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Tenant Bankruptcies: Landlord's Survival Kit
Course Materials

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I. Introduction

A. The purpose of this seminar is to help owners, lawyers and landlords understand their rights and remedies when a commercial tenant files for bankruptcy.

B. Landlords have been granted a series of significant rights under the Bankruptcy Code. (11 U.S.C. § 101 et seq.)(the "Code"). This seminar will examine some of the recent prevalent strategies and legal theories that are being utilized in many larger cases by sophisticated debtors to limit or extinguish the rights of landlords. We will propose various strategies and techniques by which a landlord can attempt to counter such efforts.

C. In order to provide some empirical evidence of what is occurring, this seminar will examine some examples from the bankruptcy case of *In re Musicland Co*. filed in the United States Bankruptcy Court for the Southern District of New York and more recently, in the *Tower Records* Bankruptcy Case.

II. Basic concepts governing a landlord's rights in bankruptcy; the unique statutory duty of a tenant to "perform" its lease obligations.

A. In order to understand the strategy of a debtor it is necessary to understand some of the fundamental rights which Congress has given to landlords. It is essentially these special rights which are the focus of the attack by debtors.

B. A lease is an executory contract and is governed by 11 U.S.C. § 365 of the Bankruptcy Code (11 U.S.C. § 101 et seq.)(the "Code").

C. Ordinarily, a party to an executory contract is required to perform all of its duties, while the debtor itself is not required to perform its obligations pending assumption or rejection.

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D. However, congress granted to landlords special rights, including a statutory requirement that the debtor timely perform all "obligations" of any "unexpired lease of nonresidential real property."

E. Related to this, is the resulting right to a priority payment. Landlords are entitled to have their rent and other lease obligations paid prior to general unsecured creditors.

F. In 1984 Congress added §365(d)(3) to the Code, which states:

> The trustee shall timely perform all the obligations of the debtor. . . arising from and after the order for relief, notwithstanding section 503(b)(1) of this title.

G. Between the date on which the petition is filed and the date on which the lease is assumed or rejected, a debtor tenant is required to timely perform all of its obligations under the terms of the lease. Such obligations are fixed by the terms of the contract, and hence the tenant is obligated to pay, on a current basis, the full amount of the contract rent until there is a judicial order approving a rejection of the lease. The rationale for this rule is that otherwise the landlord would be forced to provide services to the debtor—the use of its property, utilities and other services—without payment.

H. The key language is "arising from and after the order for relief." That is, the duty of a tenant to perform its obligations depends on whether the duty "arose" after the order for relief.

I. This problem of understanding when an "obligation" arises is not the same as determining when a cause of action arises under normal rules of civil jurisprudence. Instead, specialized rules have arisen which have now apparent analog in other areas of the law.

III. **Landlord's right to priority in payment of rental, tax and other monetary obligations.**

A. Because of section 365(d)(3), above, one of the most important rights of a landlord, and the one which is frequently the target of large retail debtors, is the right to be paid current rental and tax obligations.

B. The landlord's right to a priority in payment mirrors the rights given to other creditors under 11 U.S.C. § 503, which is the section which establishes certain criteria for "administrative expenses." Post-petition obligations that arise under a commercial lease are sometimes referred to as "administrative" obligations, although the courts are somewhat divided on whether the debtor's obligation to perform its lease obligations is a unique statutory right, which is not governed by §503.

C. The distinction between the obligations under section 503 and section 365(d)(3) may be critical to landlords. As noted below, debtors will frequently try to subordinate this claim, typically in a first day motion[2] seeking debtor-in-possession financing. This technique is questionable, but prevalent.

D. Administrative expense claims are generally obligations that arise from the debtor's post-petition activities and provide value to the bankruptcy estate. Code §503 defines administrative expense claims as including the "actual, necessary costs and expenses of preserving the estate, including wages, salaries or commissions for services rendered after the commencement of the case." 11 U.S.C. §503(b). Code §507(a)(1) grants first priority in the distribution of the assets of the estate to holders of administrative expense claims. Congress granted first priority in payment to administrative expenses in order to encourage creditors otherwise wary of dealing with a chapter 11 debtor to provide the goods and services required for successful rehabilitation.

E. The debtor's obligation to perform its lease obligation are viewed by a few courts as *sui generis* and not controlled by §503. *See e.g. Campbell/Massachusetts Trust (In re Child World, Inc.)*, 161 B.R. 571 (S.D.N.Y. 1993), in which the court held that a post-petition, pre-rejection rent obligation is not technically an "administrative expense" but a special category of payment entitled to priority over all other administrative expenses.

F. In *In re Child World, Inc.*, 150 B.R. 328 (Bankr. S.D.N.Y. 1993) the court distinguished the lease obligation under §365(d)(3) from administrative expenses arising under §503:

> A debtor's obligation for post-petition rent under an unexpired lease for nonresidential real property is governed by 11 U.S.C. §365(d)(3). . . . In establishing the debtor's post-petition obligation at the level required by the unexpired lease of nonresidential property until it is either assumed or rejected, [Section] 365(d)(3) alters the prior rule that the debtor is liable for post-petition use and occupancy only to the extent it reflects a necessary cost of preserving the estate and qualifies as an administrative expense under 11 U.S.C. §503(b)(1)(A). . . . Thus, 11 U.S.C. §365(d)(3) does not require a determination of the reasonable value of the debtor's post-petition use and occupancy, and instead establishes the debtor's post-petition responsibility as comprising all the obligations under the lease until the lease is either assumed or rejected.

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[2] "First day motion(s)" refers to a typical group of pleadings, sometime over a dozen, which are filed in larger cases by many debtors on the first day of the bankruptcy. These motions are filed before any creditor or landlord has any notice of the case, and before the formation of any creditors' committee. They are usually briefly reviewed by a court and frequently signed by the Court without much review. They are rarely subject to rigorous adversarial scrutiny and as a result, may contain numerous provisions which are detrimental to landlords.

Id. at 331.[3]

G. *See also In re Duckwall-ALCO Stores, Inc*., 150 B.R. 965 (D. Kan. 1993), which stated that given the differences between §365(d)(3) and §503 the court declined to characterize the payments due under §365(d)(3) as "administrative expenses."

H. *See also In re Cardian Mortgage Corp.*, 127 B.R. 14 (Bankr. E.D. Va. 1991) holding that the rental obligation is not governed by section 503:

> Section 365(d)(3) provides that the trustee, in this case the debtor-in-possession, must timely perform all post-petition obligations under a lease of nonresidential property until it is assumed or rejected. This court has already ruled in another case that obligations arising under a lease of nonresidential property after the petition is filed but before rejection of the lease are governed by the terms of the lease and are not subject to the requirements under 11 U.S.C. §503(b) that the obligations be "actual [and] necessary costs and expenses of preserving the estate." *In re Virginia Packaging Supply Co.*, 122 B.R. 491, 494 (Bankr. E.D. Va. 1990). *Virginia Packaging* also ruled that §363(d)(3) obligations are entitled to priority under §507(a). *Id.* at 15 (footnote omitted).

IV. **Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA").**

A. BAPCPA was signed into law on April 20, 2005 and became effective as to most provisions on October **insert, 20005.** BAPCPA made at least two important changes to the law affecting commercial landlords. One, it shortened the time to assume or reject leases. Second, it increased the requirements for the assumption and assignment of shopping center leases.

B. Code section 365(d)(4)(A) was also amended to provide greater protection to landlords by shortening the time to assume or reject.

> Subject to paragraph (B), an unexpired lease of 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

[3] *See also Paul Harris Stores, Inc. v. Mabel L. Slater Realty Trust*, 148 B.R. 307 (S.D. Ind. 1992); *In re RB Furniture, Inc*., 141 B.R. 706 (Bankr. C.D. Cal. 1992); *In re Coastal Dry Dock & Repair Corp*., 62 B.R. 879 (Bankr. E.D.N.Y. 1986); *In re Swanton Corp*., 58 B.R. 474 (Bankr. S.D.N.Y. 1986).

(B)(i) The court may extend the period determined under subparagraph (A) prior to the expiration of the 120-day period for 90 days on motion of the trustee or lessor for cause.

(ii) If the court grants an extension under clause (i) the court may grant a subsequent extension only upon written consent of the lessor in each instance.

C. Section 365(f)(1) was amended to indicate that the rule which limits "anti-assignment" clauses does not apply to subsection 365(b), which in turn deals with the obligation to provide adequate assurance of performance in the assumption and assignment of a shopping center lease.

Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease the trustee may assign such contract or lease under paragraph (2) of this subsection.

1. The "except as provided in subsection (b)" is key.

D. As discussed below, while these are important changes, much of what is occurring today is not driven by these changes.

Debtor's choice of venue: Using venue to dilute or limit landlords' rights.

I. Introduction.

A. A debtor's efforts to dilute or eliminate the rights of landlords often begins with its choice of venue—that is, where to file its bankruptcy case. Debtors frequently have the right to file in various places, and the determination of where to file is related to and affects landlords. Landlords have rarely, if ever, challenged the venue selection. By failing to do so, they may be surrendering value.

B. Venue for a bankruptcy case is governed by 28 U.S.C. § 1408. Generally, it provides that a case may be commenced in the district court for the district where the debtor has its principal place of business or principal assets, or in which there is a case pending under title 11 for a person's affiliate, general partner or partnership.

C. The Code permits the debtor to file where it does business or has its nerve center.

D. Debtors will sometimes file a bankruptcy case in a venue which is neither the actual never center nor the corporate headquarters, but where it has an affiliate doing business.

E. Debtors may seek out a venue which has special rules which are highly advantageous to the debtor and highly disadvantageous to landlords. An example, discussed below, deals with the obligation of the debtor to pay real estate taxes post petition.

II. **Venue Strategies—debtor's efforts to manipulate the rule that the debtor/tenant must timely perform all obligations "arising" after the order for relief.**

A. A debtor's decision on where to file for bankruptcy is frequently driven by the differences in judicial rules that relate to key issues affecting landlords.

B. One key example deals with the collection of real estate taxes, and the underlying legal issue as to when does an "obligation arise?

C. **Real estate taxes.** Real estate taxes present a special problem for debtors who file for bankruptcy. Typically, real estate tax obligations are large monetary obligations, which may be billed semi-annually. In some jurisdictions, the bills are issued by the governmental jurisdiction in arrears, and sometimes prospectively (e.g. for future periods of time).

D. When a debtor files for bankruptcy, it may do so immediately before or after the issuance of such a bill. The question then arises whether the tax bill "accrued" during the pre-petition period, and hence is a general unsecured claim, or whether it is a post petition obligation, entitled to priority or super priority.

E. Venue may determine whether the court applies the proration or billing date rule and thus may determine whether real estate taxes are paid

F. A bankrupt tenant is obligated to timely perform all of its obligations under a lease during the period that begins on the date on which the petition is filed and ends on the effective date of a lease rejection. This is the post-petition, pre-rejection period. Obligations that fall within this period are required to be paid on a current basis, and are given priority over general unsecured creditors under 365(d)(3), or under §503.

G. An obligation acquires priority only when it "arises" "from and after the order for relief." Some lease obligations span the pre- and post-petition time periods. For example, a tax obligation may be said to accrue during the course of a year, even though the taxing authority may issue the bill after the taxes have accrued. Rent is typically payable in advance on the first of the month. When do such obligations arise for purposes of understanding their status in the bankruptcy proceeding? Does an obligation "arise" when the bill is sent, or when the obligation may be said to accrue? Defining the boundaries of these time frames has led to inconsistent rules and results.

H. Two different tests have emerged. Some courts hold that an obligation is said to "arise" when the obligation accrues (the "proration" rule). Other cases hold that an obligation arises when payment is due (the "performance date" or "billing

date" rule). Both tests lead to certain difficulties, and the debtor's venue selection may frequently turn on the different views by the different courts.

III. **Proration or accrual rule.**

A. Under the proration rule, a landlord is entitled to priority payment under §365(d)(3) only for those rental obligations that relate to or accrue during the post-petition, pre-rejection period. Under this rule, the court determines whether the rental obligation (or real estate tax obligation) is for a post-petition period without reference to when payment is due.

B. *In re Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125 (7th Cir. 1998), is a leading case supporting the proration rule. In *Handy Andy*, the proration issue arose in the context of real property taxes, which were assessed against the owner, and then billed to the tenant. Taxes were billed in arrears–that is, for a period that had already occurred. The order for relief was entered on November 1, 1995 (as an involuntary petition had been filed). In February 1996, the landlord sent bills to the debtor for real estate taxes that related to a pre-petition period. Thus, the question presented was whether the tax obligation arose when it was billed, or whether it arose when it accrued. Judge Posner found it to be a pre-petition claim (or as he put it, a "pre-order" claim).

C. Judge Posner described "sunk costs," such as prior obligations that would have been incurred by the landlord regardless of the debtor's continued use, as costs that do not fall within the purpose and scope of §365's priority payment to landlords:

> This [proration] interpretation is more sensible than [the performance date interpretation] because it tracks the purpose of giving post-petition creditors a high priority in the distribution of the debtor's estate. The purpose is to enable the debtor to keep going for as long as its current revenues cover its current costs. . . . What [Handy Andy] wanted was the continued occupancy of the leased property until it rejected the lease. To get this benefit, it had to pay the full rent under the lease for every day that it continued to occupy the property. . . . But Handy Andy's debt to [the lessor] for 1994 and earlier 1995 taxes relates entirely to an earlier period, and is thus no different from its debts to trade creditors for supplies that it bought in 1994 but never paid for. A trade creditor does not, by virtue of continuing to sell to the debtor after the latter has gone into bankruptcy, obtain a priority for what the debtor owes him for goods or services sold to the debtor before the bankruptcy. [The lessor] is in no different situation by virtue of §365(d)(3).
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> *Id.* at 1127-28.

D. Several courts have adopted the proration rule and Judge Posner's rationale in *Handy Andy* for the rule. In *El Paso Properties Corp. v. Gonzales (In re Furr's Supermarkets, Inc.)*, 283 B.R. 60 (BAP 10th Cir. 2002), the Bankruptcy Appellate Panel was confronted with the issue of whether rental, tax and maintenance obligations that had accrued prior to the conversion of the chapter 11 proceeding to a chapter 7 proceeding were entitled to administrative priority within the chapter 7 bankruptcy estate. The panel held that the proration rule was more sensible because in its view, the rent claim accrued over time and did not suddenly arise on the day when it was payable, citing with approval Judge Posner's decision in *Handy Andy*. The court further noted that a billing-date rule seemed to make even less sense in terms of longer interval rental periods.

E. One of the more frequently cited district court cases that applies the proration rule is *Child World, Inc. v. Campbell/Massachusetts Trust (In re Child World, Inc.)*, 161 B.R. 571 (S.D.N.Y. 1993). In *Child World*, the district court found that rental obligations must be prorated in order to avoid a "windfall," which would arguably occur if landlords are permitted administrative priority status for payments billed during the post-petition period, but which actually pertain to a period occurring after rejection of the lease:

> Moreover, the logic of requiring debtor-tenants to pay for the "current services" their landlords must provide during the post-petition, prerejection period dictates that to the extent such payments consist of rent, they should be prorated to cover only the post-petition, pre-rejection period. Allowing landlords to recover for items of rent which are billed during the post-petition, pre-rejection period, but which represent payment for services rendered by the landlord outside this time period, would grant landlords a windfall payment, to the detriment of other creditors, without any support from the legislative history. This conclusion is reinforced by the policy of narrowly construing statutory priorities in order to treat creditors as equally as possible, as discussed above.
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> *Id.* at 576.[4]

[4] The court identified the status of existing authority, stating: "A substantial majority of the courts that have considered the issue in this case have concluded that under §365(d) (3), rent should be prorated to cover only the post-petition, pre-rejection period, regardless of the fortuity of the billing date. *See In re Ames Department Stores, Inc.*, 150 B.R. 107 (Bankr. S.D.N.Y. 1993); *In re RB Furniture, Inc.*, 141 B.R. 706, 712 (Bankr. S.D.N.Y. 1992) ("debtor was not free to pay the pre-petition part of the tax without violating the statutory distribution scheme in the Code"); *In re Ames Department Stores, Inc.*, 111 B.R. 626 (Bankr. N.D. Ohio 1989); *In re Swanton Corp.*, 58 B.R. 474 (Bankr. S.D.N.Y. 1986); *In re S & F Concession, Inc.*, 55 B.R. 689 (Bankr. E.D. Pa. 1985); *In re Barrister of Delaware, Ltd.*, 49 B.R. 446 (Bankr. D. Del. 1985); *see also In re Vause*, 886 F.2d 794 (6th Cir. 1989) (different statute but similar reasoning: 11 U.S.C. §502(b) (6), which limits lessor's recovery under rejected lease to "unpaid rent due under such lease," requires proration in case of rent payable in single annual payment at end of year, where rejection occurred four days before due date). *But see In re R.H. Macy & Co., Inc.*, 152 B.R. 869 (Bankr. S.D.N.Y. 1993), *appeal docketed*, No. 93-4414 (S.D.N.Y. June 29, 1993); *In re Duckwell-ALCO Stores*,

F. In *In re Ames Department Stores, Inc.*, 150 B.R. 107 (Bankr. S.D.N.Y. 1993), the bankruptcy court applied the proration rule to real estate taxes, stating that the relevant inquiry is whether the taxes accrued during the post-petition, pre-rejection period:

> This court rejects the argument that the time for payment governs when an obligation arises. . . . Unquestionably, the [CAM charges and real estate taxes] were incurred prior to the bankruptcy filing. . . . It is this time for payment, not the obligation itself, which arose post-petition. . . .
>
> It is profoundly more sensible to conclude that, as of the filing, a landlord has an unmatured, pre-petition claim for reimbursement of the taxes which had accrued pre-petition. Thereafter, a landlord would have an administrative claim for those taxes which accrue post-petition but before rejection.
>
> Accordingly, in the case at bar this court holds that those portions of the relevant CAM charges and real estate taxes which were incurred pre-petition are deemed a pre-petition claim. The remainder of those charges incurred post-petition shall be paid by the debtor immediately or as a post-petition administrative claim.
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> *Id.* at 108-09 (footnote and citation omitted).

G. Many other courts have also followed the *Handy Andy* formulation and applied the proration rule. *See, e.g.*, *In re Trak Auto Corp.*, 277 B.R. 655, 663 (Bankr. E.D. Va. 2002); *Newman v. McCrory Corp. (In re McCrory Corp.)*, 210 B.R. 934, 940 (S.D.N.Y. 1997); *In re William Schneider, Inc.*, 175 B.R. 769, 772-73 (S.D. Fla. 1994).

IV. <u>The billing date or performance rule: the "bright line" test</u>

A. The billing date rule holds that an obligation arises after the order for relief if the obligation becomes due and payable post petition (such as rent being due on the first of each month). In addition, the rule has been applied to mean that an obligation, such as taxes, may be post petition if the landlord was entitled to bill for such taxes post petition, even if the tax bill relates to a pre petition time period.

B. Three Circuit Courts have now adopted the performance or billing-date rule: *Centerpoint Properties v. Montgomery Ward Holding Corp.*(*In re Montgomery Ward Holding Corp.*), 268 F.3d 205 (3rd Cir. 2001); *In re Cukierman*, 265 F.3d 846, 847 (9th Cir. 2001); *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986, 989 (6th Cir. 2000).

Inc., 150 B.R. 965, 975 (D. Kan. 1993); *In re Appletree Markets, Inc.*, 139 B.R. 417 (Bankr. S.D. Tex. 1992)." *Id.* at 576.

C. In *Montgomery Ward*, the issue arose with respect to real property taxes. Montgomery Ward filed for bankruptcy on July 7, 1997. Thereafter, Montgomery Ward received three invoices from a landlord for real property taxes related to retail space it was leasing. First, it was billed for taxes incurred in the first half of 1996 (payable in 1997), a period prior to the bankruptcy. Second, it was billed for the second half of 1996 for the "estimated" taxes to be due. Third, it was billed for the taxes due in 1997 based on the lease's expiration by its terms on September 1, 1997.[5]

D. The landlord, Center Point, argued that all of the invoices should be entitled to administrative priority under §365(d)(3) because all of the tax obligations "arose" after the order for relief, relying primarily on the date when the taxes were *billed* as determinative of when the obligation arose. The Third Circuit agreed with Center Point and held that the billing date controls, and expressly prohibited the use of the proration rule, stating as follows:

> The clear and express intent of §365(d)(3) is to require the trustee to perform the lease in accordance with its terms. To be consistent with this intent, any interpretation must look to the terms of the lease to determine both the nature of the obligation and when it arises. If one accepts this premise, it is difficult to find a textual basis for the proration approach. On the other hand, an approach which calls for the trustee to perform obligations as they become due under the terms of the lease fits comfortably with the statutory text.
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> *Montgomery Ward*, 268 F.3d at 209.

E. In *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986 (6th Cir. 2000), the question presented was whether the billing-date rule should be applied in the context of a lease rejection. The debtor rejected a lease on the second day of the month. A strict application of the billing date rule meant that *all* of the rent for the month was due on the first of the month, hence all of the rent for that month was pre-rejection and entitled to priority. The Sixth Circuit agreed with this result, finding nothing inequitable about such a result, although it meant the debtor was obligated for rent after it had rejected the lease and vacated the premises. "In this case, involving a month-to-month, payment-in-advance lease, where the debtor had complete control over the obligation, we believe that equity as well as the statute favors full payment." 203 F.3d at 989.

F. In *In re Cukierman*, 265 F.3d 846 (9th Cir. 2001), the court adopted a bright-line rule, saying:

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[5] The relevant lease provision stated: "Upon receipt of an invoice from [Center Point], [Montgomery Ward] further agrees to pay before any fine … as additional rent for the premises, all taxes levied, assessed or imposed upon the premises or any part hereof, accruing during the term of this lease, notwithstanding that such taxes may not be due and payable until after the expiration of the term of this lease." *Montgomery Ward*, 268 F.3d at 207.

> Interpreting §365(d)(3) as a bright-line rule, encompassing all obligations contained in a bargained-for agreement, ensures prompt performance of lease obligations by bankruptcy trustees. The simplicity of this rule prevents delays and disputes caused by uncertainty over whether the provision applies to any given lease obligation. If the trustee fails to perform a lease obligation, the plain meaning of §365(d)(3) serves to eliminate disputes over whether the claim arising from that non-performance is entitled to administrative priority, and thus advances the interests of resolving bankruptcy cases expeditiously.
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> *Id.* at 847.

G. The bankruptcy courts in Delaware apply the performance rule. *See, e.g., In re HQ Global Holdings, Inc.*, 282 B.R. 169 (Bankr. D. Del. 2002). In that case, the rent became due on the first day of each month. The debtor did not pay rent due on March 1, 2002, and filed for bankruptcy on March 13, 2002. The landlord moved to compel current payment of the rent for the period of March 13 through March 31 as an administrative expense, pursuant to §365(d)(3). The court denied the claim and held that the landlord could not demand immediate payment, as an administrative expense, of the portion of the rent accruing from the petition date to the end of the month. The court reasoned that the rent actually came due on March 1, 2002, which was prior to the bankruptcy filing, and that therefore all rent that accrued during March was a pre-petition debt, and was therefore a general unsecured claim that did not have to be paid on a current basis.

H. The following cases have also adopted the performance date rule: *In re CCI Wireless, LLC*, 279 B.R. 590, 594 (Bankr. D. Colo. 2002) (holding that performance rule "is more well reasoned, persuasive, and, in this instance, more appropriate"); *In re Krystal Co.*, 194 B.R. 161, 164 (Bankr. E.D. Tenn. 1996); *Inland's Monthly Income Fund, L.P. v. Duckwall-ALCO Stores, Inc. (In re Duckwall-ALCO Stores, Inc.)*, 150 B.R. 965 (D. Kan. 1993); *In re F&M Distributors, Inc.*, 197 B.R. 829 (Bankr. E.D. Mich. 1995) (applying performance rule to landlord's administrative claim for taxes).

V. **Did the debtors in Musicland use venue to avoid payment of real estate taxes to landlords?**

A. In *Musicland* the decision of where to file the case may, or may not, have been based on issues relating to landlords and real estate taxes. However, even if the decision was based on other factors, landlords were substantially effected by the decision and had certain rights to challenge the venue selection. There was no apparent challenge to venue and the result may have resulted in the surrender of substantial value.

B. *Musicland* filed for bankruptcy on January **[insert]** 2006. *Musicland* had over 800 retail locations, and thus, an obligation to reimburse its landlords for real estate taxes on each of the 800 properties.

C. The billing date rule and the accrual rule could have changed the landlords' ability to collect real estate taxes. For example, if the landlords had sent a tax bill to the Musicland, as tenant, on December 31, 2005 and if the tax bill pertained, in whole or in part, to calendar year 2005, then all of that tax bill would have been a general, unsecured claim under the billing date rule. This is because no part of the tax liability would have been billed post-petition.

D. Conversely, if the taxes had accrued fully in calendar year 2005, and if the landlords had sent a bill on February 1, 2006, then arguably all of the same taxes would have been a priority payment. Musicland thus had an interest in trying to avoid the billing date rule and a billing date jurisdiction.

E. Musicland did not file in Minnesota, the place of its corporate headquarters. It is at least arguable that the courts in Minnesota would have applied a billing date rule and thus put Musicland at risk for taxes which had accrued in 2005.

1. There is some conflict in the cases. See *F&M Distributors, Inc.*, 197 B.R. 829 (Bankr. E.D. Mich. 1995) with *In re Travel 2000, Inc.*, 264 B.R. 444 (W.D. Mich. 2001).

2. Thus, if real estate taxes were billed in Feb. 2006 for 2005 and 2006, they would be due and owing in full

F. In New York, the courts are more likely to use the pro ration rule or accrual rule. *See Newman v. McCrory Corp. (In re McCrory Corp.)*, 210 B.R. 934, 940 (S.D.N.Y. 1997).

G. The difference in outcome was critical. Musicland's plan of reorganization ultimately paid unsecured creditors zero, the effect of this rule was to save Musicland all of the tax liability and to impose that cost on the landlords

H. Under the accrual rule, it may not matter when the bill is sent; the debtor will only pay for that period in which it is in possession.

VI. **Landlords' right to challenge venue**

A. Can landlords mount a successful challenge to venue? Such challenges are difficult and rate, but the strategy remains valuable.

B. A transfer is appropriate under 28 U.S.C. § 1404(a) where the moving party demonstrates: (1) venue is proper in both transferor and transferee court; (2) transfer is for the convenience of the parties and witnesses; and (3) transfer is in the interest of justice. *Coffey v. Van Dorn Iron Works*, 796 F.2d 217, 219 (7th Cir. 1986).

C. A landlord must show that the "transferee forum is clearly more convenient" than the transferor forum. *Heller Financial, Inc. v. Midwhey Powder Co.*, 883 F.2d 1286, 1293 (7th Cir.1989) (citing *Coffey*, 796 F.2d at 219-20).

1. Landlords must show that a transfer will promote the efficient administration of justice; they may not simply shift the inconvenience from one party to another. *See Black v. Mitsubishi Motors Credit , Inc.*, 1994 WL 424112, at * 2 (N.D.Ill. Aug.10, 1994).

D. Landlords may improve their chances of succeeding if the lease has a venue provision, and they are seeking to enforce a contractual provision:

> Although not clearly tested in bankruptcy courts, prepetition agreements restricting the venue of a future bankruptcy of a debtor may be enforceable. Such an agreement is useful to a creditor who desires either to restrict any subsequent bankruptcy case to a preferred forum or to avoid a particular forum. The advantage is that the creditor is able to deprive the debtor of the flexibility the debtor otherwise might have to forum shop.
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> Michael St. Patrick Baxter, "Bankruptcy Proofing: Bankruptcy Provisions in Restructuring Agreements," 8 JBkRLP 483 (1999).

E. The Supreme Court has held that venue provisions are <u>presumptively valid.</u>

> In a different context, the U.S. Supreme Court has held that forum-selection clauses, in general, are presumptively valid. To overcome this presumption, the party objecting to enforcement of the clause must demonstrate that (1) the clause is the result of fraud or overreaching, (2) enforcement would violate a strong public policy of the forum, or (3) enforcement would so seriously inconvenience the moving party as to be unreasonable."
>
> Baxter, id. at **[insert]**

F. On the other hand, it is written that,

> Choice-of-venue clauses are unenforceable where they contravene a strong public policy of the forum. *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972). Similarly, choice-of-law clauses are invalid where they are repugnant to a fundamental public policy of the jurisdiction whose law would apply absent an effective choice by the contracting parties. *Lauritzen v. Larsen, 345 U.S. 571 (1953). Id.*

VII. <u>Challenging improper venue through the "cure" requirement</u>

A. Landlords should consider tying a mandatory venue provision to their "cure" strategy as it relates to assumption of a lease.

B. Section 365(b)(1)(A) requires a tenant to cure all defaults as a condition to the assumption of a lease. However, BAPCPA exempts from this requirement non-monetary defaults "if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the tie of assumption. . .

C. Landlords should consider arguing that the "impossibility" requirement cannot be manufactured through a voluntary decision to breach the lease. Tenants may counter that all breaches are volitionally voluntary and that there is no meaningful distinction. If taken to its logical extreme, this argument would mean that debtors who file outside of a selected venue cannot assume a lease. Since debtors will have multiple landlords and divergent venue provisions, debtors would never be able to assume leases. If, however, the choice of venue was made to avoid payment of taxes, would a court give more consideration to such an argument?

Debtor in Possession Financing Order: Techniques for Subordinating Landlord's Payment Priority

I. Introduction.

A. Most operating companies will seek and obtain an order permitting the Debtor to obtain Debtor-in-Possession financing (the "DIP Loan" and "DIP Lender").

B. DIP financing is expressly permitted by the Code, which permits the DIP lender to obtain a series of statutory protections that will induce the lender to make the loan.

C. Section 364(c)(1) authorizes a debtor to give the DIP Lender an administrative expense claim that has priority over "any or all administrative expenses of the kind specified in section 503(b) or 507(b)."

D. The governing code section is §364(c), which states as follows:

> If the trustee is **unable to obtain unsecured credit** allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and hearing, may authorize the obtaining of credit or the incurring of debt---
>
> (1) with priority over any or all administrative expenses of the **kind specified in 503(b)** or 507(b) of this title;
>
> (2) secured by a lien on property of the estate. . .
>
> (Emphasis added).

E. Generally speaking, a DIP Lender can only obtain certain statutory benefits upon a showing that no lender would make a loan on terms more favorable to the debtor.

F. Debtors typically retain firms to seek out DIP financing and to determine what the best terms are in the market place.

G. Nevertheless, the DIP Lender is frequently a pre-petition lender. A pre petition lender may have a direct conflict of interest with unsecured creditors, and in particular, with landlords, who possess certain rights to both an unsecured claim and an administrative priority claim.

II. **Potential for abuse.**

A. The courts have long recognized that DIP lenders frequently extract terms which "tilt" the case and which give such lenders unwarranted advantages, which are either not sanctioned by the Code or if permitted, are unfair to the estate. Indeed, almost all DIP loan requests have provisions which are considered questionable and/or offensive to the courts.

1. The local rules in many jurisdictions now require that a frequently used group of terms be identified and bolded so that a judge may readily determine if the debtor is seeking to use such terms.

B. Examples of questionable provisions include the following:

1. The appointment of a trustee is an event of default.

2. Post petition lender conclusively deemed to have valid and perfected pre-petition lien and loan.

3. Lender is to be paid post petition interest on a current basis on its pre petition loan.

4. Cross collateralization of DIP lender's pre petition loan with post petition collateral.

5. Waiver of the estate's right to surcharge the collateral if the estate has to incur expenses to preserve or dispose of the collateral. *See In re Ames Dept. Store, Inc.,* 115 B.R. 34, 38 (Bankr. S.D.N.Y. 1990).

III. **Using the DIP Loan to prime the landlord's priority claim.**

A. The landlord's priority claim for post petition rent and taxes can be a large claim, especially in multi-store, large retail bankruptcy cases.

B. Typically, the DIP lender will seek a provision which states that its loan must be paid with priority over all other administrative expenses. In addition, the DIP loan will seek a court order that gives the DIP lender priority over the landlord priority which arises under section 365(d)(3).

C. It is unclear whether a DIP lender is entitled to a priority over the landlord's priority rights, as set forth in section 365(d)(3). It is not yet fully settled whether the landlords claims under 365(d)(3) are the "kind specified in 503(b)."

IV. Blanket consent provision in DIP Order.

A. Another kind of typical provision is the consent waiver provision. Below is an example from one recent case:

> Any provision of any **lease** or other license, contract or other agreement that requires (i) the **consent or approval** of one or more landlords or other parties or (ii) the payment of any fees or obligations to any governmental entity, in order for any Debtor to pledge, grant, sell, assign, or otherwise transfer any such leasehold interest, or the proceeds thereof, or other post-petition collateral related thereto, is hereby deemed to be inconsistent with the applicable provisions of the Bankruptcy Code. Any such provision shall have no force and effect with respect to the transactions granting post-petition liens, in such leasehold interest or the proceeds of any assignment and/or sale thereof by any Debtor, in favor of the DIP Lenders in accordance with the terms of the DIP Credit Agreement or this Order.

B. Question: how broad or effective is this consent? If the landlord has a right to consent to an assignee in a shopping center, is that right now deemed "inconsistent with the applicable provisions of the Bankruptcy Code."

V. Mandatory sale of assets

A. Another provision in the DIP Loan may be a requirement that the debtor promptly sell or, or substantially all, of its assets.

B. In *Musicland* a group of prepetition secured creditors were alleged to have had a strong interest in a prompt and immediate liquidation. Accordingly, the DIP Loan provision mandated that a sale of substantially of the assets had to occur before a set date.

C. [**obtain provision and verify]**

VI. Limited right to appeal DIP financing order.

A. Generally, an order entered approving a DIP loan cannot be challenged on appeal if the credit was extended in "good faith."

B. Section 364(e) states as follows:

> The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

C. A similar provision pertains to the sale of property of the estate under 11 U.S.C. § 363(m). Both sections require "good faith" and some cases require an express factual determination by the court.

D. Certain provisions, such as cross-collateralization may be found to be improper, and hence subject to an appeal despite the language of section 364(e). *See e.g., Shapiro v. Saybrook Manufacturing Company,* 963 F.2d 1490 (11th Cir. 1992), holding that "section 364(e) was not designed to prohibit creditors from challenging pre-petition matters and that 'lenders should not be permitted to use their leverage in making emergency loans in order to insulate their prepetition claims from attack."

E. The purpose of the loan may also make it subject to an appeal and reversal, despite section 363(m). *See e.g., In re EDC Holding Co.,* 676 F.2d 945, __ (7th Cir. 1982) holding that a post petition loan can be set aside if the purpose of the loan is improper, such as the use of the proceeds to pay a claim which otherwise is not allowable. "Where it is evident from the loan agreement itself that the transaction has an intended effect that is improper under the Bankruptcy Code, the lender is not in good faith, and it is irrelevant what the improper purpose is." Id.

F. Given that such orders are heard on a highly expedited basis and at the outset of the case, it is very difficult for a landlord to determine or establish a lack of good faith.

G. Query: the protection on appeal is for the validity of the debt and the lien priority. But what about those terms in the order that relate to rights given to the lender on account of the pre petition debt and the priority for such?

Assumption and assignment of leases:
Debtor strategies to limit landlords' rights

I. Introduction

A. Because a commercial lease is considered to be an executory contract, the debtor is given the statutory right either to "assume" the lease, making its obligations binding on the estate, or conversely, to "reject" the lease, creating what is considered to be a pre-petition breach of the lease. Once assumed, a lease may be assigned to third parties.

B. Assumption is favorable to the landlord in that it assures continuance of the lease, and requires that the debtor cure all or most pre-petition defaults. Assumption may be viewed as unfavorable to the landlord where the lease is below market, or the tenant remains a credit risk.

C. Once the bankruptcy case has commenced, a landlord's typical concern will be to obtain a quick determination on the issue of whether the tenant is going to assume or reject its lease. Many landlords seek prompt rejection and a recovery of the premises. This may occur where the landlord fears that the tenant will leave the space dark or will seek to assume and assign the lease to a new tenant who may alter the tenant mix or create a credit risk. Conversely, if a landlord obtains a prompt assumption, the landlord may be able to ensure that it receives immediate payment of current rent and the cure of any unpaid arrearages.

D. Debtors frequently adopt an attitude of deferral and delay, hoping to avoid a final decision on assumption or rejection until the prospects for reorganization are clearer. In particular, debtors prefer to delay the decision to assume or reject until they know if it is likely that a plan of reorganization will be confirmed or if the lease can be assigned to a third party. Otherwise assumption merely creates a cash drain to the estate since the lease payments are deemed an administrative expense that must be paid in accordance with the lease terms. This practice of delay will no longer be available under BAPCPA.

E. The assumption or rejection of a lease is a significant turning point in a bankruptcy case with serious consequences for debtor, landlord and other creditors. Once assumed, the lease becomes a binding obligation of the estate, the subsequent breach of which results in an administrative expense priority claim. *See NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531-32 (1984) ("Should the debtor-in-possession elect to assume the executory contract, however, it assumes the contract *cum onere*, and the expenses and liabilities incurred may be treated as administrative expenses, which are afforded the highest priority on the debtor's estate").

F. Once a lease is assumed, the lease may be assigned to a third party, despite any provision in the lease forbidding assignment. In 1984, Congress adopted the so-

called shopping center amendments to the Bankruptcy Code,[6] which were designed to protect landlords from assignments that did not comply with such provisions as the radius, use or exclusivity provisions in shopping center leases. Despite the 1984 amendments, the trend in many courts had been to permit assignment of a lease absent a showing of a material injury to the landlord. This has now been changed under BAPCPA §365(f)(1). Prior to BAPCPA, if a lease was assumed and later rejected, the damage claim was not subject to the statutory cap that pertains to the ordinary rejection of a lease. *See generally, In re Klein Sleep Products, Inc.*, 78 F.3d 18 (2d Cir. 1996). However, this has now been addressed in amended §503(b)(6), discussed below, which generally seeks to limit the amount of an administrative expense claim of a landlord.

G. Lastly, while assumption is supposed to be of the lease in its entirety, it would appear that several courts have suggested that some lease modifications may be permitted in the context of an assumption–once again signifying a major departure from state property law.

H. Generally, the decision to assume or reject is said to be based on the debtor's exercise of its business judgment. With respect to lease rejection, this standard has become so elastic that, according to some views, it is no standard at all. Few, if any, cases demonstrate the court's willingness to second-guess the debtor's business judgment.

I. If a lease is in default, then assumption requires that most defaults be cured, that compensation be paid for loss arising from such default, or that the debtor provide assurances of a prompt cure. *See* 11 U.S.C. §365(b)(1)(A). This code section may permit a debtor to cure defaults that, under ordinary state law principles, would not be curable and might have otherwise justified termination of the lease. The cure requirements are supposedly higher if the lease is a shopping center lease. *See* 11 U.S.C. §365(b)(3).

II. **Strategies associated with the assumption of leases.**

A. Certain recurring strategies have been used by large retail debtors in the assumption process to avoid, dilute or alter the rights of landlords. Typically, this will include the following:

1. Loss of landlord's equity in below market lease.

2. Accelerated sale.

3. Sale of designation rights.

4. Loss of appeal rights through assumption as sale and invocation of section 363 (m).

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[6] The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333, effective July 10, 1984.

5. Loss or dilution of cure rights through procedural hard ball.

6. Procedural hard ball—the three barriers: limited time to object; limited time to appeal; limited grounds for appeal.

III. **Time to assume or reject a lease.**

A. Prior to BAPCPA, a debtor was required to assume or assign a lease of non-residential real property within 60 days, or such additional time as the court ordered within that 60 days.

B. This led to a famous ruling in *Klein Sleep* in which the Second circuit essentially permitted an extension of time to assume or reject until confirmation. *See generally, In re Klein Sleep Products, Inc.*, 78 F.3d 18 (2d Cir. 1996).

C. Thereafter, many courts routinely extended the time to assume or reject.

D. Now, new section 365(d)(4) states that a debtor has 120 days to assume or reject and that the court may extend the period for 90 days only, unless the landlord consents. This means the period is now 210 days or 7 months.

E. Is this good news or bad news for landlords or debtors?

1. It seems likely that the result of the effort to increase the time for assumption has led to or encouraged a form of procedural hard ball in which the first day motions are used to obtain "authority" to reject a lease at a later date, thus calling into question whether the 210 day period has been complied with. (See discussion below on premature rejection).

IV. **Sale of the equity**

A. Many leases provide that if there is an assignment of the lease, and if the assignment or sale is for more than the stated contract rate, the balance (or equity) is property of the landlord, or is to be shared between landlord and tenant.

B. The question has sometimes arisen as to whether a debtor's assumption of a lease requires that it comply with this provision, and permit the landlord to share in the equity. The argument against this is that the equity in the lease is sometimes one of the most valuable assets of a debtor, especially a retail debtor with many leases. In addition, the lease equity has been held to be property of the estate. The counter argument is that the Code's plain meaning states that the debtor can only assume and assign a lease if it complies with all of the conditions, including an equity sharing provision.

C. The statutory language of section 365 was amended in 1984 to read as follows:

> (3) For the purposes of paragraph (1) of this subsection and paragraph (2)(b) of subsection (f), adequate assurance of future

performance of a lease of real property in a shopping center includes adequate assurance---

(c) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as radius, location, use, or exclusivity provision. . .

D. Section 365(b)(3) has not been fully effective in terms of requiring strict compliance with lease provisions. Many courts had declined to enforce strictly this section, and had found, for example, that a "use provision" did not have to be enforced because it would amount to an improper anti-assignment clause that is not enforceable under Code §365(f). *See In re Rickel Home Centers,* 240 B.R. 826 (D. Del. 1998) (holding that anti-assignment provisions override the shopping center protections).

E. However, BAPCPA amends §365(f)(1) and provides that Code §365(b)(3) takes priority over 365(f)(1). Section 365(f) now reads as follows:

Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease the trustee may assign such contract or lease under paragraph (2) of this subsection.

F. The "except as provided in subsection (b)" is key as an argument can now be made that this amendment requires literal compliance with a lease assignment provision, including sharing of the equity.

G. Despite this amendment, courts may still require some threshold showing of materiality. Courts may rule that the equity is property of the debtor and cannot be restricted by the landlord. Otherwise, "use" provisions may well become the ultimate bankruptcy "proofing" device.

V. **Assumption and sale of all or most leases; designation rights**

A. Designation rights have been described as follows:

These sales are usually structured as auction sales of the designation-rights for a number of retail fee and leased properties. When a debtor sells its designation rights, it typically transfers to the designation-rights purchaser the sole, exclusive, and continuing right to select, identify, and designate (on one or more occasions): (1) the real estate to be conveyed and to whom, (2) the commercial leases to be assumed and assigned and to whom, and (3) what properties are to be excluded from any transaction....

In a typical designation-rights sale, the bankruptcy debtor is paid a significant up-front fee for the designation rights. The

successful bidder then has a period of time within which to market the properties to buyers of the fee properties or assignees/sublessees of the leased properties. Any profits generated above certain benchmarks are then split in some fashion between the debtor and the bidder.

Susan G. Talley & Harris Ominsky, "Assignment of Retail Leases in Bankruptcy, Part 2: On the Right Track?" Prob. & Prop., Mar./Apr. 2005, at 42.

B. Ken Klee has written that is such a serious change that retail debtors with a significant number of leases will simply refuse to file voluntary petitions during slower periods and will instead wait to be forced into an involuntary, and then use the extended gap period as additional time. Kenneth N. Klee, *The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005."*

C. In *In re Ames Department Stores, Inc.*, 287 B.R. 112 (Bankr. S.D.N.Y. 2002), the court endorsed the power of a debtor to sell "designation rights" to third parties. In *Ames*, the debtor agreed to sell the "designation rights" to a third party. The designation purchaser was then obligated to market the leases to an ultimate end user.

1. The designation purchaser had the right to "direct" the debtor to assume the lease, and then to assign the lease to the end-user. The court would then consider and rule upon the motion to assume and assign, thus giving the landlord a right to object to the assumption and assignment. During the interim marketing period, the designation purchaser paid the carrying costs associated with the lease.

2. The court permitted the sale of designation rights based on the following underlying principles: (i) the equity in a lease is property of the bankruptcy estate, and may be sold or disposed of, as with any other property; (ii) the sale of the designation right is not the sale of a federally created right; (iii) the procedure protects the estate and landlords by providing that all operating costs are paid by the buyer during the period the leases are being marketed; (iv) equity in a lease belongs to the estate and is for the benefit of the creditors; (v) the anti-assignment provisions in the Bankruptcy Code protect that equity and permit the debtor to sell an interest in a lease and to benefit from the equity in the lease; and (vi) landlords may lack standing to object to the sale of designation rights.

VI. **Landlord's strategy: aggressive assertion of "use provision." change in section 365(f): use restrictions in shopping center lease**

A. Prior to BAPCPA, the Code stated that if there was an assignment of a lease of a shopping center, the debtor had to honor the lease covenants, including the "use" provision. However, code section 365 (f) also stated, that the court could invalidate provisions that were anti assignment clauses.

B. Some courts had held that a highly restrictive use provision was an impermissible anti assignment clause. If the lease said the premises had to be used as a blockbusters, then a landlord could not block assumption of the lease on the grounds that the new user would be operating some other kind of retail store.

C. Under the new law, section 365(f) was amended so that the prohibition against assignment does not pertain to 365(b) which is the shopping center provision.

D. This now means that the use provision may be an effective barrier to assumption. This might be the single most explosive change in the new law.

VII. **Landlord's strategy: objection to sale as sub rosa plan of reorganization.**

A. A related problem to the sale of leases in bulk under the "designation rights" approach (above) is that frequently the leases are sold in bulk as part of a first day motion, or very early in the case.

B. In *Musicland* the motion to auction a large group of leases was included as part of the first day motions. The initial sales date was less than 12 days after the case was initiated.

C. Can landlords challenge sales which are put into place as part of a package of first day orders? Can landlords argue that a sale of all or substantially all of the leases is an improper sub rosa plan?

D. The courts are split on whether a debtor may sell all or substantial portion of its assets during a case outside the context of a plan of reorganization. *See e.g.*, *Pension Benefit Guar. Corp. v. Braniff Airways Inc. (In re Braniff Airways, Inc)*, 700 F2d 935 (5th Cir. 1983); *In re White Motor Credit Corp.* 14 B.R. 584 (Bankr. N.D. Ohio 1981)(sale of substantial assets can only occur in an emergency); cf *Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2d Cir. 1983) (holding that a court may authorize a sale of significant assets when there is an articulated business purpose and not requiring an emergency).

VIII. **Limited appeal rights where lease are assumed and assigned.**

A. A landlord's efforts to assert its rights will have to confront the problem of the limited appeal rights from a sale or assumption of leases.

B. Many courts have determined that an assumption of a lease, governed by section 365, is also a "sale" under section 363. By finding that the assumption is a sale, the debtor can invoke the limited appeal rights of section 363(m).

C. Section 363(m) provides that unless an objecting party obtains a stay pending appeal, the reversal on appeal of the order authorizing the sale will not affect the validity of the sale.

D. Some courts have held that in order for the protections to apply, the court must make a finding that the purchaser was acting in good faith. *In re Abbots Dairies, Inc.,* 788 F.2d 143 (3rd Cir. 1986).

E. A sale of substantial assets may also be challenged if there is a finding that insiders or management will unfairly benefit. For example, if current management is paid a fee, or anticipates being employed by the purchaser, questions may arise as to a collusive sale. *Abbots Dairies, supra.*

Rejection Issues

I. Introduction

A. A debtor has a statutory right to "reject" a lease of nonresidential real property, and by so doing, to limit the financial burden of future rental payments. It is the damage cap and not the right to reject that protects a debtor from the obligation to pay all future rent, a large damage claim. The rejection right, coupled with the statutory cap on the damages that may be "allowed" to a landlord, makes bankruptcy an extremely effective reorganization device from the perspective of a retail or commercial tenant.

B. A debtor's right to reject a lease is said to be "vital to the basic purposes of a chapter 11 reorganization, because it can release the debtor's estate from burdensome obligations that can impede a successful reorganization." *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984). "By permitting debtors to shed disadvantageous contracts but keep beneficial ones, §365 advances one of the core purposes of the Bankruptcy Code: to give worthy debtors a fresh start." *In re Carp*, 340 F.3d 15, 25 (1st Cir. 2003).

C. The meaning of "rejection" continues to be debated. At its most basic level, the rejection of a lease constitutes a "breach" of the lease, and thus gives rise to a claim for payment in favor of the landlord. This "breach" is treated as if the breach had occurred immediately prior to the filing of the bankruptcy, and thus makes the claim by the landlord for breach a pre-petition, unsecured claim. The timing of when the breach is deemed to occur, and the cap on damages, make the claim subject to being "treated" in a bankruptcy plan, and thus reduced to a *pro rata* amount equal to what other unsecured creditors will be receiving in the case.

D. An open issue is whether rejection is a breach, or a termination of the lease. Although some highly regarded scholars agree that rejection is *not* a termination for most types of executory contracts, some courts have held that the rejection of a commercial real estate lease should be viewed as a termination. Under state law, a breach of the lease does not cause the real property interest of the tenant to be extinguished, and conversely, a tenant remains obligated to continue to pay rent for the life of the lease. A "termination" ends the leasehold estate, and gives the landlord a claim for contractual damages only, not rent. Differences in the

two theories may arise under rules pertaining to mitigation of damages. One may have a duty to "mitigate" damages, but conversely, one does not typically have to mitigate an obligation pay rent. The termination issue also affects the courts' view of the rights of third parties that are derivative of the lessee's rights, such as sub-tenants and leasehold mortgagees.

E. Generally, a debtor's motion to reject a lease will be granted on a minimal showing, and will prove difficult to contest. Landlords' efforts to interject conditions upon the rejection have not met with success. *See, e.g., In re Ames Department Stores, Inc.*, 306 B.R. 43 (S.D.N.Y. 2004). Where landlords have sought to "condition" rejection on payment of past due amounts, payment of administrative claims and payment for clean-up costs, courts have held that a debtor's statutory right to reject a lease cannot be qualified or conditioned by requirements not contained in the Code.

II. **When does rejection occur? The requirement for express court approval.**

A. An important issue to landlords is the date of rejection. As discussed below, by seeking to defer the date or apply it retroactively, debtors can achieve certain results that may be unwarranted.

B. Courts have adopted at least four different rules regarding when rejection occurs. These four possibilities include: (i) when a trustee's intent to reject is unequivocally communicated to the lessor; (ii) when a motion to reject is filed; (iii) when the court announces the approval of a motion to reject; and (iv) when an order approving the rejection is entered on the court's docket. The better rule is that rejection occurs when the order approving the rejection is entered on the docket.

C. *In re Revco D.S., Inc.*, 109 B.R. 264 (Bankr. N.D. Ohio 1989), holds that the effective date of a lease rejection is when the court enters an order:

> Unilateral acts or decisions of a debtor do not constitute a rejection of a lease. The requirement of express court approval in order to reject an executory contract or unexpired lease under §365(a) is well supported by case law. *In re Hejco, Inc.*, 87 B.R. 80, 82 (Bankr. D. Neb. 1988); *Guardian Equipment Corp. v. Whiteside (In re Guardian Equipment Corp.)*, 18 B.R. 864, 867 (Bankr. S.D. Fla. 1982); *In re National Oil Co.*, 80 B.R. 525, 526 (Bankr. D. Colo. 1987) ("the plain, unequivocal language of §365(a) indicates that court approval is required before a lease can be rejected"); *Sealy Uptown v. Kelly Lyn Franchise Co. (In re Kelly Lyn Franchise Co.)*, 26 B.R. 441, 444 and 446 (Bankr. M.D. Tenn. 1983) ("the explicit requirement of court approval is now clear under the language of §365(a) of the Code," and "the lease in this case remains property of the estate until the court approves a rejection");

> *Frank C. Videon, Inc. v. Marple Publishing Co. (In re Marple Publishing Co.)*, 20 B.R. 933, 935 (Bankr. E.D. Pa. 1982) ("any assumption or rejection of an unexpired lease is devoid of validity without the court's approval"). *See also* 2 COLLIER ON BANKRUPTCY, para. 365.03(2) at 365-30 (15th ed. 1989) ("in a chapter 11 case, rejection can only come about upon order of the court under §365(a) or by virtue of the provisions of a confirmed plan. As long as rejection is not ordered, the contract continues in existence").
>
> *Id.* at 267-68.

D. *In re Federated Department Stores, Inc.*, 131 B.R. 808 (S.D. Ohio 1991), follows *Revco*, citing several policy reasons for conditioning rejection on the entry of a court order. First and foremost, factual certainty is needed in determining the date of rejection. Second, by making rejection effective only upon court order, the landlord knows when it is free to re-let the debtor's space. In *Federated*, the debtor argued that it was unfair to force the debtors to pay for space during the time that the court was considering a motion to reject, but the court rejected this argument. *See also Paul Harris Stores, Inc. v. Mabel L. Slater Realty Trust (In re Paul Harris Stores, Inc.)*, 148 B.R. 307 (S.D. Ind. 1992); *In re Virginia Packaging Supply Co.*, 122 B.R. 491 (Bankr. E.D. Va. 1990); *In re Garfinkels, Inc.*, 118 B.R. 154 (Bankr. D. D.C. 1990).

III. **Debtor strategy: using retroactive rejection to the date of the petition.**

A. Even though most courts hold that a rejection can only occur with a formal court order, some courts have found that a rejection could be retroactive, which technically violates the majority rule and can cause considerable harm to landlords.

B. *See, e.g.*, *New Valley Corp. v. Corporate Property Associates (In re New Valley Corp.*), 2000 U.S. Dist. LEXIS 12663 (D. N.J. 2000), which supported the majority rule, above, but concluded that a court may make the rejection retroactive based on equitable considerations; s*ee also In re Joseph C. Spiess Co.*, 145 B.R. 597 (Bankr. N.D. Ill. 1992); *In re Mid Region Petroleum, Inc.*, 111 B.R. 968 (Bankr. N.D. Okla. 1990), *aff'd.*, 1 F.3d 1130 (10th Cir. 1993) (holding that rejection is effective when the lessor receives unequivocal notice of the trustee's intent to reject and denying administrative priority for rents due after the date of the notice); *In re 1 Potato 2, Inc.*, 58 B.R. 752 (Bankr. D. Minn. 1986).

C. Landlords are adversely affected by retroactive lease rejection because of the effect it may have on their entitlement to priority payment. By making rejection retroactive to the date of the petition, a debtor may arguably eliminate all of the post petition obligations under 365(d)(3).

D. Rejection is deemed a breach of the lease as of the time immediately prior to the bankruptcy filing. This priority might be defeated, however, if a court rules that a rejection is retroactive to the petition date.

E. If the debtor makes rejection retroactive to the first day of the case, then the debtor may have effectively eliminated all post petition rental obligations, and thus eliminated all administrative priority.

F. This is because section 365(d)(3) which creates the landlords' priority is only effective until such lease is assumed or rejected.

G. And 365(g) states that rejection is a breach which occurs immediately before the case is filed—which some courts view as meaning the lease is terminated immediately before the case is filed.

H. If rejection occurs the day before the bankruptcy case is filed, then there is no post petition rent and no post petition priority– including for taxes, even if there has been post petition occupancy and use.

I. Thus, if the debtor closes a store, but does not surrender it for two months, those two months of post petition rent may become unsecured claims, and paid zero.

J. The second adverse consequence deals with real estate taxes.

K. If the court permits retroactive rejection to the day before the case was filed, then even a bill sent after the petition date will be deemed to have been sent after rejection, and hence, may defeat the effect of the billing date rule.

IV. **Premature rejection.**

A. Most case law holds that rejection must be by court order, and must be based on a determination that the debtor has exercised its business judgment.

B. The question has arisen as to whether the debtor can ask the court to "authorize" it to reject leases at a later time, thus asking the court to assume that later the determination to reject will be sound, even if the circumstances of the case have changed.

C. One problem with this is that it puts the landlord in a decidedly weakened position, who is constantly under the threat of a possible termination.

D. There is some case law that might be used by a landlord to challenge this. *See* e.g., *In re U.S. Airways Corp,* 287 B.R. 643, 646 (Bankr. E.D. Va. 2002)("As a conceptual matter there is obviously no way by which the court can make a meaningful determination whether the debtors in possession have exercised sound business judgment in seeking to abandon a particular encumbered aircraft or to reject a particular unexpired lease when the debtor has not yet elected which aircraft are to abandoned and which leases are to be rejected. Furthermore to simply give a trustee or debtor in possession carte blanch to make that determination itself would be to abdicate the court's essential supervisory role over the reorganization process.

V. **Rejection following assumption.**

A. Under the prior law, many courts held that once a debtor assumed a lease, and then rejected the lease, all resulting damages would be administrative expenses entitled to first priority in payment. See, e.g., In re Smith, 315 B.R. 77, 80 (Bankr. W.D. Ark. 2004).

B. The new law adds section 503 (b)(7)

C. This states that if a lease is assumed, and then rejected, the allowed administrative claim shall be a sum equal to all monetary obligations for the period of 2 years following the later of rejection or the date of actual turnover.

D. The balance of any claim is then a claim under section 502(b)(6), which means it is a claim for future unpaid rent, and subject to the cap.