

2007 ADVANCE COMMERCIAL REAL ESTATE LEASES CONFERENCE

Bankruptcy: An Update on Amendments That Changed the Commercial Leasing Playing Field

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Introduction

On October 17, 2005, significant bankruptcy reform legislation known as The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") became effective. At the time of its passage in April 2005, most commentators and the media focused on the consumer bankruptcy reforms in the legislation and the role of the credit card industry in its enactment. There were, however, several significant changes in the Bankruptcy Code with respect to the treatment of commercial leases that appear to change the landscape for commercial landlords and their debtor-tenants. As we observe the two-year anniversary of the effective date of BAPCPA, the application of a number of the BAPCPA amendments impacting commercial leases have not yet been considered by the bankruptcy courts or produced published opinions.

Limitations on Extensions of Time To Assume or Reject Non-Residential Real Property Leases

Under prior law, a debtor-tenant had 60 days from the commencement of its case to assume or reject its non-residential real property leases or such leases would be deemed rejected. Extensions of time were available for "cause" and bankruptcy courts routinely granted multiple extensions of time of the time to assume or reject, frequently extending up until the time of confirmation of a plan, in many cases simply because the debtor asserted that it needed more time to make a decision.

BAPCPA places limits on the bankruptcy court's discretion by extending the initial time for the debtor-tenant to assume or reject from 60 to 120 days but allows for extensions for "cause" of only 90 additional days, absent written consent of the affected landlord, thereby strictly limiting the courts' discretion by setting a maximum time of 210 days to assume or reject. Bankruptcy Code section 365(d)(4) now provides:

(A) Subject to subparagraph (B), an unexpired lease of non-residential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that non-residential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of

- (i) the date that is 120 days after the date of the order for relief; or
- (ii) the date of the entry of an order confirming a plan.

(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 the 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 prior written consent of the lessor in each instance.

According to the legislative history, "[t]his provision is designed to remove the bankruptcy judge's discretion to grant extensions of time for the retail debtor to decide whether to assume or reject a lease after a maximum possible period of 210 days from the

time of entry of the order for relief." H.R. Rep. 109-31(I), 109th Cong., 1st Sess. 2005, p. 153, 2005 U.S.C.C.A.N. 86. The debtor-tenant must still remain current on its post-petition lease obligations (§365(d)(3)) and the landlord may still seek relief during the initial 120-day period if the debtor fails to do so.

In the first reported case on the amended Section 365(d)(4), the bankruptcy court in In re Tubular Technologies, LLC, 362 B.R. 243 (Bankr. D.S.C. June 21, 2006), held that the amended statute "plainly requires the Court to enter an order extending the time for Debtor to assume the lease prior to the expiration of the time period set forth in §365(d)(4)(A)." Since the statute is "self executing," the debtor-tenant's failure in Tubular Technologies to timely assume the lease resulted in the subject lease being deemed rejected and the debtor was ordered to immediately surrender the leased premises.

The "hard and fast" 210-day deadline to assume or reject unexpired leases under the amended Bankruptcy Code section 365(d)(4) will have the practical effect of forcing Chapter 11 debtors to make quicker decisions regarding the future of their non-residential real property leases. Multiple extensions of time to await seasonal sales results (e.g., postponing assumption or rejection for one or more Christmas seasons before deciding which leases to assume or reject) or to permit prolonged marketing of a debtor's leases (see, e.g., In re Ernst Home Center, Inc., 209 B.R. 974 (W.D. Wash. 1997) (authorizing 14-month extension to market leases) are a thing of the past. Lease assumption or rejection decisions must now realistically be part of a debtor's pre-bankruptcy planning. Lease disposition programs (utilizing third party real estate consultants to market a debtor's leases for assignment or through the sale of "designation rights") will have to be accelerated to accomplish their objectives within seven months, potentially resulting in less success in concluding transactions and diminished returns.

The requirement that landlords give consent to an additional extensions of the time to assume or reject beyond the 210-day period provided by BAPCPA would appear

to give landlords considerable leverage in responding to extension requests, yet there are certainly circumstances where a landlord might wish to avoid the detriment of a "dark store" or permit the debtor additional time to decide the future of a borderline profitable store under certain conditions. Most commentators believe that there are opportunities for negotiation and drafting with respect to consensual extensions of the 210 days afforded by Section 365(d)(4). For example, the landlord may consent to an extension of time in exchange for "holiday protection," i.e., the debtor's agreement to keep a store open and operating through the holiday retail season. A gross sales "kick out" provision may be another alternative that accommodates the objectives of both the landlord and debtor-tenant with respect to a consensual extension of time.

The parameters of the new landlord consent provision (§365(d)(4)(B)(ii)), however, have not been tested in reported decisions and there are many unresolved questions. For example, what is "written consent" for purposes of new Section 365(d)(4)(B)(ii)? Would an e-mail from a property manager suffice? If the parties amend their lease in connection with an extension of time to assume or reject, say by adding a new gross sales termination option, is such an arrangement a transaction outside "the ordinary course of business" that would require bankruptcy court approval? Could a landlord go so far as to obtain a "consent fee" from the debtor? Answers to these questions will have to await case development.

The New Cap on a Landlord's Administrative Claim Arising From The Rejection of a Lease Previously Assumed

Given the accelerated 210-day timetable to make decisions to assume or reject nonresidential real property leases under amended Section 365(d)(4), mistakes by the debtor-tenant are inevitable, i.e., valuable leases will be rejected and leases that were assumed, in retrospect, should have been rejected. Under prior law, by assuming a lease,

the debtor-tenant agreed to be bound by all of its obligations, and such obligations for the entire balance of the lease term had administrative priority over all general unsecured obligations of the estate without the "cap" on rejections claims provided by Bankruptcy Code section 502(b)(6).¹ See, e.g., In re Merry-Go-Round Enterprises, Inc., 180 F.3d 149 (4th Cir. 1999); In re Klein Sleep Products, Inc. (2d Cir 1996) 78 F3d 18.

BAPCPA attempted to ameliorate the impact of potentially imprudent assumption decisions by limiting the claims of landlords resulting from the post-assumption rejection of a nonresidential lease. New Section 503(b)(7) limits a landlord's administrative priority damage claim when an assumed lease is later rejected to rent due for the two-year period subsequent to rejection (or the date of actual return of the leased premises, whichever is later). The landlord's claim for rent accruing beyond the initial two-year period is now an unsecured claim capped by Section 502(b)(6). Thus, a debtor-tenant faced with an impending 210-day deadline under Section 365(d)(4) that remains uncertain as to the future value of the lease in question, may determine to assume that lease with the understanding that the lease could later be rejected and the landlord's claim capped under Section 503(b)(7). Similarly, a debtor-tenant could assume a lease with the objective of seeking to assign it later (Section 365(f) does not require that assumption and assignment be simultaneous) knowing that a landlord's claim would be limited if such marketing effort proved unsuccessful.

The new language of Section 503(b)(7) introduces some concepts that will no doubt be the source of future controversy and case development. For example, the landlord's administrative priority claim is to be "without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor." Under this language, a security deposit given by the debtor-tenant

¹ Under Bankruptcy Code section 502(b)(6), a landlord's claims for damages resulting from the rejection of a real property lease are limited to "rent reserved" by the lease, without acceleration, for the greater of either one year or fifteen percent (15%) of the remaining term of the lease, not to exceed three years following the earlier of the bankruptcy filing or the date on which the landlord repossessed or the debtor-tenant surrendered the leased property.

would not reduce the administrative priority claim resulting from rejection of the previously assumed lease but would rather be applied, consistent with existing law, against the unsecured portion of the landlord's lease rejection claim. Whether a letter of credit given by the debtor would receive the same treatment is uncertain. The reference to sums "to be received" from third parties is potentially troublesome to landlords, appearing to require a reduction of the administrative priority claim for sums due under third party guarantees that might be disputed or ultimately uncollectible. How Section 503(b)(7) interacts with state law regarding the landlord's duty (or not) to mitigate damages resulting from breach of the lease (are rents from potential replacement tenants sums "to be received"?) is also unclear at this time. Given the impact that the reduction of significant administrative claims (i.e., two years' rent) has on recovery to lower priority unsecured claims, it is inevitable that there will be litigation over the application of new Section 503(b)(7).

New Limitations on Bankruptcy Court Invalidation of Alleged De Facto Anti-Assignment Provisions

BAPCPA also added new limits on a debtor-tenant's ability to assign shopping center leases, reinforcing the proposition that assignments of leases under Bankruptcy Code section 365(f) are subject to all provisions protecting landlords under Bankruptcy Code section 365(b). Prior to BAPCPA, there was a conflict in the case law concerning whether the provisions of Bankruptcy Code section 365(b), requiring that an assignee take an assignment of a shopping center lease subject to all of its terms and conditions (including lease provisions concerning use, radius, and exclusivity), took precedence over the debtor's ability to assign its leases under Section 365(f), which makes anti-assignment clauses unenforceable.

BAPCPA amended Section 365(f)(1) to make it clear that bankruptcy courts cannot use Section 365(f)(1) to override the mandate of Section 365(b) to protect use and other provisions of shopping center leases. While Section 365(f)(1) formerly read, "except as provided in subsection (c)...", it now plainly reads "Except as provided in subsections (b) and (c)..." The purpose of this amendment was to override cases which permitted assignments of shopping center leases contrary to existing use and other leases provisions on the ground that they were unenforceable *de facto* anti-assignment provisions under Section 365(f)(1). Compare In re Rickel Home Centers, 240 B.R. 826 (Bankr. D.Del. 1999) (authorizing assignment of home improvement store leases to Staples over landlord objections) with In re Trak Auto Corporation, 367 F.3d 237 (4th Cir. 2004) (rejecting proposed assignment of lease for auto parts store to apparel retailer).

While the amendments to Section 365(f)(1) prevent the characterization of use, alteration and other lease provisions in shopping center leases as anti-assignment provisions as a matter of bankruptcy law, such provisions can, and will be, tested under state law. For example, practitioners should be careful to analyze whether use provisions in a shopping center lease are so narrow and restricted that they may be unenforceable under applicable state law. On the other hand, ambiguities in use restrictions may be construed in favor of unrestricted use. See, e.g., Cal. Civil Code §1997.220.

New Case Law Development

On October 1, 2007, the Ninth Circuit Court of Appeals issued its decision in In re El Toro Materials Company, Inc. (Saddleback Valley Community Church v. El Toro Materials Company, Inc. ___ F.3d. ___ (9th Cir. Oct. 1, 2007), raising new questions about the scope of the "cap" on a landlord's lease rejection damages and potentially creating drafting opportunities in future lease transactions to limit the possible application of Bankruptcy Code section 502(b)(6).

In El Toro, the debtor, a mining company, rejected a lease providing for a monthly rental of \$28,000, abandoning on site its mining equipment, other materials and “one million tons of its wet clay ‘goo’”, which cost the landlord \$23 million to remove. Reversing the Bankruptcy Appellate Panel, the Ninth Circuit held that the landlord’s clean-up expenses, asserted under theories of waste, nuisance, trespass and breach of contract, were not limited by the cap on lease rejection damages under Section 502(b)(6). Concluding that the harm to the landlord's property existed whether or not the lease was rejected, the Ninth Circuit concluded that the damage claim was "collateral" to damages resulting from the termination of the lease and rent reserved and thus not subject to the limitations of Section 502(b)(6), distinguishing In re McSheridan, 184 B.R. 91 (9th Cir. BAP 1995). The Ninth Circuit observed that "extending the cap to cover any collateral damage to the premises would allow a post-petition but pre-rejection tenant to cause any amount of damage to the premises—either negligently or intentionally—without fear of liability beyond the cap."

The Ninth Circuit explained its conclusion as follows:

It makes sense to cap damages for lost rental income based on the amount of expected rent: Landlords may have the ability to mitigate their damages by re-leasing or selling the premises, but will suffer injury in proportion to the value of their lost rent in the meantime. In contrast, collateral damages are likely to bear only a weak correlation to the amount of rent: A tenant may cause a lot of damage to a premises leased cheaply, or cause little damage to premises underlying an expensive leasehold.

Judge Kozinski's opinion in El Toro is expressed in broad policy terms and raises many questions regarding the scope of the "cap" on a landlord's damages under Bankruptcy Code section 502(b)(6) that might be addressed at the lease drafting stage. For example, will the holding in El Toro be limited to its extreme facts and tort theories of recovery? Can landlords structure credit enhancements (security deposits, letters of credit and guaranties) to bifurcate rent and other regularly accruing monetary obligations ("rent reserved") from restoration obligations, particularly where the tenant has developed

the property with significant or unique improvements (e.g., an internet data center, underground storage tanks) that would require significant landlord expenditure to remove? (In the words of the El Toro opinion, the "million-ton heap of dirt was not put there by the rejection of the lease.") Could El Toro be extended to recovery of the unamortized value of tenant improvements constructed or financed by the landlord?

Like the BAPCPA amendments to the Bankruptcy Code, the precise impact of El Toro is not clear at this time but presents an opportunity for landlords to preserve and maximize potential claims and recovery, at the lease negotiation and drafting stage, should a tenant later seek bankruptcy protection.