

***BANKRUPTCY: AN UPDATE ON
AMENDMENTS THAT CHANGED
THE LEASING PLAYING FIELD***

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Introduction

The Bankruptcy Abuse, Prevention and Consumer Protection Act of 2005 (S. 256) (the “BAPCPA”) was passed and signed into law in April 2005. BAPCPA became effective, with regard to the majority of its provisions, as to all cases filed on and after October 17, 2005. While the primary focus of BAPCPA was on consumer related provisions of the Bankruptcy Code, several significant changes were implemented which affect leases of non-residential real estate.

The Bankruptcy Code

I. Significant Code Provisions

A basic knowledge of certain provisions of the Bankruptcy Code (11 U.S.C. § 101 *et seq.*, hereinafter the “Code”) is useful, if not essential, in understanding the impact of a bankruptcy proceeding on the landlord-tenant relationship.

- **Section 362 - The Automatic Stay**

This section provides for an automatic stay, or an injunction, prohibiting most actions against the debtor which relate to claims that arose prior to the commencement of the case. These include the commencement or continuation of any action or proceeding that was or could have been commenced prior to the commencement of the case to recover a claim against the debtor, as well as the prohibition of any act to obtain possession of property of the estate or to exercise control over property of the estate. The automatic stay is applicable to both voluntary and involuntary cases and applies equally to petitions filed under Chapters 7, 11 and 13.

- **Section 363 - Use, Sale or Lease of Property**

Section 363 sets forth the debtor’s rights to control property including, but not limited to, the debtor’s use of what is defined as “cash collateral”. The cash collateral issue becomes important where a debtor intends to use another party’s cash collateral and that party insists upon receiving adequate assurance for the use. The section is also employed by debtors to sell their property out of the ordinary course of business.

- **Section 364 - Obtaining Credit**

The section allows the Court to grant super-priority liens in favor of a debtor’s lender where the debtor is unable to obtain unsecured credit with that unsecured credit being simply an administrative expense of the estate. Again, the section is important since it is through these positions that lenders often attempt to secure liens on all of the debtor’s property, including leasehold interests. Further, the lenders do not necessarily stop at simply obtaining the lien, but often include provisions in the loan agreement, and order approving the loan, which would allow the lender to have unfettered control of the property.

- Section 365 - Executory Contracts and Unexpired Leases

This is the primary section which details the debtors' rights and obligations regarding their leases. The provisions of this section, particularly with regard to a debtor's duty to "timely perform its obligations", have been the subject of much litigation. This section also details the rights of a tenant when a landlord files for protection under the Code.

- Section 366 - Utility Service

Section 366 prohibits a utility from taking action against a debtor simply because the party is a debtor. Nevertheless, the utility may take action, such as refusing, or discontinuing service, unless the debtor furnishes adequate assurance of payment in the form of a deposit or other security. Landlords who purchase utility service at wholesale and then resell it to the debtor/tenant may be deemed to be utilities and, therefore, governed by this section. BAPCPA has strengthened this provision for the benefit of the utilities. Where the landlord is the utility provider, the landlord should consider including provisions in the lease which take advantage of the modified Section 366.

- Section 547 - Preferences

The Section sets forth the rules governing preferential payments, as well as the defenses thereto. Subject to various defenses, a party may have received a preference if payment was made for or on account of an antecedent debt, within ninety (90) days before the filing of the petition and such payment enables that creditor to receive more than the creditor would have received if the case were a case under Chapter 7, the transfer had not been made and the debtor was insolvent at the time of the payment. Among the most common defenses are those known as "ordinary course" and "new value". Prior to BAPCPA the ordinary course defense was available if the payments received were both in the ordinary course of the business of the debtor and transferee and made according to ordinary business terms, based on the usual course of business in the industry. Under BAPCPA the transferee may now defend based on either course of dealing between the parties or standards of dealing in the industry.

- Section 548 - Fraudulent Transfers and Obligations

This section sets forth a statutory scheme of fraudulent conveyances which are in addition to, and not in lieu of, state fraudulent conveyance statutes.

- Section 105

Section 105 of the Code is the "trump card" in the event that there is no specific statutory authority allowing a party, usually the debtor, to take the action which it asks a court to approve. The section provides that a court may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of the Code. While some judges caution parties that attempting to invoke the provisions of Section 105 without some additional statutory or precedential authority will not be viewed favorably, other courts regularly invoke the powers of this section to expand the authority of the debtor to do whatever is necessary in order to maximize the value of the estate.

II. Lease Issues in Bankruptcy

A. Assumption and Rejection of Leases Generally

Subsection (a) of Section 365 provides that the trustee (whenever the term “trustee” is used, it is synonymous with the debtor or debtor-in-possession), subject to the court’s approval, may assume or reject any unexpired lease (or executory contract) of the debtor. For the purpose of these materials, we are dealing solely with leases of non-residential real property. In bankruptcy even an innocuous phrase such as “subject to the court’s approval” tends to produce a significant amount of litigation. For example, debtors often seek retroactive rejection of leases, especially with regard to locations that have been closed as of, or prior to, the filing of the bankruptcy petition. Does “subject to the court’s approval” mean that a rejection cannot take place until a court approves the rejection, or unless a court approves the rejection?

As an example, in the *Wherehouse Entertainment, Inc.* bankruptcy matter, previously pending in the District of Delaware, the Debtor attempted to reject various leases retroactive to the date of filing of its motion. Many landlords objected stating that subtenants were still in possession of the stores. Over the argument of *Wherehouse* that it had no further responsibility to the landlords, and specifically no responsibility to turn over the premises without the occupancy of the subtenants, the Court ruled that *Wherehouse* failed to meet one of the tests for allowing retroactive rejection, *i.e.* it had not turned over completely vacated premises to the landlords. At the Circuit Court level both the Ninth and First Circuits have sustained retroactive rejection of leases.

In representing landlords and tenants, counsel must understand that rejection of a lease is not equivalent to termination of the lease. A rejection is simply a breach of the lease. This may not be a significant issue if there is no subtenant and there are no third party rights involved. However, if a subtenant is in place the landlord may find that it has a substantial problem gaining possession of the premises, even if the subtenant has no independent right to possession. Landlords should consider requiring that all subleases contain a provision either requiring the subtenant to vacate upon rejection of the lease and notice from the landlord, or requiring the subtenant to attorn to the landlord following the rejection. Similarly, subtenants need to consider placing provisions in subleases granting them rights in the event of a bankruptcy situation. Certainly non-disturbance agreements must be considered where a subtenant is making an investment in the space.

Rejection motions also often include provisions allowing the debtor to abandon property remaining in the premises. While the courts have been divided as to whether or not the landlord’s expense of cleaning out and restoring the premises is an administrative expense, which may well be paid in full, or, rather, an unsecured claim with payment at pennies on the dollar, there now appears to be a majority of courts holding that those costs are unsecured claims. Careful drafting of the provisions of the lease governing the condition of the premises upon termination, or earlier turnover, may lead the courts to decide this issue more favorably to the landlord. Further, unless the debtor is compelled to provide information to the landlord regarding possible interests of third parties, the

landlord is at risk in disposing of property unless it first performs a thorough secured party investigation.

B. Assumption and Assignment Generally

Subsection (a) of Section 365 provides that a lease may be assumed subject to the court's approval, while subsections (b), (c) and (f) set forth details regarding the assumption and/or assumption and assignment process. Before BAPCPA, Subsection (f) of Section 365 provided that, except in certain unrelated circumstances, a lease could be assigned notwithstanding any provision therein that prohibits, restricts or conditions the assignment. BAPCPA amended subsection (f)(1) by changing the phrase "Except as provided in subsection (c) of this Section," to now read "Except as provided in subsections (b) and (c) of this Section, . . .". Before BAPCPA, a number of bankruptcy courts had held that the provisions of the former subsection (f)(1), the so-called "anti-assignment clause" provisions, trump the specific requirements of subsection (b)(3) with regard to adequate assurance of future performance. Accordingly, those courts used subsection (f)(1) to allow changes in a use clause, subdivision of a store into several stores, *etc.* despite the specific language of the lease and subsection (b) of Section 365.

Subsection (f) further provides that in order for there to be an assignment of an unexpired lease, the debtor must first assume the lease and there must be adequate assurance of future performance by the assignee, whether or not there has been a default under the lease. Under subsection (b), where there is an assumption but no assignment, there is no requirement for the provision of adequate assurance unless there has been a default under the lease.

1. Assumption by the Debtor

Subsection (b)(1) requires that, if there has been a default under a lease, in order to assume the lease, the debtor must cure, or provide adequate assurance that it will promptly cure, the default; compensate, or provide adequate assurance that it will promptly compensate, the landlord for any actual pecuniary loss resulting from the default; and, provide adequate assurance of future performance under the lease. These provisions apply to all leases regardless of the nature of the property. Subpart (3) of this subsection further defines adequate assurance of future performance of a lease of real property in a shopping center. With regard to such leases, adequate assurance includes, but is not limited to, the source of rent and other consideration due under the lease and, in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors shall be similar to the financial condition and operating performance of the debtor and its guarantors at the time the debtor became the lessee; that percentage rent due under the lease will not decline substantially; that assignment of the lease is subject to all of the provisions thereof, including, but not limited to, provisions such as radius, location, use or exclusivity and will not breach any such provision

contained in other leases; and, that assumption or assignment will not disrupt any tenant mix or balance in the shopping center.

a. Cure The bankruptcy does not define “cure”. However, it is generally accepted that one is only required to cure a default. Accordingly, accrued items which are not as yet due, such as real estate taxes, need not be “cured” at the time of assumption. Nevertheless, those items still need to be addressed in cases where the lease is assumed. Prior to BAPCPA, issues often arose regarding non-curable defaults, historical defaults such as a failure to operate or to timely repair the premises. Certain courts held if such non-curable defaults existed, the lease could not be assumed. BAPCPA modified this section to exclude from the cure obligation non-monetary defaults if it is impossible to cure same by performing the non-monetary acts at and after assumption. However, defaults resulting from failure to operate are to be cured by resuming operation in the premises at and after assumption. If the debtor does not, or cannot, immediately cure the defaults, it must provide adequate assurance that it will promptly cure. What constitutes adequate assurance of prompt cure is, as might be expected, open to debate. A debtor with a single leasehold might be found to have different cure obligations, from a timing standpoint, than a debtor such as a retail tenant, with 1500 locations. Landlords should consider requesting that funds sufficient to cover all cure costs be escrowed or segregated in trust to assure that the monies will be available to pay cure costs when the cure obligation is finally resolved.

b. In order to assume a lease a debtor must also pay the landlord its “actual pecuniary loss” associated with the default. As with cure, the Code does not define “actual pecuniary loss”. Losses attributable to the default might include such items as interest and penalty due to some third party (*i.e.* payment of interest and penalty to a taxing authority where the debtor has failed to pay real estate taxes, such payment being the direct liability of the tenant under the terms of its lease). Actual pecuniary loss could also include attorney’s fees, at least to the extent provided under the lease. Most courts have held, however, that absent a specific lease provision, the inclusion of the phrase “actual pecuniary loss” does not entitle a landlord to be reimbursed for its attorneys fees. Moreover, courts look very carefully at the particular attorney’s fees clause in the lease. For example, clauses which only allow for reimbursement to the successful party in litigation are unlikely to provide any reimbursement to the landlord for participation in the bankruptcy case. Indeed, many courts do not allow reimbursement simply for participating in and monitoring the case as opposed to enforcing the landlord’s rights under its lease or collecting monies due to it pursuant to the terms of the lease. Would a court enforce the following clause from a landlord’s form?

In the event a proceeding is filed by or against Tenant under any chapter of the United States Bankruptcy Code, as presently existing or as may be amended (the "Bankruptcy Code"), or Tenant makes an assignment for the benefit of creditors, or commences or otherwise becomes the subject of any insolvency, receivership, or similar proceeding, Landlord shall be entitled to recover from Tenant or any trustee, custodian, receiver, assignee, or other representative acting on Tenant's behalf, all of Landlord's costs, expenses, and reasonable attorneys' fees incurred in or in connection with any such proceeding. In addition to any other sums due and owing by Tenant under this Lease, such costs, expenses, and reasonable attorneys' fees shall constitute (i) an obligation of Tenant hereunder and (ii) a component of any cure claim assertable by Landlord under 11 U.S.C. § 365(b) or otherwise.

c. The provision of adequate assurance of future performance with regard to an assumed, but not assigned, lease has probably not received the attention that it deserves. In the vast majority of cases, landlords are simply happy to have a continuing tenant paying rent and do not address this issue. If the landlord were to view the credit risk of the reorganized debtor as a new tenant, rather than a continuing tenant, the landlord might have a different view of the situation. Landlords should consider whether or not a security deposit, letter of intent, guaranty or other consideration might be necessary, particularly if the landlord has any obligations to the tenant (i.e. significant maintenance or build-out obligations) post-confirmation.

2. Assumption and Assignment.

As already noted, the provisions of subsection (b) of Section 365 apply whether there is an assumption or an assumption and assignment of the lease. The particular provisions regarding shopping center leases, although applicable equally to assumption only cases, are most often litigated in the assumption and assignment arena.

a. Source of Rent and Other Consideration.

Lease assignments obviously may cover a wide range of potential assignees. Assignment from a debtor to a major credit tenant rarely causes a problem from a financial standpoint. However, it is very common in the retail area for debtors to propose assignment of stores to "Newco" or some much smaller, thinly capitalized company. "One-offs" to operators of just a few stores are not unusual. Even a successful retailer which is purchasing a number of stores to expand its lines of business may not want to jeopardize its existing business by placing those stores, and that business, within its existing corporate framework, thereby forming its own

“Newco”. Many retailers use SPE’s for each of their locations. In such circumstances, it is incumbent upon the landlord to insist upon adequate assurance from both a cash and operating performance standpoint. Unfortunately, the courts’ view of the provisions of Subsection (b)(3)(A) are often different from how others might otherwise interpret the “plain meaning” of this section. For example, it is often impossible for a start-up company to match the financial condition and performance of an existing national retailer/debtor. Nevertheless, courts interpret the word “similar” broadly enough to allow assignments over landlord objections. Indeed, there have been instances where the landlords have shown that the projected financial assumptions of the proposed assignee, and lack of guaranteed financing, put the proposed transaction significantly at risk. Nevertheless, the courts have approved those transactions, only to find that the acquirer has filed its own bankruptcy proceeding within six months to a year. While many landlords include provisions in their leases requiring tenants to provide annual financial information, a large number of those landlords do not police and enforce those provisions. Doing so might help the landlord establish that it is vigilant with regard to financial condition and that such a condition is important to it with regard to future assignments. Landlords who obtain financial information in connection with initial leases should maintain that information in their files through the duration of the lease.

b. Assignment Subject to All Provisions of the Lease.

The provision requiring that assignments be subject to all of the provisions of the lease, as found in Subsection (b)(3)(C), has produced some of the most significant litigation and decisions during the last ten years, particularly with regard to the requirement regarding “use”. While the language contained in this section would seem to be clear and precise on its face, a complicating factor was always that portion of Subsection (f)(1) which provided that except as provided in Subsection (c) of 365, the debtor may assign a contract notwithstanding a provision that prohibits, restricts or conditions the assignment. Accordingly, a number of courts held that subsection (f) trumps Subsection (b), notwithstanding the general rules of statutory construction that would favor enforcement of specific provisions, such as Subsection (b)(3)(C), over more general provisions such as Subsection (f)(1). Thus, one court held that where the particular use defined in the lease was a use that was now essentially obsolete, the provisions of the Code would allow the debtor/tenant to assign the lease to anyone that it wished rather than requiring the return of the leasehold to the landlord.

Shortly before the enactment of BAPCPA the Fourth Circuit overturned the ruling of the bankruptcy court in *Trak Auto*, which had allowed a change of use, holding that the courts should give due deference to Congress’ intent in enacting subsection (b). The BAPCPA change to

subsection (f)(1) was intended to take any discretion regarding use and other provisions identified in subsection (b) out of the hands of the bankruptcy courts. Thus far there are no reported cases dealing with this issue. However, earlier this year the Bankruptcy Court for the District of Arizona refused to allow the change of use from a donut shop to a fast food chicken restaurant, strictly interpreting the change mandated by BAPCPA, effectively negating the intended assignment of the lease.

The case law prior to BAPCPA demanded that drafters walk a fine line between use clauses which were so narrow that they may be excised in the bankruptcy arena versus those which were so broad that they may allow unwanted assignments, whether in or outside of bankruptcy. Until a body of law is established on this issue, care should still be given to the drafting of such clauses.

c. Tenant Mix and Balance.

Tenant mix is defined as the general array of tenants that a landlord selects for its shopping center. On the other hand, tenant balance involves the particular placement of those tenants in various locations throughout the shopping center. As one visits various large centers, one often notes how certain landlords attempt to balance their tenants. For example, it is quite common to find mid-priced in-line tenants in the areas closest to the mid-market department store and the high end tenants closer to the higher end department stores. In addition, while some landlords have begun to cluster particular types of tenants in the same area, other landlords prefer to spread the various types of tenants throughout the shopping center. Certain landlords will not rent to specific categories in prime, high traffic areas. Some courts have held that unless the lease specifically demonstrates, either by language or otherwise, that tenant mix and balance is important to the landlord, and was a consideration in the leasing, that the Bankruptcy Code provision regarding same does not give the landlord any additional rights. In other cases, testimony of the owner and the facts demonstrated by the actual layout of the center, have prevailed. If these considerations are important to the landlord, the landlord should consider appropriate language in the lease itself. The BAPCPA changes to subsection (f)(i) may also change the landscape here.

d. Definition of Shopping Center.

The Bankruptcy Code does not define the term “shopping center” either in the provisions of Section 365 detailing the additional adequate assurance to which landlords of shopping centers are entitled, or elsewhere. Rather, this definition is left to judicial interpretation. While there are a few cases which have attempted to define the elements of a shopping center, one often finds that what a landlord is sure is, indeed, a shopping center may not be one and what a tenant is sure is not a shopping

center may be found to be one. Complicating factors include out parcels, shopping areas in mixed use developments or as part of an office complex and assemblages of buildings which are not under common ownership. Arguments can be made for or against the inclusion of such properties within the term “shopping center” so as to invoke the additional protections granted to the landlord. Quite obviously, where a debtor is seeking to avoid the shopping center protections, one can expect litigation over this issue. In one recent case, the debtor and its proposed assignee took the position that since the premises were more than fifty percent vacant, it was no longer a shopping center, even if it was a shopping center at some prior time. In another recent case a court held that even though the landlord initially had several tenants and intended to develop a shopping center the fact that there were now only two tenants meant that the property was not a shopping center. Suffice it to say that simply stating in the lease that the property is within a shopping center will not be determinative of the issue.

3. Time for Assumption or Rejection of Leases.

Prior to BAPCPA the Bankruptcy Code provided that, with regard to leases of non-residential real property, if the trustee did not assume or reject the lease within sixty days after the order for relief, or such additional time as the court, for cause, fixed, then the lease was deemed rejected as of the sixtieth day and the trustee was required to immediately surrender the non-residential property to the lessor. For cases filed on and after October 17, 2006, the initial period granted to the debtor to assume or reject was enlarged to 120 days. The debtor may then be granted a 90 day extension for “cause”. After this 210 day period, extensions may only be granted with the written consent of the landlord or upon motion of the landlord.

a. The Bankruptcy Code does not define the term “cause”. A number of cases have set forth various tests to determine whether or not cause exists. Such elements as whether or not the lease is essential to the reorganization of the debtor, whether or not the debtor is remaining current in its rental payments, whether the landlord is otherwise prejudiced, the amount of time that has expired and the analyses that may be necessary to determine whether to assume or reject the lease, are all factors to be considered. As a practical matter, however, it is a rare case where a bankruptcy court finds that cause does not exist. In a recent case in New Jersey, however, the Court held that it was not sufficient to allege as “cause” that the Debtor was profitably operating the stores where the debtor had already expressed its intent to assume the leases for those stores and reject the lease for its fourth store.

b. Prior to BAPCPA some debtors attempted to extend the time to assume or reject leases beyond the confirmation of their Plan of

Reorganization. Under BAPCPA this should no longer be an issue. Section 365(d)(4) now provides that leases must be assumed or rejected by the earlier of the deadline mentioned above or entry of the order confirming a plan of reorganization. There is, however, still an open issue of what happens between entry of the confirmation order and the effective date of the plan.

c. Prior to BAPCPA numerous courts had held that if a debtor files a motion to assume or assume and assign leases prior to the expiration of the statutory period for assuming and rejecting leases the court did not have to act on that motion prior to the expiration of the statutory period. The rationale behind those cases was that Section 365 only requires that the debtor assume or reject prior to the expiration of the statutory period, not that the court act within that period of time. Although that argument ignores the fact that a debtor cannot assume or reject a lease without the court's approval under subsection (a) of Section 365, thus far no court has required that the entire assumption process take place within the statutory period. Thus, while the drafters of the BAPCPA amendments to Section 365 believed that they were setting absolute deadlines for assumption and rejection the reality is that a few courts have already ruled that the prior law is unaffected by the BAPCPA changes. In one instance a debtor filed a motion to assume and assign as many leases as it could after it held an auction. The court ruled that that motion was sufficient to extend the time to assume or reject those leases that were subject to the motion even though at the time of filing there were no proposed assignees of the leases and the debtor did not even know if it would have a proposed assignee. The court stated that the landlords did not object to the specificity of the motion and that, therefore, it would approve the assumption and assignment of the leases several months after the statutory period had expired.

C. Performance of Obligations Under Section 365(b)(3)

This section provides for the timely performance of "all obligations" of the debtor from and after the order for relief under any unexpired lease of non-residential real property until the lease is assumed or rejected. As noted several times above, unfortunately we are left without definitions of key terms. Therefore, the enforcement, and indeed the meaning, of this section has been left to judicial interpretation.

1. Accrual vs. Billing Date.

A significant issue with which many courts have dealt concerns what Congress meant when it said that the debtor must perform the obligations "arising from and after the order". Some courts have decided the issue based upon when the obligation arose, while others have addressed the issue based upon the time that the obligation accrued. This

accrual/payment debate may have a significant impact on both landlords and tenants.

The Third Circuit has ruled that it is the due date of the obligation which is determinative of whether a payment obligation is pre- or post-petition, not the time period of the accrual of the obligation. Thus, where a debtor is responsible for the prior year's real estate taxes, all of which cover a pre-petition period of time, but the billing date for those taxes is post-petition, the debtor must pay the taxes in full. The Court did not, however, rule on whether obligations which accrued during the post-petition period but were not billed until after rejection are administrative or unsecured claims. Although the Sixth Circuit addressed a similar, but not identical, problem, it is suspected that the Sixth Circuit would be aligned with the Third Circuit. The Seventh Circuit, however, issued an opinion which would indicate that it would follow the accrual, or proration, approach. Thus, in the example cited, none of the taxes would be due unless the lease were assumed since those taxes were all pre-petition. Where the tax period spanned both a pre-petition and post-petition period of time, the proration courts would require payment of the post-petition prorated portion of the taxes whereas the billing date courts would simply look to the billing date to determine whether all or none of the real estate taxes must be paid. In an interesting twist, in an opinion delivered in September, 2003, the Seventh Circuit held that where rent was due on the first of the month, the debtor was obligated to pay the entire month's rent even though the lease was rejected prior to the end of the month. While this outcome might have been expected in the Third Circuit (even though that issue has not been decided by that Court), where the Court had adopted the billing date approach, it was somewhat unexpected in the Seventh Circuit which had appeared to adopt the accrual approach. The Court, however, differentiated between "sunk costs" such as taxes, and rent which was being paid month by month, in advance.

Based upon the Third Circuit decision, the Bankruptcy Court in the District of Delaware has ruled that, with regard to the payment of rentals, if the debtor files its petition after the first of the month and the rentals are due on the first of the month under the terms of the lease, the debtor need not pay, on a current basis, any portion of the rent for the month in which the filing occurred.¹ This does not mean that the landlord will not be entitled to the post-petition rentals, only that payment may be delayed. In the event that the lease is eventually assumed, the debtor will be required to cure all defaults and will have to pay the rentals due in full. If the lease

¹ However, one court in Delaware held that where the premises were being used by the Debtor for GOB sales, and the liquidator was paying the Debtor the rent due on a *per diem* basis, that rent had to be paid over to the landlord.

is eventually rejected, the landlord would appear to have an administrative claim for the unpaid post-petition rent for the month of filing. It is unclear, however, whether or not the landlord would be entitled to the benefits of Section 365(d)(3) which require the payment of rent in full notwithstanding other provisions of the Bankruptcy Code, or, rather, would only be entitled to payment for the use and occupancy of its premises to the extent that there was benefit to the estate. Obviously this issue may well dictate where and when a debtor files its voluntary petition.

Query whether or not lease language could be inserted which would have the effect of requiring the payment of partial monthly rental based upon various trigger events, such as a bankruptcy filing, without doing injustice to other provisions of the lease requiring absolute payment of monthly rentals in full? One landlord has added the following language to its lease form:

Insolvency. Notwithstanding Tenant's obligation to pay Minimum Rent, Percentage Rent, and Additional Rent as of the first day of each month during the Term, in the event that an insolvency, bankruptcy or similar proceeding is filed by or against Tenant or Guarantor (if any), Tenant shall be obligated to pay all such Minimum Rent, Percentage Rent, and Additional Rent on a ratable basis from the date of the commencement of any such proceeding through the end of the month in which such proceeding is commenced.

Percentage rent payments provide a further opportunity for courts to opine on the meaning of this Code section. One would assume that in the Third Circuit if percentage rent were paid on an annual basis, and the payment due date were after the filing, the full amount of the percentage rent would be due as a post-petition expense. The treatment of percentage rent in an accrual, or proration, jurisdiction, however, presents several other problems. Assume that a debtor is on a calendar year basis for percentage rent purposes and files its voluntary petition on September 1st. Assume further that the tenant achieved its percentage rent breakpoint, obligating it to pay percentage rent, prior to the filing. Would the debtor be required to pay the entire amount of percentage rent from the date of filing through the end of the year, since each dollar of sales which occurred after the filing was subject to the payment of percentage rent? Or, could it be argued that the achievement of the percentage rent breakpoint reflects sales which took place earlier in the year and, therefore, percentage rent payments should be allocated based upon either the percentage of sales pre- and post-petition, the number of days pre- and post-petition, or some combination thereof? Would the answer change if the breakpoint were achieved post-petition? As one might suspect, there is no uniformity in court decisions regarding this issue. In the *Kmart* case, the court found that the date the breakpoint was reached was the

determinative factor, such that if the breakpoint was reached on or after the filing date all percentage rent was post-petition.

III. The Landlord as Debtor

A tenant's rights if a landlord files for bankruptcy are governed by Subsection 365(h). That subsection provides that if the lessor is the debtor and the lessor elects to reject the unexpired lease of real property, the lessee has a choice of remedies. Either the lessee can treat the lease as terminated by virtue of the rejection and make any claim it may have as a result of such termination, or, as long as the lease has commenced, the lessee may retain its rights under the lease, including rights such as the amount and timing of rent, use, possession, quiet enjoyment, assignment and subletting, for the balance of the term and for any renewal or extension rights that it has. In the event that the lessee retains its rights, it may offset against the rent due under the lease the value of any damage caused by the non-performance by the lessor after the date of such rejection. If the lease is a lease of property in a shopping center, the rejection of the lease does not effect the enforceability under applicable non-bankruptcy law of provisions relating to radius, location, use, exclusivity or tenant mix or balance. Thus, a lessor debtor may not simply rid itself of a tenant which has an exclusive use in a shopping center by simply rejecting the lease. Under such circumstances, the lessee would be protected.

The foregoing analysis of a tenant's rights when the landlord becomes a debtor was dealt a blow, even if just a glancing blow, by a decision of the Seventh Circuit in April of 2003. In that case, the debtor-landlord sold assets pursuant to Section 363 of the Bankruptcy Code "free and clear" of any "interests". The Seventh Circuit held under the facts of that case that Section 363(f) trumps Section 365(h) and that the tenant under the lease was divested of its right to remain in the premises by virtue of the Section 363 sale. While some commentators have suggested that this holding is limited to the particular, and possibly peculiar, facts of that case, others have suggested that the holding may have far wider implications, indeed even extending beyond landlord/tenant issues. More recently, a bankruptcy court in the First Circuit declined to follow the Seventh Circuit's holding and held that the tenant's rights were protected under Section 365(h). Various professional organizations are also proposing legislation to attempt to "fix" this anomaly in the law.