656 (S.D.N.Y. 1990); *see In re HQ Global Holdings, Inc.*, 507, 511 (Bankr. D. De. 2003) (stating that a debtor's decision to reject an executory contract is governed by the business judgment standard and can only be overturned if the decision was the product of bad faith, whim or caprice).
 - a. The business judgment rule has vitality in chapter 11 cases and shields a debtor's management from judicial second-guessing. *See Comm. of Asbestos-Related Litigants and/or Creditors v. Johns-Manville Corp.*, 60 B.R. 612, 615-16 (Bankr. S.D.N.Y. 1986) ("[T]he Code favors the continued operation of a business by a debtor and a presumption of reasonableness attaches to a debtor's management decisions").

4. Bankruptcy court will waive compliance with state and local laws, statutes, rules and ordinances restricting store closing sales.
 - a. The Bankruptcy Code preempts state and local laws concerned with economic regulation that conflict with its underlying policies. *See In re Shenango Group, Inc.*, 186 B.R. 623, 628 (Bankr. W.D. Pa.) ("Trustees and debtors-in-possession have unique fiduciary and legal obligations pursuant to the bankruptcy code ... [A] state statute[] cannot place burdens on them where the result would contradict the priorities established by the federal bankruptcy code"), *aff'd*, 112 F.3d 633 (3rd Cir. 1997).
 - i. The Bankruptcy Code does not preempt state law concerned with public health and safety. *In re Baker & Drake, Inc.*, 35 F.3d 1348, 1353-54 (9th Cir. 1994); *see also In re Scott Housing Sys. Inc.*, 91 B.R. 190, 196-97 (Bankr. S.D. Ga. 1998) (holding that automatic stay under section 362 is broad and preempts state law except for those laws designed to protect public health and safety).
 - b. The sales procedures order may contain language enjoining any action by a party to prevent, interfere with or otherwise hinder consummation of the store closing sales. *See Missouri v. U.S. Bankruptcy Court*, 647 F.2d 768, 776 (8th Cir. 1981).
5. Provisions in lease restricting or prohibiting the debtor from conducting store closing, liquidation or similar sales are unenforceable in bankruptcy. *See, e.g., In re R. H. Macy and Co., Inc.*, 170 B.R. 69, 73-74 (Bankr. S.D.N.Y. 1994) (holding that the lessor could not recover damages for breach of a covenant to stay open because the debtor had the duty to maximize the value to the estate and the debtor fulfilled this obligation by holding a store closing sale and closing the store); *In re Tobago Bay Trading Co.*, 112 B.R. 463, 467-68 (Bankr. N.D. Ga. 1990) (finding that the debtor's efforts to reorganize would be significantly impaired to the detriment of creditors if lease provisions prohibiting a debtor from liquidating its inventory were enforced); *In re Lisbon Shops, Inc.*, 24 B.R. 693, 695 (Bankr. E.D. Mo. 1982) (holding restrictive lease provision unenforceable in chapter 11 case in which debtor sought to conduct going-out-of-business sale).

B. Things for landlords to watch out for in proposed GOB sales orders.

1. Sale of FF&E that belong to landlord.
2. Inadequate amount of time to evaluate lease rejection notice and file an objection.

3. Automatic approval of the rejection of a lease without consideration of any objection.
4. Whether debtor is required to remove all personal property in the leased premises prior to the effective date of any rejection.
5. Whether debtor is required to vacate premises and restore possession of premises to landlord on or before effective date of any rejection of the lease.
6. Proration of debtor's obligations under the lease on a per diem basis for the month on which the effective date of the rejection occurs.

VII. Bankruptcy Treatment of *Ipsa Facto* Clauses, "Go Dark" Clauses, and "Broom Clean" Clauses.

- A. An *ipso facto* clause terminates the lease upon the bankruptcy of a party.
 1. *Ipsa facto* clauses were enforceable under the 1898 Bankruptcy Act, but with enactment of the Bankruptcy Code in 1978, such clauses were rendered unenforceable. 11 U.S.C. § 365(e).
 - a. A clause that provides for the termination or modification of an executory contract or unexpired lease conditioned on the debtor's insolvency or financial condition, the commencement of a bankruptcy case or the appointment of a receiver or custodian is inoperative in a bankruptcy case. *Id.*
 - b. Section 365(e) has also been held to preempt contrary provisions of state law that purport to release the nondebtor from a contract upon a bankruptcy filing. *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608 (1st Cir. 1995) (portion of Massachusetts limited partnership act that purports to terminate the partnership upon the bankruptcy of the general partner held not enforceable).
 2. The *ipso facto* clause prohibition does not apply to contracts or leases that are nonassignable under applicable nonbankruptcy law or to contracts to make a loan or to extend financial accommodations or debt financing to or for the benefit of the debtor or to issue a security of the debtor. 11 U.S.C. § 365(e)(2).
- B. Continuous use provisions may be seen as an unenforceable de facto anti-assignment provisions.

1. A provision in a lease which provided that if the tenant failed to operate on the leased premises for a continuous period of nine (9) months after tenant opens for business for reasons other than damage or destruction by reason of fire, casualty or eminent domain, the landlord is given the right to purchase tenant's leasehold improvements was held to be unenforceable under section 365(f) as an anti-assignment clause. *Ramco-Gershenson Properties, L.P. v. Service Merchandise Co., Inc.*, 293 B.R. 169, 182 (M.D. Tenn. 2003).
 2. Incorporating more flexible continuous operations provisions in shopping center lease, *e.g.*, allowing tenant to go dark for up to sixty (60) days for renovations, and harmonizing such provisions with co-tenancy clauses in other leases at the shopping center that allow other tenants to escape their leases or receive rent abatements if an anchor tenant goes dark should allow the landlord to argue more effectively that the "go-dark" clause does not preclude assignment of the lease because the assignee can take up to sixty (60) days to renovate the premises and prepare for reopening. *See In re The IT Group, Inc., Co.*, 302 B.R. 483, 488 (D. De. 2003) (bankruptcy courts have discretion in determining whether lease provisions that do not explicitly prohibit assignment qualify as de facto anti-assignment clauses) (citations omitted).
- C. "Broom clean" clauses.
1. If the debtor vacates the property upon rejection of the lease without complying with lease provisions that require that the premises be surrendered in "broom clean" condition, landlord will likely not be accorded administrative expense claim for clean-up costs, assuming there is no showing that hazardous materials were left on premises or that damage was caused to premises during the post-petition period. *In re Ames Dep't Stores, Inc.*, 306 B.R. 43 (Bankr. S.D.N.Y. 2004).
 - a. Such clean-up costs are not necessary costs and expenses of preserving the bankruptcy estate and, consequently, can not be accorded administrative expense priority. 11 U.S.C. § 503(b).
 - b. With the rejection of the lease, the debtor is relieved of any contractual obligation to surrender the premises in "broom clean" condition and, accordingly, debtor is not required to timely perform such an obligation under section 365(d)(3) of the Bankruptcy Code.
 2. Landlords can claim their clean-up costs as part of their lease rejection claim under section 365(g). These are general unsecured claims and may be subject to a statutory maximum under section 502(b)(6).

3. In large retail bankruptcy cases, the obligation to surrender leased premises in "broom clean" condition are commonly imposed on the sales agent/liquidator under the agency agreement between the debtor and the liquidating agents.
4. The sales order entered by the bankruptcy court can require that the debtor honor its obligation under the lease to surrender the premises whose leaseholds are not sold in "broom clean" condition.

VIII. Landlord's Ability to Recover Legal Fees.

IX. Landlord Bankruptcies.

- A. A landlord may reject an unexpired lease of real property as a debtor in bankruptcy. 11 U.S.C. §§ 365 (a), 365(h)(1)(A).
 1. Tenant's rights if landlord rejects prime lease.
 - a. If the rejection amounts to such a breach of the lease as would entitle the tenant to treat the lease as terminated under the terms of the lease, applicable nonbankruptcy law or any agreement made by the tenant, the tenant can elect to treat the lease as being terminated by the rejection. 11 U.S.C. § 365(h)(1)(A)(i).
 - b. Alternatively, if the term of the lease has commenced, the tenant may retain its rights under the lease for the balance of the lease term and for any renewal or extension of the lease. 11 U.S.C. § 365(h)(1)(A)(ii). The statute specifically conditions this alternative on whether the lease has commenced, as opposed to whether tenant is in physical possession of the property.
 - i. If the tenant elects to retain its rights under the lease, the tenant's only redress for any damages suffered as a result of the landlord's nonperformance under the lease is the offset of tenant's damages against its rent obligation. 11 U.S.C. § 365(h)(1)(B).
 - c. The rejection by landlord of a shopping center lease under which the tenant remains in possession does not affect the enforceability under applicable nonbankruptcy law of any provision in the lease pertaining to radius, location, use, exclusivity or tenant mix or balance. 11 U.S.C. § 365(h)(1)(C).
 2. Subtenant's rights if sublandlord rejects prime lease.

- a. If the rejection of the lease is deemed to be a termination of the lease, *e.g.*, a deemed rejection combined with the requirement of immediate surrender of the premises under section 365(d)(4), the sublease is terminated as well, extinguishing the subtenant's right to possession of the premises. *See, e.g., In re Stalter & Co., Ltd.*, 99 B.R. 327, 331 (E.D. La. 1989) (concluding, after a sublessor's deemed rejection of the master lease, "there is *no real property to which the subleasehold* attaches as soon as the primary lease is terminated) (emphasis in original); *In re Child World, Inc.*, 161 B.R. 349, 351 (Bankr. S.D.N.Y. 1993) (noting "the rejection of the prime lease also results in the rejection of the sublease"); *Chatlos Systems, Inc. v. Kaplan*, 147 B.R. 96, 100 (Bankr. D. Del. 1992) (holding "when a lease is deemed rejected pursuant to § 365(d)(4), any subleases under the primary lease must also be deemed rejected since the sublessee's rights in the property extinguish with those of the sublessor").
 - b. Other federal courts treat the rejection of a lease as a breach which does not adjudicate the rights of third parties. *Matter of Austin Dev. Co.*, 19 F.3d 1077, 1082 (5th Cir. 1994); *In re Modern Textile, Inc.*, 900 F.2d 1184, 1191 (8th Cir. 1990); *Leasing Serv. Corp. v. First Tenn. Bank Nat. Ass'n*, 826 F.2d 434, 436-37 (6th Cir. 1987); *see* 11 U.S.C. § 365(g) (except as provided in subsections 365(h)(2) and (i)(2), the rejection of an unexpired lease of the debtor constitutes a breach of the lease). If the master lease is not terminated as a matter of law for all purposes as a result of the sublessor's rejection of the master lease, the question of the viability of the sublease is a question of state law. *Stalter*, 99 B.R. at 330; *In re Dial-A-Tire, Inc.*, 78 B.R. 13, 16 (Bankr. W.D.N.Y. 1987).
 - i. In those jurisdictions in which state law determines the viability of the sublease when a sublessor rejects the prime lease, any separate contract entered into by the subtenant which gives the subtenant a right to possession of the property, *e.g.*, a subordination and non-disturbance agreement, will be material and should be considered.
- B. Sale of real estate free and clear of any interest in such property – *Qualtech Steel Corporation*.
1. The Bankruptcy Code allows a debtor to sell property of the bankruptcy estate free and clear "of any interest" as long as certain conditions are met. 11 U.S.C. § 365(f). With respect to a sale of real property subject to a lease, sections 363(f) and 365(h), which allows a tenant to elect to remain in possession if its lease is rejected, appear to be in conflict. The Seventh

Circuit Court of Appeals in *Precision Indus., Inc. v. Qualtech Steel SBO, LLC (In re Qualtech Steel Corp.)*, 327 F.3d 537 (7th Cir. 2003), reconciled these two sections in a way that may alarm tenants of nonresidential real property. The Seventh Circuit determined that the real estate could be sold "free and clear" of the tenant's lease, determining that the tenant's protections under section 365(h) were limited by its terms to situations in which the landlord rejected the lease. Further, the Seventh Circuit determined that a party whose interests are adversely affected under section 363(f) is protected under section 363(e), which provides that a party with an interest in the property to be sold may object to the sale and request that the bankruptcy court protect its interest. The Seventh Circuit noted, however, that if the tenant would not be allowed to remain in possession, the tenant would have to be compensated for the value of its lost leasehold interest, typically from the proceeds of sale. Unfortunately, for the tenant in the *Qualtech* case, it did not object to the sale.

2. The *Qualtech* decision is inconsistent with prior decisions of lower courts that had considered the issue, and the decision has not been adopted by any other circuit court or followed outside of the Seventh Circuit.

6242683_v4