Negotiating and Drafting Commercial Leases Volume II

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Dedication

We dedicate this book to our wives, Teri and Mary Jo, and to our children, Jonathan, Emily, Alexander, Megan and Corinne, each of whom has provided the inspiration for this work. Also to Mary Anne Scala whose efforts and unfailing support have helped to make this writing possible.

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Bankruptcy[1]

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§ 28.01 The Bankruptcy Code and Rules: An Overview

[1]—The Bankruptcy Code and Court System

[a]—History and Structure of Bankruptcy Code

U.S. federal bankruptcy law is principally codified as title 11 of the United States Code.[2] The Bankruptcy Code has been enacted under the grant of authority of Article I, Section 8 of the United States Constitution, which often times is referred to

[2] 11 U.S.C. §§ 101 *et seq.* (1978, as amended).

as "the Bankruptcy Clause" and which authorizes Congress to establish "uniform" bankruptcy laws throughout the United States. Major bankruptcy statutes have been enacted in the U.S. in 1800, 1841, 1867, 1898 and 1978.[3] Practitioners and the Federal Rules of Bankruptcy Procedure refer to the current bankruptcy statute as the "Code" and the 1898 statute as the "Act."[4]

The Bankruptcy Code consists of nine Chapters. Chapters 1, 3 and 5 generally apply to all cases, under the Bankruptcy Code, while Chapters 7, 9, 11, 12, 13 and 15 apply to specific types of bankruptcy cases, involving specific types of debtors, i.e., consumers, businesses, wage earners, farmers, municipalities, etc., and to the substantive rights applicable in cases commenced under such Chapters.

Chapter 1 of the Bankruptcy Code is entitled—General Provisions and includes definitions, rules of construction, powers of the court, rules governing the extension of certain time periods and a group of other provisions generally applicable to all bankruptcy cases. Chapter 3 of the Bankruptcy Code is entitled—Case Administration. Chapter 3 is divided into four Subchapters: Subchapter I—Commencement of a Case; Subchapter II—Officers, Subchapter III—Administration; and Subchapter IV—Administrative Powers. Chapter 5 of the Bankruptcy Code is entitled—Creditors, the Debtor and the Estate. It is divided into three Subchapters: Subchapter I—Creditors and Claims Subchapter II—Debtor's Duties and Benefits and Subchapter III—The Estate.

The bankruptcy courts are so-called Article I courts,[5] rather than Article III courts, as they have been legislated into existence under the Bankruptcy Clause in Section 8 of Article I of the Constitution.[6] By way of comparison, the federal district courts, the courts of appeal, and the United States Supreme Court have been established pursuant to Article III of the Constitution and are the so-called "Courts of the United States."[7] Under principles of the separation of powers, bankruptcy judges cannot exercise the judicial power reserved for Article III judges, i.e., district court judges, circuit court judges, and U.S. Supreme Court Justices.

In *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.* (*Marathon*), the Supreme Court struck down certain provisions of the Bankruptcy Act of 1978 because they conferred Article III judicial power on bankruptcy judges.[8] Nearly two years later, Congress enacted the Bankruptcy Amendments and Federal Judgeship Act of 1984[9] to fix the statutory infirmity identified in *Marathon*. The jurisdictional scheme for bankruptcy courts continues in force today, or nearly so. Congress "fixed" the constitutional problem identified in *Marathon* by providing for the jurisdiction of the bankruptcy courts in the Federal Judicial Code (title 28).[10]

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[3] Bankruptcy Act of 1800, 2 Stat. 19; Bankruptcy Act of 1841, 5 Stat. 440; Act of March 2, 1867, 14 Stat. 517; Bankruptcy Act of 1848, 30 Stat. 544; 11 U.S.C. §§ 101 *et seq*. (1978, as amended).

[4] Fed. R. Bankr. P. 1001 Advisory Committee Note.

[5] Fed. R. Bankr. P. 1001 Advisory Committee Note.

[6] U.S. Const. Art. 1, § 8, cl. 4.

[7] U.S. Const. Art. 3, § 1.

[8] Northern Pipeline Construction Co. v. Marathon Pipe Line Co., 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982).

[9] Pub. L. No. 98-353 (1984).

[10] 28 U.S.C. §§ 1 *et seq.* ("title 28").

As amended in 1984, 28 U.S.C. § 1334 provides that the district courts shall have "original and exclusive jurisdiction of all cases under title 11" and "original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11."[11] Section 151 of title 28 provides that each bankruptcy court is "a unit of the district court" in the federal district where it is located.[12] Each district court may—but need not—refer cases and matters within the scope of bankruptcy jurisdiction to the bankruptcy court in its district. Section 157(b) of title 28 provides that "[b]ankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11 or arising in a case under title 11."[13] Thus, a bankruptcy court may enter a final order with respect to all bankruptcy cases before it and all matters within the scope of its "core" jurisdiction. Such a final order is subject to appellate review by the applicable district court or bankruptcy appellate panel (and, thereafter, by the applicable court of appeals). Section 157(b)(2) of title 28 provides a nonexclusive list of matters that purportedly fall within "core" jurisdiction.[14]

In *Stern v. Marshall,* the U.S. Supreme Court held that, even though bankruptcy courts are statutorily authorized under 28 U.S.C. § 157(b)(2) to enter final judgments on various categories of bankruptcy-related claims, Article III prohibits bankruptcy courts from finally adjudicating certain of those claims.[15] Specifically, the Court ruled that a bankruptcy court lacks constitutional authority under Article III to enter a final judgment on a state law counterclaim of the bankruptcy estate that is not resolved in the process of ruling on a creditor's proof of claim, even though 28 U.S.C. § 157(b)(2)(C) identifies such a counterclaim as a core proceeding.[16] Post *Stern*, courts were left to struggle with the following issues:

(1) whether a bankruptcy court has jurisdiction to address, and how it should deal with, a claim that, while statutorily denominated as core, is not in fact constitutionally determinable by an Article III judge (a "*Stern* claim"); and

(2) the effect of a party's consent to adjudication of a *Stern* claim by a bankruptcy court.

In its 2014 ruling, in *Executive Benefits Insurance Agency v. Arkison*, the Supreme Court determined that when a bankruptcy court is confronted with a claim that is statutorily denominated as "core," but is not constitutionally determinable by a bankruptcy judge under Article III of the U.S. Constitution, the bankruptcy judge should treat such a claim as a noncore "related to" claim that is subject to *de novo* review by a district court.[17],[18] A year later, in *Wellness Int'l Network, Ltd. v. Sharif*, the Supreme Court held that so long as consent—whether express or implied—is "knowing and voluntary," Article III of the U.S. Constitution is not violated by a bankruptcy court's adjudication of such a claim.[19] *Wellness* and *Arkison* nonetheless leave several

[11] 28 U.S.C. § 1334.
[12] See 28 U.S.C. § 151.
[13] See 28 U.S.C. § 157(b). RIGHT?.
[14] See 28 U.S.C. § 157(b)(2).
[15] Stern v. Marshall, 564 U.S. 462, 131 S.Ct. 2594, 180 L.Ed.2d 475 (2011).
[16] *Id.*
[17] Executive Benefits Insurance Agency v. Arkison, 134 S.Ct. 2165, 189 L.Ed.2d 83 (2014).
[18] *Id.*
[19] Wellness International Network, Ltd. v. Sharif, 135 S.Ct. 1932, 191 L.Ed 2d 911 (2015).

significant jurisdictional and constitutional questions unanswered, as neither opinion offers guidance as to—

- what constitutes "knowing and voluntary" consent or when such consent (express or implied) must be given in order to cure any constitutional deficiency.
- which claims, as a constitutional matter, can be determined finally by a bankruptcy judge.

Thus, disputes over whether a claim is a *Stern* claim are likely to continue.

Part of the concern expressed by the Supreme Court in its *Stern* decision centered on the fact that the bankruptcy judges, as Article I judges, do not share the same constitutional protections as Article III judges.[20] For example, bankruptcy judges are appointed by the judicial conference for the respective federal judicial circuits for fourteen-year terms.[21] In contrast, the justices of the U.S. Supreme Court, the judges of the U.S. circuit courts of appeal and the judges of the federal district courts are appointed by the President of the United States and confirmed by the Senate. Such Article III appointments are lifetime appointments.[22]

Jurisdiction over federal bankruptcy cases resides with the United States district courts. The district courts are invested with the exclusive and original jurisdiction over every bankruptcy case, and original, but not "exclusive jurisdiction" over civil proceedings arising in, arising under, or related to each such bankruptcy case.[23] The United States bankruptcy courts are units[24] of the district courts, and every district court may refer bankruptcy cases filed in their district to the bankruptcy courts for that district.[25] Virtually all federal districts operate using a standing orders of reference[26], under which bankruptcy cases automatically are referred to the local bankruptcy courts; however, such reference may be withdrawn under appropriate circumstance.[27] "Withdrawal of the reference" may be with regard to an entire bankruptcy case or with respect to a specific contested matter or adversary proceeding that constitutes a single element of a case.

The Bankruptcy Code operates in tandem with the Federal Rules of Bankruptcy Procedure (the "Rules").[28] To supplement, and in aid of the Rules, virtually all of the judicial

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[20] Stern v. Marshall, 564 U.S. 462, 482–84, 131 S.Ct. 2594, 2608–2609, 180 L. Ed.2d 475 (2011).

[21] 28 U.S.C. §§ 152 and 153.

[22] U.S. Const. Art. 3, § 1.

[23] 28 U.S.C. § 1334(a).

[24] 28 U.S.C. § 151.

[25] 28 U.S.C. § 157(a).

[26] You need to fill this in.

[27] 28 U.S.C. § 157(d).

[28] *Id.* The Rules are applicable in cases and proceedings under title 11, whether before a district court judge or bankruptcy judge.

Third Circuit: Phar-Mor, Inc. v. Coopers & Lybrand, 22 F.3d 1228, 1237, 30 C.B.C.2d 1553, 1565 (3d Cir. 1994); VFB LLC v. Campbell Soup Co., 336 B.R. 81, 84 (D. Del. 2005).

Fourth Circuit: In re Celotex Corp., 124 F.3d 619, 630 (4th Cir. 1997).

Fifth Circuit: Lentz v. Trinchard, 730 F. Supp. 2d 567, 577 n.33 (E.D. La. 2010).

Seventh Circuit: Diamond Mortgage Corp. of Illinois v. Sugar, 913 F.2d 1233, 23 C.B.C.2d 1275 (7th Cir.), *cert. denied* 498 U.S. 1089 (1990).

districts around the country have implemented local bankruptcy rules of procedure.[29] With respect to evidentiary matters, the bankruptcy courts apply the Federal Rules of Evidence with regard to contested matters (motion practice) and adversary proceedings (litigation commenced by the filing of a complaint with the Clerk of the Bankruptcy Court.[30]

[b]—Venue

A bankruptcy case may be filed in the district of the debtor's domicile, residence, principal place of business or assets for 180 days before filing or longer portion of such 180 days than anywhere else.[31]

Bankruptcy proceedings may be filed

(a) in the district where the *case* is pending (or anywhere else allowed by general venue statutes) except;

(b) in "smaller" proceedings, only in the district where defendant resides.

[c]—The Benefits of Voluntary Bankruptcy Relief

Consumer and commercial entities may file for voluntary bankruptcy relief for a variety of reasons, including severe financial distress, as a tool to manage litigation or for other strategic purposes. Insolvency is not a prerequisite for a voluntary filing under the Bankruptcy Code.[32] A financially distressed natural person or business entity subject to the jurisdiction of a bankruptcy court generally is referred to by the Bankruptcy Code as a "debtor."[33] The Bankruptcy Code does not use the term "bankrupt," which was a term widely used in cases governed by the Act.[34]

[2]—Chapter 7 Cases—Types of Bankruptcy Cases

A debtor[35] may commence a Chapter 7 case by filing a "Voluntary Chapter 7 Petition."[36] Practitioners refer to this type of case as "straight bankruptcy." Chapter 7 relief is

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[29] See Fed. Rule Bankr. Proced. § 9029(a). The local bankruptcy rules for each federal judicial district are available on the respective bankruptcy courts' websites, which can be found at http://www.uscourts.gov/court-locator (last visited April 12, 2022). PLEASE CONFIRM THAT THIS IS CORRECT.

[30] Fed. Rule Bankr. Proced. § 9017. ("EVIDENCE. The Federal Rules of Evidence and Rules 43, 44 and 44.1 Fed. R. Civ. P. apply in cases under the Code.")

[31] 28 U.S.C. § 1408(1).

[32] Bankruptcy Code §§ 109 (Who May Be a Debtor) and 301 (Commencement of Voluntary Cases).

[33] Bankruptcy Code § 101(13) defines "debtor." Debtor means person or municipality concerning which a case under the bankruptcy law has been commenced. This is a change in terminology from present law, which calls a person that is proceeding in a straight bankruptcy liquidation case the "bankrupt," and a person or municipality that is proceeding under a debtor rehabilitation chapter (chapters VIII through XIII of the Bankruptcy Act) a "debtor." The general term debtor is used for both kinds of cases in this bill, for ease of reference in chapters 1, 3 and 5 (which apply to straight bankruptcy and reorganization cases), and as a means of reducing the stigma connected with the term bankrupt.

House Report No. 95-595, 95th Cong. 1st Sess. (1977) 310, Senate Report No. 95-989, 95th Cong. 2d Sess. (1978).

[34] *Id.*

[35] Bankruptcy Code § 101; 11 U.S.C. § 101.

[36] Bankruptcy Code § 301; 11 U.S.C. § 301.

available to natural persons and business entities, subject to the exceptions set forth in the Section 109 of the Bankruptcy Code.[37] Exceptions to the general rule of eligibility for voluntary Chapter 7 relief include: banks, broker dealers, and insurance companies, as such entities are subject to state and federal government statutes and regulations. In contrast, bank holding companies and insurance holding companies may file for relief under the Bankruptcy Code, as they are unregulated business entities.[38]

In addition to voluntary relief, the Bankruptcy Code provides that creditors may file an involuntary bankruptcy petition against an "alleged debtor, pursuant to Section 303 of the Bankruptcy Code."[39] The purpose of an involuntary petition is to invoke the jurisdiction of the Bankruptcy Court over a natural person or a business entity to prevent such "alleged debtor" from taking steps inimical to the financial interests of the creditors.[40]

The Bankruptcy Code imposes a heavy burden of proof on creditors seeking to force an individual or a business entity into an involuntarily bankruptcy case, as forcing an individual or a business entity into the jurisdiction of a bankruptcy court is a drastic remedy.

Section 303 of the Bankruptcy Code sets forth the elements that must be proven to successfully file an involuntary petition and obtain the desired involuntary relief.[41] If the debtor has more than twelve creditors, there must be at least three petitioning creditors, with total unsecured claims of $15,775 that are not contingent or the subject of a *bona fide* dispute as to liability or amount.[42] If the debtor has fewer than twelve creditors, only one petitioning creditor is required.[43]

After an involuntary petition is filed, the alleged debtor has an opportunity to respond. If the alleged debtor contests the involuntary petition, the petitioning creditor must establish that the debtor is generally not paying its debts that are not subject to a *bona fide* dispute as the debts come due.[44] After the petitioning creditors establish the elements necessary for an involuntary petition, the bankruptcy court will enter an "order for relief" granting the involuntary petition.

To prevent abuse of the involuntary bankruptcy remedy, the consequences for filing an involuntary petition that is dismissed can be significant.[45]

The bankruptcy court may enter judgment against the petitioning creditor for the debtor's attorney's fees and costs.[46] Additionally, if the bankruptcy court finds that the filing was in bad faith, the court can award compensatory and even punitive damages.[47]

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[37] See Bankruptcy Code § 109; 11 U.S.C. § 109.
[38] *Id.*
[39] Bankruptcy Code § 303; 11 U.S.C. § 303.
[40] *Id.*
[41] See Bankruptcy Code § 303; 11 U.S.C. § 303.
[42] Bankruptcy Code § 303(b)(1); 11 U.S.C. § 303(b)(1).
[43] Bankruptcy Code § 303(b)(2); 11 U.S.C. § 303(b)(2).
[44] Bankruptcy Code § 303(h); 11 U.S.C. § 303(h).
[45] See Bankruptcy Code § 303(b); 11 U.S.C. § 303(b).
[46] Bankruptcy Code § 303(i)(1); 11 U.S.C. § 303(i)(1).
[47] Bankruptcy Code § 303(i)(2); 11 U.S.C. § 303(i)(2).

Upon the filing of a voluntary Chapter 7 case, an "order for relief" is entered, and an interim trustee is appointed.[48] Such interim trustee may be replaced by a permanent trustee elected by creditors or, if no replacement is elected, the interim trustee may continue as the permanent trustee.[49] In an involuntary case, the court enters an order for relief after a determination by the court that an "alleged debtor" should be a debtor subject to bankruptcy court jurisdiction.[50] Until the entry of an "order for relief" in an involuntary Chapter 7 case, no trustee is appointed, unless the petitioning creditors or another interested party "shows cause," and the bankruptcy court enters an order providing for such interim relief.[51]

Most property of a Chapter 7 debtor as it existed on the filing date of the bankruptcy case will constitute "property of the [bankruptcy] estate" in the debtor's Chapter 7 case.[52] This concept is of the utmost importance to creditors, as the bankruptcy trustee will only administer "property of the estate" for the benefit of creditors.[53] After satisfying the claims of secured creditors, the trustee will distribute the unencumbered property of the debtor's estate, generally cash, to the other creditors.[54] Such distributions will be made in accordance with a priority scheme for distribution of estate property to creditors.[55]

Certain pre-filing date property of a natural person who becomes a debtor after filing for Chapter 7 relief may be claimed by such individual as "exempt property."[56] Such "exempt" property is excluded from the bankruptcy estate and may be retained by the debtor.[57] Thus, a distinction correctly must be drawn in such cases between "property of the debtor," which includes all of a debtor's exempt and nonexempt property, and property of the "estate," which includes only nonexempt property. The concept of exempt property only applies to individuals and does not apply to business entities filing for relief under the Bankruptcy Code.[58]

Holders of secured claims, absent unusual circumstances, will retain their security interests in and liens on collateral.[59] Determining whether a claim is secured depends on the principles of applicable non-bankruptcy law governing the attachment and perfection of security interest and liens.[60] A creditor, in most circumstances, only has an allowed secured claim, for bankruptcy purposes, to the extent of the value of its collateral.[61] Thus, a creditor with collateral worth $600,000, securing a loan with an outstanding balance of $1,100,000 will have a secured claim of $600,000 (equal to the value of the collateral) and a general unsecured claim for the $500,000 balance. The

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[48] Bankruptcy Code § 701; 11 U.S.C. § 701.
[49] Bankruptcy Code §§ 702(d), 11 U.S.C. § 702 (d).
[50] Bankruptcy Code §§ 701 and 702; 11 U.S.C. §§ 701 and 702.
[51] Bankruptcy Code § 303(g); 11 U.S.C. § 303(g).
[52] Bankruptcy Code § 541; 11 U.S.C. § 541.
[53] *Id.*
[54] See Bankruptcy Code §§ 501, 502, 503, 505, 506, 507 and 726; 11 U.S.C. 501, 502, 503, 505, 506, 507 and 726.
[55] Bankruptcy Code §§ 507, 510 and 726; 11 U.S.C. § 507, 510, and 726.
[56] Bankruptcy Code § 522; 11 U.S.C. § 522.
[57] Bankruptcy Code §§ 522(b)(1) and 541; 11 U.S.C. §§ 522(b)(1) and 541.
[58] Bankruptcy Code §§ 522(b)(1); 11 U.S.C. § 522(b)(1).
[59] Bankruptcy Code § 506; 11 U.S.C. § 506.
[60] Butner v. United States, 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979).
[61] Bankruptcy Code §§ 506(a) and 1111(b); 11 U.S.C. §§ 506(a) and 1111(b).

upshot is that a single creditor may hold two different claims, a secured claim and an unsecured claim (akin to a deficiency claim under non-bankruptcy law) for purposes of distributions to be made under the Bankruptcy Code.

In exchange for the loss of pre-bankruptcy assets by a natural person, as such assets are administered for the benefit of creditors, a Chapter 7 debtor (assuming there is no exception to discharge of an individual debt or a denial of the discharge for conduct subject to sanction under the Bankruptcy Code) will receive a discharge of his or her debts.[62] The individual debtor's financial life essentially ends with the filing of a Chapter 7 bankruptcy, and, phoenix-like, a second financial life begins and the debtor gets a so-called "fresh start."[63] Obtaining a discharge[64] usually is the reason an individual files a voluntary Chapter 7 case. Corporations and other forms of business entities, including partnerships, LLCs, and LLPs are not eligible for a Chapter 7 discharge.[65] Rather, a business entity filing a Chapter 7 case generally is expected to be wound down and then dissolved under non-bankruptcy law after filing for "straight" bankruptcy under Chapter 7.[66]

[3]—Chapter 11 Cases

Chapter 11 provides for the reorganization of an entity's financial affairs.[67] Natural persons and commercial entities, including corporations, partnerships, LLPs, LLC and the like are eligible for Chapter 11 relief.[68] A Chapter 11 case may be commenced voluntarily or involuntarily, just like a Chapter 7 case.[69] Thus, for example, a financially distressed tenant may file for voluntary relief either under Chapter 7 or 11 of the Bankruptcy Code. Commercial entities may be liquidated under Chapter 11 or Chapter 7.

Chapter 11 has been enacted to provide for a debtor to reorganize its business affairs and pay debts, in whole or in part, through a Chapter 11 plan confirmed in accordance with specific statutory criteria.[70] The plan may provide for reorganization or liquidation.[71] Creditors, whose legal rights are being modified by such plan, will have an opportunity to vote to accept or reject the plan.[72]

Under Chapter 11, the debtor, whether a commercial entity or natural person, remains in control of assets as a debtor-in-possession, unless a trustee is appointed "for cause."[73] Another remedy available, to aggrieved parties where there are allegations of financial impropriety or other misconduct is the appointment of an examiner to investigate a debtor's business affairs.[74] Finally, in appropriate circumstances, a

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[62] Bankruptcy Code §§ 523, 524 and 727; 11 U.S.C. §§ 523, 524 and 727.
[63] See: Bankruptcy Code §§ 524 and 727; 11 U.S.C. §§ 524, 727.
[64] See Bankruptcy Code §§ 721 and 727; 11 U.S.C. §§ 721 and 727.
[65] See Bankruptcy Code §§ 727(a)(1), 1141(d)(2)(A); 11 U.S.C. §§ 727(a)(1), 1141(d)(2)(A).
[66] Bankruptcy Code §§ 727(a)(1); 11 U.S.C. § 727(a)(1).
[67] Bankruptcy Code §§ 1101–1146; 11 U.S.C. §§ 1101–1146.
[68] Toibb v. Radloff, 501 U.S. 157, 111 S.Ct. 2197, 115 L.Ed.2d 145 (1991).
[69] See: Bankruptcy Code §§ 301, 303 and 1101, *et seq.*; 11 U.S.C. §§ 301, 303 and 1101, *et seq*.
[70] Bankruptcy Code § 1129; 11 U.S.C. § 1129.
[71] See Bankruptcy Code §§ 1129(a) and 1141(d)(3); 11 U.S.C. §§ 1129(a) and 1141(d)(3).
[72] See Bankruptcy Code §§ 1126, 1129; 11 U.S.C. §§ 1126, 1129.
[73] See Bankruptcy Code § 1107; 11 U.S.C. § 1107.
[74] *Id.*

Chapter 11 case may be converted to a Chapter 7 case, resulting in the appointment of a Chapter 7 Trustee.[75]

[4]—Chapter 9, 12, 13, and 15 Cases

Chapter 9 of the Bankruptcy Code is used for the adjustment of debts by a municipality (cities, towns, counties, taxing districts, school districts, and others).[76] Chapter 12 of the Bankruptcy Code is used for the adjustment of debts of a family farmer or family fisherman with regular annual income.[77] Chapter 12 allows the family farmer or family fisherman to reorganize debts through a payment plan. A debtor under Chapter 12 may continue to operate the farming or commercial fishing operation as a debtor-in-possession (DIP). Relief under the provisions of Chapter 13 of the Bankruptcy Code is only available to wage earners, the self-employed, and sole proprietors (one-person businesses).[78] To qualify for Chapter 13 debtor status and relief, an individual must have regular income, have filed all required tax returns for tax periods ending within four years of the Chapter 13 bankruptcy filing, and meet other requirements set forth in the Bankruptcy Code. Chapter 15 of the Bankruptcy Code allows for the recognition in the U.S. of foreign bankruptcy proceedings and access to the domestic bankruptcy court system by foreign representatives.[79] Cases filed under these chapters of the Bankruptcy Code generally do not involve office lease issues, and a discussion of these types of cases is beyond the scope of this Chapter.

[5]—Landlords and Tenants

Bankruptcy can be an extremely complicated process. Section 365(a) of the Bankruptcy Code gives the bankruptcy trustee or debtor-in-possession the power to assume (keep) and the power to reject (disavow) executory contracts and unexpired leases entered into prior to a bankruptcy filing.[80] Assumption and rejection rights are central to the landlord and tenant relationship in many bankruptcy cases, as they are central to the relationship between a debtor and all its contractual counterparties. Congress' struggles to clarify and update the statutory scheme concerning this area of the law underscore the complex nature of the law of executory contracts and unexpired leases in bankruptcy.

Section 365 is one of the most amended sections of the Bankruptcy Code. Since its original adoption in 1978, Congress has added specific provisions to deal with shopping center leases,[81] timeshare agreements,[82] intellectual property contracts,[83] collective bargaining agreements,[84] and retirement benefits.[85] Moreover, Congress has

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[75] *Id.*
[76] 11 U.S.C. Code Chapter 9.
[77] See 11 U.S.C. Code Chapter 12.
[78] See 11 U.S.C. Code Chapter 13.
[79] See 11 U.S.C. Code Chapter 15.
[80] Bankruptcy Code § 365(a); 11 U.S.C. § 365(a).
[81] Bankruptcy Code § 365(b93); 11 U.S.C. § 365(b)(3).
[82] Bankruptcy Code § 365(h)(2) and (i); 11 U.S.C. § 365(h)(2) and (i).
[83] Bankruptcy Code § 365(n); 11 U.S.C. § 365(n).
[84] Bankruptcy Code § 1113; 11 U.S.C. § 1113.
[85] Bankruptcy Code § 1114; 11 U.S.C. § 1114.

modified provisions expressly related to the timing and process for the assumption and rejection of leases for nonresidential real property.[86]

At least since the enactment of the Bankruptcy Code, landlords and tenants have been immersed in the bankruptcy process, with debtors seeking to preserve cash in the face of disruption, including as a result of cash flow difficulties, changing macro business trends and regulatory environments. The bankruptcy statutes and rules have established a process for handling the bankruptcy estate from the filing of the bankruptcy petition to final disposition. While detailed and elaborate, the statutes and rules lack clarity with regard to any number of key concepts affecting the rights of landlords and tenants of commercial property.

Landlord and tenant representative should be well versed in the Bankruptcy Code and know their rights under the law. There is a good probability that they will be dealing directly with a bankruptcy situation as either a debtor or as a creditor during their career. It is necessary to know the process and the effects that a bankruptcy will have on the landlord/tenant relationship if one of the parties seeks protection. It is also imperative that industry participants understand the interplay between the statutory scheme and the leverage each of the parties to a commercial lease has at any given time in the business cycle. There will be times when it is a "seller's market," with available square footage at a premium because of demand. However, there are also times when the market is saturated with available space and it will be a "buyer's market," with tenants and prospective tenants having the greater leverage. Although this may appear to be obvious to anyone familiar with the business cycle, what is less obvious is how industry participants can use the tools provided by the Bankruptcy Code to their advantage.

Moreover, even without being caught up in an actual bankruptcy case, there is a great incentive for the parties to prophylactically draft their lease agreements around many bankruptcy issues. In this way, the parties can be prepared if one or the other files for bankruptcy protection during the term of a commercial lease.

[86] Bankruptcy Code § 365(d)(4); 11 U.S.C. § 365(d)(4).

§ 28.02 Principal Bankruptcy Code Sections and Rules Applicable to Commercial Leasing Transactions

[1]—Introduction

A voluntary bankruptcy case is commenced by the filing of a petition. The filing results in the entry of "an order for relief." Involuntary cases are different. They are commenced by the filing of a complaint, followed by service of a summons with such complaint.[1] In an involuntary case, an "order for relief" is not entered when the case is filed; rather, it is entered either if the "alleged" debtor converts the involuntary case to a voluntary case thereby becoming a debtor, or if the bankruptcy court determines that the statutory requirement for sustaining an involuntary petition have been satisfied by the petitioning creditors.

The principal Bankruptcy Code sections governing the rights of commercial landlords and tenants are Bankruptcy Code §§ 362, 363, 365 and 541.[2] Section 362(a) of the Bankruptcy Code provides for the automatic stay of collection efforts, effective upon the filing of most voluntary bankruptcy cases.[3] Section 362(b) lists exceptions to the automatic stay, while § 362(d) through (j) cover the process for obtaining relief from the automatic stay and related procedural matters.[4] Bankruptcy Code Section 363 governs the sale, use, and other disposition of a debtor's interest in property, including property that may be located in office space or other commercial leasehold occupied by a debtor.[5]

Section 365 of the Bankruptcy Code governs executory contracts and unexpired leases, including leases for nonresidential real (commercial) property, e.g., office leases. Such leases may be "assumed" or "rejected" by a trustee in a Chapter 7 or 11 case, or by a debtor-in-possession exercising the authority of a trustee to assume or reject in a Chapter 11 case.[6] If a lease is assumed by a tenant, the tenant retains its leasehold interest; if rejected, the tenant will lose its leasehold interest. However, upon rejection, the tenant is relieved from its obligations to perform as tenant.[7]

- Bankruptcy Code Section 541provides the statutory definition of "property estate." The property included in the definition of "property of the estate" is central to the function of the Bankruptcy Code and the applicability of many of its provisions. For example, an unexpired office lease only is subject to the effect of the automatic stay of Section 362 and the provisions of Section 363 and Section 365 of the Bankruptcy Code, if the lease in question is "property of the [bankruptcy] estate" of a debtor.[8] Every office lease or other commercial lease with a remaining "term," to which a debtor is a party, is property of such debtor's estate and an "unexpired lease" subject to the provisions of the Bankruptcy Code. Under the Bankruptcy Code, however, a nonresidential real property lease receives special treatment that has major consequences for a debtor/tenant. Pur-

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[1] Bankruptcy Code § 303(h); 11 U.S.C. § 303(h).
[2] See: Bankruptcy Code §§ 362, 363, 365 and 541; 11 U.S.C. §§ 362, 363, 365 and 541.
[3] Bankruptcy Code § 362(a); 11 U.S.C. § 362(a).
[4] See Bankruptcy Code 362(d)—(j); 11 U.S.C. § 362(d)—(j).
[5] See Bankruptcy Code § 363; 11 U.S.C. § 363.
[6] Bankruptcy Code § 365; 11 U.S.C. § 365.
[7] A complete discussion of Section 365 follows at § 28.03[3][d] *infra*.
[8] Bankruptcy Code § 541; 11 U.S.C. § 541.

suant to Sections 362(b)(10), 365(c)(3), 365(d)(4)(A) and 541(b)(2) of the Bankruptcy Code, if a lease for nonresidential real property was terminated before a bankruptcy filing so that the debtor no longer has a property interest in such lease, then Sections 362, 363 and 365 largely are inapplicable to the lease.[9]

[2]—Bankruptcy Concepts

[a]—Property of the Estate

The court in which a bankruptcy case is commenced obtains exclusive jurisdiction over any and all property of the estate.[10] Bankruptcy Code Section 541(a)[11] provides that property of the estate is composed of all of the following, "wherever located and by whomever held:"

(1) all legal and equitable interests of the debtor in property as of the commencement of the case;
(2) certain interests of the debtor and the debtor's spouse in community property as of the commencement of the case;
(3) any interest in property that the trustee recovers under enumerated provisions of the Bankruptcy Code;
(4) any interest in property preserved for or transferred to the estate under Section 510(c) (equitable subordination) or Section 551 (preservation of avoided transfer);
(5) certain interests in property acquired by the debtor or to which an entitlement arises, within 180 days after filing, by bequest, devise, inheritance, property settlement, divorce decree, life insurance policy or death benefit plan;
(6) proceeds of any of the above, except for post-petition wages in a Chapter 7 case; and
(7) property that the estate acquires after commencement of the case.

Although the term "property of the estate" for bankruptcy purposes is defined in Section 541 of the Bankruptcy Code, the nature and extent of a debtor's interest in property is determined under applicable nonbankruptcy law (state, federal, or foreign), including local real estate law affecting office leases.[12] However, whether a property interest is estate property under Section 541 is determined by application of federal bankruptcy law.[13]

Property of the estate includes non-leviable or even nontransferable rights of a debtor.[14] This is true notwithstanding that these property rights may not fall within more traditional or common law concepts of property, which usually encompass

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[9] See e.g. Moody v. Amoco Oil Co., 734 F.2d 1200, 1207 (7th Cir. 1984) ("A contract that is properly terminated pre-bankruptcy may not be revived or assumed"); In re Maxwell, 40 B.R. 231, 236 (N.D. Ill. 1984) ("Leases terminated before bankruptcy are simply not assumable by the trustee")."

[10] 28 U.S.C. § 1334(e).

[11] Bankruptcy Code § 541(a); 11 U.S.C. § 541(a).

[12] Butner v. United States, 440 U.S. 48, 55, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979).

[13] In re Haedo, 211 B.R. 149 (Bankr. S.D.N.Y. 1997).

[14] Bankruptcy Code § 541(a)(1); 11 U.S.C. § 541(a)(1).

physical property, claims to property and causes of action. For example, the broad statutory language of Section 541 encompasses the tax attributes of a debtor.[15] Undoubtedly, a debtor's interest, as tenant under an office or other commercial lease is a property interest, subject to all of the rights and burdens imposed on such interests under Sections 541, 362, 363 and 365 of the Bankruptcy Code.[16]

[b]—Exclusions from Property of the Estate

A bankruptcy estate includes only property in which a debtor has an interest. The estate's interest in specific property can be no broader than the interest of a debtor in such property, e.g., his or her share of the property.[17] Exclusions from property of the estate are listed in Section 541(b) of the Bankruptcy Code. Of specific interest with respect to office leases and other commercial leases is Section 541(b)(2), which states that property of the estate does not include:

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

[3]—Claims

The term "claim," as used in the Bankruptcy Code, means any right to payment, even if the right is not reduced to judgment and is unmatured, unliquidated, contingent or disputed.[18] For example, a right to equitable relief for breach of "performance" may constitute a claim under the Bankruptcy Code, even if the right to such equitable relief is not reduced to judgment and is unmatured, unliquidated, contingent and disputed.[19] Thus, a commercial landlord may hold a variety of claims when its tenant becomes a debtor under the Bankruptcy Code, including, for example, liquidated claims for unpaid pre-bankruptcy rent, unmatured claims for the balance of the rent reserved by the commercial lease, and disputed claims for damages allegedly caused by the tenant/debtor to the leasehold.

Certain types of equitable relief will not constitute a "Claim" as such term is defined by the Bankruptcy Code. The only time equitable relief will give rise to a claim under the Bankruptcy Code is when a right to payment is an alternative remedy for the wrong that has given rise to the right to equitable relief.[20] A party may possess a claim

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[15] In re Prudential Lines Inc., 107 B.R. 832 (Bankr, S.D.N.Y. 1989) (potential ability of a debtor-in-possession or a reorganized debtor to use tax loss carryovers to offset future taxable income is estate property).

[16] *Executory Contracts*. Property of the estate includes the debtor's interest in an executory contract, notwithstanding a nonassignability or a bankruptcy default clause. In re Computer Communications, Inc., 824 F.2d 725 (9th Cir. 1987).

[17] See In the Matter of Southmark Corp., 49 F.3d 1111 (5th Cir. 1995).

[18] See Bankruptcy Code § 101(5); 11 U.S.C. § 101(5).

[19] *Id.*

[20] *Id.*

under the Bankruptcy Code even if, under applicable nonbankruptcy law, a cause of action has not yet accrued.[21]

Generally, claims are satisfied under the Bankruptcy Code in accordance with the "absolute priority rule."[22] In the broadest sense, for purposes of distributions of estate property, the "absolute priority rule" means that secured claims are paid first, unsecured claims next and equity interests last. There are certain claims and interests afforded priority treatment within these three major categories of claims. For example, a first lien creditor is paid before a second lien creditor and a claim for rent accruing during the administration of a bankruptcy case is paid (to the extent funds are available) before most other unsecured claims.[23] Generally, equity interests receive no recovery until all claims, whether they are general unsecured claims or claims entitled to a priority, are paid in full.

The specific provisions of the Bankruptcy Code creating a priority scheme (most notably Sections 503(b),507(a) and 726(a) apply only to unsecured claims. Priorities among secured claims and liens generally are governed by applicable nonbankruptcy law.[24] The highest priority unsecured claim cannot be paid out of secured creditor's collateral, until such secured creditor has been paid in full, the bankruptcy court surcharges the secured creditor's collateral has agreed to "carve out" payments from its collateral for the benefit of junior creditors, including unsecured creditors, whether the claims they hold are priority claims, or basic general unsecured claims.[25] Thus, with respect to the office leases and other commercial leases, rent accruing during the pending of bankruptcy case cannot be paid out of a tenant's accounts receivable (which is cash collateral, subject to a lenders interest) without the consent of the secured creditor or a court order authorizing and directing such payment.[26]

A debtor/tenant must timely perform its obligations under a lease of nonresidential real property, including an office lease, until such time as the lease either is assumed or rejected.[27] Although not expressly set forth in the Bankruptcy Code, many courts construe this directive as a grant to lessors of a *de facto* "super-priority" claim, requiring payment of rent during the pendency of the bankruptcy case as and when a periodic payment is due.[28] Priority claims generally only are paid on the effective date of a plan of reorganization confirmed by a bankruptcy court or as directed by a court after notice and a hearing. Other courts disagree with this approach.

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[21] *Id.*

[22] Bankruptcy Code §§ 507, 726(a) and 1129(b); 11 U.S.C. §§ 507, 726(a) and 1129(b).

[23] Bankruptcy Code § 507(a)(2); 11 U.S.C. § 507(a)(2).

[24] Butner v. United States, 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979).

[25] Bankruptcy Code §§ 505, 506 and 507; 11 U.S.C. §§ 505, 506 and 507.

[26] Bankruptcy Code § 363(a) and (b); 11 U.S.C. § 363(a) and (b).

[27] Bankruptcy Code § 365(d)(3); 11 U.S.C. § 365(d)(3).

[28] The debtor's obligations under § 365(d)(3) are made expressly independent of the normal standards for administrative expense claims under § 503(b)(1) and constitute an administrative expense payable without notice and a hearing.

First Circuit: In re Rare Coin Galleries of America, Inc., 72 B.R. 415 (D. Mass. 1987).

Second Circuit: In re Coastal Dry Dock & Repair Corp., 62 B.R. 879, 883 (Bankr. E.D.N.Y. 1986).

Fifth Circuit: In re Amber's Stores, Inc., 193 B.R. 819 (Bankr. N.D. Tex. 1996).

But see:

Sixth Circuit: In re ABC Books & School Supplies, 121 B.R. 329 (Bankr. S.D. Ohio 1990).

Currently, there are ten categories of unsecured claims assigned priority status, in descending order of priority, under Section 507(a) of the Bankruptcy Code.

(a) The following expenses and claims have priority in the following order:

(1) First:

(A) Allowed unsecured claims for domestic support obligations that, as of the date of the filing of the petition in a case under this title, are owed to or recoverable by a spouse, former spouse, or child of the debtor, or such child's parent, legal guardian, or responsible relative, without regard to whether the claim is filed by such person or is filed by a governmental unit on behalf of such person, on the condition that funds received under this paragraph by a governmental

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Ninth Circuit: In re Cukierman, 265 F.3d 846, 850–51 (9th Cir. 2001); In re Pacific Atlantic Trading Co., 27 F.3d 401 (9th Cir. 1994); In re Leisure Time Sports, 189 B.R. 511 (Bankr. S.D. Cal. 1995); In re MS Freight Distribution, 172 B.R. 976 (Bankr. W.D. Wash. 1994).

After reading In re Klein Sleep Products Inc., 78 F.3d 18 (2d Cir. 1996) and In re Burger Boys Inc., 94 F.3d 755 (2d Cir. 1996), one cannot be sure of the Second Circuit's opinion of the relationship of sections 365(d)(3) and 503(b)(1). Commercial landlords were entitled to immediate payment in full during the pre-assumption or rejection administration period, without the possibility of disgorgement, to permit a debtor to carry out a "high risk" reorganization strategy. *In re Rich's Department Stores, Inc.*, 209 B.R. 810 (Bankr. D. Mass. 1997). Such payments were necessary to carry out prior orders of the Court and to prevent the lessors from being forced to share their administrative rent *pari passu* with counsel for the debtor, who counseled the debtor to disregard prior Court orders requiring payments to the lessors. *Id.* Thus, the *Rich's* Court did not reach the issue of whether nonresidential lessors are entitled to payment in full, even where there are not enough funds available to pay other costs of administration in full. *Id.*

Section 365(d)(3), according to most courts, does not afford automatic super priority status to post-petition, pre-rejection, non-residential real property rent claims. See:

First Circuit: In re MJ 500, Inc., 217 B.R. 93 (Bankr. D. Mass. 1998); In re J.T. Rapps, Inc., 225 B.R. 257 (D. Mass. 1998).

Second Circuit: In re Microvideo Learning Systems, Inc., 254 BR. 90, 92–93 (S.D.N.Y. 1999); In re Wingspread Corp., 116 B.R. 915 (Bankr. S.D.N.Y. 1990); see In re Pudgie's Development of New York, Inc., 239 B.R. 688, 694 (S.D.N.Y. 1999) (holding that landlord is entitled to immediate payment under Section 365(d)(3) and court may not order disgorgement of payments, but when estate is administratively insolvent, unpaid rent does not have super-priority status).

Third Circuit: In re Nutri/System of Florida Associates, 178 B.R. 645, 655 (E.D. Pa. 1995); In re U.S. Fax, Inc., 114 B.R. 70, 74 n.4 (E.D. Pa. 1990).

Eleventh Circuit: In re Food Etc., L.L.C., 281 B.R. 82, 88 (Bankr. S.D. Ala. 2001).

However, a number of courts approve super-priority status for unpaid pre-assumption or rejection rent. See:

First Circuit: In re McCabe, 212 B.R. 21 (Bankr. D. Mass. 1996).

Seventh Circuit: In re Telesphere Communications, Inc., 148 B.R. 525, 531 (Bankr. N.D. Ill. 1992) (holding that operational payments, including rent payments under Section 365(d)(3), are entitled to a de facto super-priority because they are not subject to disgorgement).

Ninth Circuit: In re Leisure Time Sports, Inc., 189 B.R. 511, 513 (Bankr. S.D. Cal. 1995) (declining to require landlord to disgorge payments and recognizing "special priority" of payments under a commercial lease).

unit under this title after the date of the filing of the petition shall be applied and distributed in accordance with applicable nonbankruptcy law.

(B) Subject to claims under subparagraph (a), allowed unsecured claims for domestic support obligations that, as of the date of the filing of the petition, are assigned by a spouse, former spouse, child of the debtor, or such child's parent, legal guardian, or responsible relative to a governmental unit (unless such obligation is assigned voluntarily by the spouse, former spouse, child, parent, legal guardian, or responsible relative of the child for the purpose of collecting the debt) or are owed directly to or recoverable by a governmental unit under applicable nonbankruptcy law, on the condition that funds received under this paragraph by a governmental unit under this title after the date of the filing of the petition be applied and distributed in accordance with applicable nonbankruptcy law.

(C) If a trustee is appointed or elected under Section 701, 702, 703, 1104, 1202, or 1302, the administrative expenses of the trustee allowed under paragraphs (1)(A), (2), and (6) of Section 503(b) shall be paid before payment of claims under subparagraphs (a) and (b), to the extent that the trustee administers assets that are otherwise available for the payment of such claims.

(2) Second, administrative expenses allowed under Section 503(b) of this title, unsecured claims of any federal reserve bank related to loans made through programs or facilities authorized under Section 13(3) of the Federal Reserve Act (12 U.S.C. § 343),[1] and any fees and charges assessed against the estate under Chapter 123 of title 28.

(3) Third, unsecured claims allowed under Section 502(f) of this title.

(4) Fourth, allowed unsecured claims, but only to the extent of $10,000 for each individual or corporation, as the case may be, earned within 180 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first, for—

(A) wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by an individual; or

(B) sales commissions earned by an individual or by a corporation with only 1 employee, acting as an independent contractor in the sale of goods or services for the debtor in the ordinary course of the debtor's business if, and only if, during the 12 months preceding that date, at least 75 percent of the amount that the individual or corporation earned by acting as an independent contractor in the sale of goods or services was earned from the debtor.

(5) Fifth, allowed unsecured claims for contributions to an employee benefit plan—

(A) arising from services rendered within 180 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first; but only

(B) for each such plan, to the extent of—

(i) the number of employees covered by each such plan multiplied by $10,000; less

(ii) the aggregate amount paid to such employees under paragraph (4) of this subsection, plus the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan.

(6) Sixth, allowed unsecured claims of persons—

(A) engaged in the production or raising of grain, as defined in Section 557(b) of this title, against a debtor who owns or operates a grain storage facility, as defined in Section 557(b) of this title, for grain or the proceeds of grain, or

(B) engaged as a U.S. fisherman against a debtor who has acquired fish or fish produce from a fisherman through a sale or conversion, and who is engaged in operating a fish produce storage or processing facility—

but only to the extent of $4,000 for each such individual.

(7) Seventh, allowed unsecured claims of individuals, to the extent of $1,800 for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided.

(8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for—

(A) a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition—

(i) for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;

(ii) assessed within 240 days before the date of the filing of the petition, exclusive of—

(I) any time during which an offer in compromise with respect to that tax was pending or in effect during that 240-day period, plus 30 days; and

(II) any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days; or

(iii) other than a tax of a kind specified in Section 523(a)(1)(B) or 523(a)(1)(C) of this title, not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case;

(B) a property tax incurred before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition;

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity;

(D) an employment tax on a wage, salary, or commission of a kind specified in paragraph (4) of this subsection earned from the debtor before the date of the filing of the petition, whether or not actually paid before such date, for which a return is last due, under applicable law or under any extension, after three years before the date of the filing of the petition;

(E) an excise tax on—

(i) a transaction occurring before the date of the filing of the petition for which a return, if required, is last due, under applicable law or under any extension, after three years before the date of the filing of the petition; or

(ii) if a return is not required, a transaction occurring during the three years immediately preceding the date of the filing of the petition;

(F) a customs duty arising out of the importation of merchandise—

(i) entered for consumption within one year before the date of the filing of the petition;

(ii) covered by an entry liquidated or reliquidated within one year before the date of the filing of the petition; or

(iii) entered for consumption within four years before the date of the filing of the petition but unliquidated on such date, if the Secretary of the Treasury certifies that failure to liquidate such entry was due to an investigation pending on such date into assessment of antidumping or countervailing duties or fraud, or if information needed for the proper appraisement or classification of such merchandise was not available to the appropriate customs officer before such date; or

(G) a penalty related to a claim of a kind specified in this paragraph and in compensation for actual pecuniary loss.

An otherwise applicable time period specified in this paragraph shall be suspended for any period during which a governmental unit is prohibited under applicable nonbankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days; plus any time during which the stay of proceedings was in effect in a prior case under this title or during which collection was precluded by the existence of 1 or more confirmed plans under this title, plus 90 days.

(9) Ninth, allowed unsecured claims based upon any commitment by the debtor to a Federal depository institutions regulatory agency (or predecessor to such agency) to maintain the capital of an insured depository institution.

(10) Tenth, allowed claims for death or personal injury resulting from the operation of a motor vehicle or vessel if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance.

(b) If the trustee, under section 362, 363, or 364 of this title, provides adequate protection of the interest of a holder of a claim secured by a

lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under subsection (a)(2) of this section arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from the granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim allowable under such subsection.

(c) For the purpose of subsection (a) of this section, a claim of a governmental unit arising from an erroneous refund or credit of a tax has the same priority as a claim for the tax to which such refund or credit relates.

(d) An entity that is subrogated to the rights of a holder of a claim of a kind specified in subsection (a)(1), (a)(4), (a)(5), (a)(6), (a)(7), (a)(8), or (a)(9) of this section is not subrogated to the right of the holder of such claim to priority under such subsection.

The second priority created by Section 507, as set forth above, benefits all "administrative expenses" allowed under Section 503(b). This priority is of special interest to landlords, as rent accruing during the pendency of a bankruptcy case, at the very least, gives rise to a second priority claim, as a cost of administration.

Administrative expenses under Section 503(b) include, among other things:

(1) all actual, necessary costs and expenses of preserving the estate, including wages, salaries, commissions, costs incurred in the post petition operation of the debtor's business, wages and benefits awarded pursuant to a judicial or NLRB proceeding, liabilities incurred in the ordinary course of the debtor's post petition business (including amounts owed to vendors and suppliers that have sold goods or furnished services), and liabilities arising under post petition loans or advances to the debtor;

(2) all post petition taxes (including, in some cases, fines and penalties associated therewith);

(3) all fees and expenses of retained professionals (including professionals retained by any committees);

(4) the actual and necessary expenses of creditors who file an involuntary petition against the debtor;

(5) the actual and necessary expenses of a creditor who, with the approval of the court, recovers property of the estate that was concealed or transferred;

(6) the actual and necessary expenses of a creditor incurred in a related criminal prosecution;

(7) the actual, necessary expenses, other than compensation and reimbursement, incurred by any creditor, indenture trustee or equity holder that makes a "substantial contribution" to the debtor's case (any such entity must apply for payment to the court demonstrating, among other things, its substantial contribution to the case);

(8) the expenses and fees of a prepetition custodian;

(9) reasonable compensation and reimbursement to professionals of the creditors referred to immediately above and to indenture trustees making a substantial contribution to the case (also necessary applications);

(10) witness fees and mileage expenses;

(11) monetary obligations due with respect to a nonresidential real property lease;

(12) the costs and expenses of closing a health care business incurred by a trustee or agency; and

(13) value of goods received (in the ordinary course of the debtor's business) by the debtor within twenty days before the commencement of a case.[29]

[4]—The Automatic Stay

[a]—Bankruptcy Code Section 362(a)

The automatic stay operates as an *ex parte* injunction against collection efforts, binding upon the world, without a need to show the elements ordinarily required for the issuance of a temporary restraining order, including irreparable injury.[30] The stay applies upon the filing either of a voluntary or an involuntary case.[31] In addition to collection efforts, the stay prohibits a creditor from taking actions that inevitably would have an adverse effect on property of the estate.[32]

The stay is designed to shield debtors from financial pressure.[33] Thus, any exceptions to the automatic stay should be read narrowly.[34] The stay covers a debtor's property situated inside and outside the territory of the United States.[35]

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[29] Bankruptcy Code § 503(b); 11 U.S.C. § 503(b).

[30] Hudson Valley Cablevision Corp. v. Route 202 Developers, Inc., 169 B.R. 531 (S.D.N.Y. 1994). The automatic stay is codified in Bankruptcy Code § 362(a); U.S.C. § 362(a).

[31] *First Circuit: In re* Great Northern Paper, Inc., 318 B.R. 613, 613 n.3 (D. Me. 2005).

Second Circuit: In re Delta Air Lines, 359 B.R. 454, 459 (Bankr. S.D.N.Y. 2006);

LNC Investments, Inc. v. First Fidelity Bank, 247 B.R. 38, 43 (S.D.N.Y. 2000); Kommanditselskalb Supertrans v. O.C.C. Shipping Lines, 79 B.R. 534, 540 (S.D.N.Y. 1987).

Third Circuit: Interpool, Ltd. v. Certain Freights of the M/Vs Venture Star, Mosman Star, Fjord Star, Lakes Star, Lily Star, 878 F.2d 111, 112 n.4 (3d Cir. 1989).

Fourth Circuit: Equal Employment Opportunity Commission v. McLean Trucking Co., 834 F.2d 398, 399 (4th Cir. 1987).

Fifth Circuit: In re Edwin A. Epstein, Jr. Operating Co., 314 B.R. 591, 600 (Bankr. S.D. Tex. 2004*);* In re Williams, 195 B.R. 644, 647 (Bankr. N.D. Tex. 1996); see In re MortgageAmerica Corp., 714 F.2d 1266, 1273 (5th Cir. 1983).

Ninth Circuit: In re E.D. Willkins Grain Co., 235 B.R. 647, 649 (Bankr. E.D. Cal. 1999).

Bankruptcy Code §§ 362(b)(21), 109(g), 362(c)(3) and 362(d)(4); 11 U.S.C. §§ 362(b)(21), 109(g), 362(c)(3) and 362(d)(4) (limits on the application of the automatic stay).

But see In re Acelor, 169 B.R. 764, 765 (Bankr. S.D. Fla. 1994).

[32] In re Prudential Lines, Inc., 119 B.R. 430 (S.D.N.Y.), *aff'd* 928 F.2d 565 (2d Cir.), *cert. denied* PSS S.S. Co., Inc. v. Unsecured Creditors, 502 U.S. 821 (1991).

[33] In re Stringer, 847 F.2d 549 (9th Cir. 1988).

[34] *Id.*, *accord* In re Shamblin, 878 F.2d 324 (9th Cir. 1989) ("any equitable exception . . . should be narrow and applied only in extreme circumstances").

[35] In re Nakash, 190 B.R. 763 (Bankr. S.D.N.Y. 1996).

The stay shields a debtor and its property from collection efforts, but it does not extinguish or discharge any debt.[36] The stay creates no greater rights for a debtor, than those it has outside of bankruptcy.[37]

Bankruptcy courts may vacate the stay in appropriate circumstances to permit a party to exercise rights and remedies, although the bankruptcy court itself will not enforce such rights and remedies.[38] Landlords, including lessees of commercial space, after obtaining relief from the stay from a bankruptcy court, in most jurisdictions, will have to go to the appropriate nonbankruptcy court to obtain a warrant of eviction. When a lease has been rejected or terminated, many bankruptcy courts will direct landlords of office leases and other landlords to proceed in the state courts to effect rights and remedies. Some courts have found that the language of Section 365(d)(4) of the Bankruptcy Code requires a debtor/tenant and any subtenants who claim an interest in the premises to immediately surrender the premises upon rejection of a lease, without the necessity of any eviction proceedings under state law.[39] Others have held to the contrary.[40]

The automatic stay does not enjoin a debtor from prosecuting a pending appeal of an unfavorable jury verdict in a wrongful termination action, but it does stay the plaintiff employee's cross-appeal challenging the adequacy of a jury award.[41] This holding, although made in the employment area, applies to office leasing, and it is easy to see how this principle applies to landlord and tenant litigation that is subject to appellate

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[36] Franklin Savings Ass'n v. Office of Thrift Supervision, 31 F.3d 1020, 1022 (10th Cir. 1994) (quoting Pennsylvania Dep't of Public Welfare v. Davenport, 495 U.S. 552, 110 S. Ct. 2126, 109 L. Ed. 2d 588 (1990).

[37] In re Synergy Development Corp., 140 B.R. 958 (Bankr. S.D.N.Y. 1992).

[38] In re Inge, 158 B.R. 326 (Bankr. E.D.N.Y. 1993).

[39] See:

First Circuit: In re Criadores De Yabucoa, Inc., 75 B.R. 96, 97 (Bankr. D.P.R. 1987).

Second Circuit: In re Kong, 162 B.R. 86, 97–98 (Bankr. E.D.N.Y. 1993); In re O.P. Held, Inc., 77 B.R. 388, 391 (Bankr. N.D.N.Y. 1987); In re Westview 74th Street Drug Corp., 59 B.R. 747, 752 (Bankr. S.D.N.Y. 1986).

Sixth Circuit: In re Hurst Lincoln-Mercury, Inc., 70 B.R. 815, 817 (Bankr. S.D. Ohio 1987).

Ninth Circuit: In re Elm Inn, Inc., 942 F.2d 630, 633–634 (9th Cir. 1991); In re Southwest Aircraft Service, Inc., 53 B.R. 805, 809–810 (Bankr. C.D. Cal. 1985), *aff'd* 66 B.R. 121 (9th Cir. 1986), *rev'd on other grounds,* 831 F.2d 848 (9th Cir. 1987), *cert. denied,* 487 U.S. 1206 (1988).

Tenth Circuit: In re Duckwall-Alco Stores, Inc., 150 B.R. 965, 972 (D. Kan. 1993).

Eleventh Circuit: In re The Deli Den, LLC, 425 B.R. 725, 727 (Bankr. S.D. Fla. 2010); In re 6177 Realty Associates, Inc., 142 B.R. 1017 (S.D. Fla. 1992).

[40] See, e.g.:

Third Circuit: In re Adams, 65 B.R. 646, 648–649 (Bankr. E.D. Pa. 1986).

Eleventh Circuit: In re Williams, 171 B.R. 420, 421 (Bankr. S.D. Ga. 1994).

[41] In Simon v. Navon, 116 F.3d 1 (1st Cir. 1997), a conversion action brought by secured creditor to recover proceeds of a Chapter 7 debtor's accounts receivable that allegedly were diverted to an affiliate of the debtor, a competing secured creditor, was not stayed; though the accounts may once have been "property of the estate," they could not be considered "property of the estate" for purposes of Section 362, until such time as they were recovered. See also, Bank Brussels Lambert v. Credit Lyonnais (Suisse) S.A., 192 B.R. 73 (S.D.N.Y. 1996).

review. The prosecution of claims that were or could have been asserted before the filing of a bankruptcy case by a commercial landlord against the now debtor tenant, is automatically stayed.[42] Thus, a landlord's action to enforce rights and remedies under an office lease may be stayed so long as the landlord and tenant relationship has not been terminated.[43] The stay, however, does not apply to actions on claims arising against a debtor while its bankruptcy case is being administered.[44]

[b]—Landlords/Tenants and the Automatic Stay

The filing by a tenant of a voluntary bankruptcy case stays its landlords from terminating or exercising remedies ordinarily available to landlords.[45] With few exceptions, legal actions are stayed or suspended until the bankruptcy case is concluded or the stay is vacated.[46] However, as noted below, if the lease term expires before the commencement of a bankruptcy case, or if the lease term expires during the course of the bankruptcy case, the automatic stay may not (or may no longer) apply.[47]

[c]—Obtaining Relief from the Automatic Stay: Statutory Requirements

Section 362(d) provides a creditor, including a landlord, with the means to seek judicial relief from the stay that is automatically imposed upon the filing of a bankruptcy case in appropriate circumstances.[48] Section 362(d) includes four subsections, each of which sets forth a different path to stay relief; the subsections of Section 364(d) are drafted in the disjunctive, so that a party seeking relief need only satisfy the requirements of one of the four subsections to obtain the relief it seeks.[49]

Aggrieved commercial landlords may be able to obtain stay relief under subsection 362(d)(1) for "cause shown."[50] Cause is not defined anywhere in the Bankruptcy Code, but it may include virtually any act that impinges on a landlord's right to the peaceful use of his or her property.

Section 362(d)(2) provides that a party may obtain relief if "(A) the debtor does not have an equity in such property; and (B) such property is not necessary for an effective reorganization." For the stay to be lifted under Section 362(d)(2), both prongs of

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[42] In re Johns-Manville Corp., 57 B.R. 680 (Bankr. S.D.N.Y. 1986).

[43] Bankruptcy Code § 362(b)(23); 11 U.S.C. § 362(b)(23).

[44] In re A. Tarricone, Inc., 77 B.R. 430 (Bankr. S.D.N.Y. 1987). See also, In re Chateaugay Corp., 86 B.R. 33 (S.D.N.Y. 1987).

[45] Bankruptcy Code § 362(a); 11 U.S.C. § 362(a).

[46] Bankruptcy Code § 362(b)(10); 11 U.S.C. § 362(b)(10).

[47] See § 28.03[3][d] *infra*.

[48] Relief from the stay is available under subsections (d)(1), (d)(2), (d)(3) and (d)(4). Bankruptcy Code § 362(d); 11 U.S.C. § 362(d). Each of these subsections provides for relief from the stay on different grounds. *Id.*

[49] In re Touloumis, 170 B.R. 825 (Bankr. S.D.N.Y. 1994) (citing In re de Kleiman, 156 B.R. 131, 136 (Bankr. S.D.N.Y. 1993); In re Diplomat Electronics Corp., 82 B.R. 688, 692 (Bankr. S.D.N.Y. 1988)).

[50] Section 362(d)(1) provides that on request of a party in interest, the stay may be lifted, "for cause, including the lack of adequate protection of an interest in property of such party in interest." See Bankruptcy Code § 362(d)(1); 11 U.S.C. § 362(d)(1).

the test must be satisfied.[51] In determining whether property is essential for effective reorganization, the court must determine whether an effective reorganization plan is in prospect.[52] However, the court need not determine whether a plan is confirmable; only whether the components of the plan are workable.[53]

Section 362(d)(3) applies only to single asset real estate cases, and allows the court to provide relief from the stay if certain debtor actions were not taken within ninety days after the order for relief was entered "or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later."

The purpose of the requirement that the plan be filed within ninety days in a single asset real estate case is: (1) to impose an expedited time frame in this type of case, and (2) to provide that the stay be lifted without *"further ado"* if a plan is not filed within that time frame.[54]

Bankruptcy Code Section 362(d)(4) provides relief from a stay of an act against real property under subsection (a) by a creditor whose claim is secured by an interest in such real property if the court finds that the filing of the petition was part of a scheme to delay, hinder and defraud creditors that involved either transfer of all or part interest in the property without consent of the secured creditor or court approval, or multiple bankruptcy filings affecting such real property. An order under Section 362(d)(4) is binding in any other case purporting to affect the property, filed within two years of the date of the entry of the order by the court providing for stay relief. One exception to the two-year rule is if a debtor in a subsequent case moves for relief from the Section 362(d)(4) order to extend the stay, based on changed circumstances or for good cause shown, after notice and a hearing.

[d]—The Effect of Dismissal, Discharge, Plan Confirmation, and Other Code Provisions on the Automatic Stay

The stay is dissolved upon dismissal of a case.[55] In contrast, the discharge of a debtor in an individual under Chapter 7 of the Bankruptcy Code serves to convert the automatic stay, which is in the nature of a temporary injunction, into a permanent

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[51] In re New Era Co., 125 B.R. 725 (S.D.N.Y. 1991).

[52] In re Ritz-Carlton D.C., Inc., 98 B.R. 170 (S.D.N.Y. 1989).

[53] *Id.*

[54] In re Kkemko, Inc., 181 B.R. 47 (Bankr. S.D. Ohio 1995). See also, In re Philmont Development Co., 181 B.R. 220 (Bankr. E.D. Pa. 1995) (concluding debtor's series of semidetached houses constituted a "single project," and, thus, constituted "single asset real estate," and, accordingly, mortgagee was entitled to relief from the automatic stay since debtor had not filed a reorganization plan within ninety days of entry of orders for relief).

[55] *First Circuit:* Lamagno v. Salomon Brothers Realty Corp., 320 B.R. 473, 478 (B.A.P. 1st Cir. 2005).

Third Circuit: Haymaker v. Green Tree Consumer Discount Co., 166 B.R. 601, 608 (Bankr. W.D. Pa. 1994).

Fifth Circuit: Browning v. Navarro, 743 F.2d 1069, 1083 (5th Cir. 1984); In re Edwin A. Epstein Jr. Op. Co., 314 B.R. 591, 601 (Bankr. S.D. Tex. 2004).

Sixth Circuit: Webb MTN, LLC v. Exec. Realty Partnership, L.P. (In re Webb MTN, LLC), 420 B.R. 418, 429 (Bankr. E.D. Tenn. 2009).

Ninth Circuit: In re Watson, 192 B.R. 739, 749 (B.A.P. 9th Cir. 1996).

injunction, i.e. a discharge, which serves to prohibit creditors from collecting monies on the debts discharged.[56] Similarly, upon confirmation of a Chapter 11 plan of reorganization, the stay is terminated.[57] However, claims dealt with by such plan, including those discharging debts and enjoining collection and enforcement efforts against a reorganized debtor and its property, can serve to bar collection efforts just as a discharge of an individual does in a Chapter 7 case.[58] For example, once a bankruptcy case is dismissed, the bankruptcy court loses its jurisdiction to determine the effect of its order granting stay relief entered at the request of one secured creditor while a case was pending, on the rights of that creditor vis-à-vis a junior secured creditor in a mortgage foreclosure action.[59]

[e]—The Use, Lease, or Sale of the Property During the Pendency of a Bankruptcy Case

Section 363 governs the terms and conditions for the use, lease or sale of the property during a bankruptcy case by a debtor-in-possession or trustee and describes when "adequate protection" is required. Some courts have held a landlord is not entitled to "adequate protection" under Section 363 of the Bankruptcy Code but has its exclusive rights and remedies under Section 365.[60] Recently, the interplay of Sections 363 and 365 has been subject to much academic discussion.

But see In re Wytch, 223 B.R. 190 (B.A.P. 9th Cir. 1998), *rev'd without opinion* 213 F.3d 645 (9th Cir. 2000) (inadvertent dismissal of a Chapter 7 case as a result of a clerical error did not serve to vacate a prior bankruptcy Court order annulling the stay).

[56] Green v. Welsh, 956 F.2d 30 (2d Cir. 1992).

[57] In re Brady Texas Municipal Gas Corp., 936 F.2d 212 (5th Cir. 1991), *cert. denied*, 502 U.S. 1013 (1991).

[58] *Id.*

[59] In re Fisher, 242 B.R. 908 (Bankr. E.D. Tex. 1999).

[60] See In re Sweetwater, 40 B.R. 733 (Bankr. Utah 1984), *aff'd* 57 B.R. 743 (D. Utah 1985). But see, In re Grant Broadcasting of Philadelphia, Inc., 71 B.R. 891 (E.D. Pa. 1987).

§ 28.03 Leases and Contracts: The Effect of Bankruptcy

[1]—Options Available to the Trustee/Debtor-in-Possession

The power of a bankruptcy trustee to "assume" (keep or affirm) or "reject" (disavow) executory contracts and unexpired leases entered into prior to bankruptcy is set forth in Section 365(a).[1] A debtor-in-possession, in a Chapter 11 case, standing in the shoes of the bankruptcy trustee, is vested with this power.[2]

The concept of rejection has its roots in the principle that the bankruptcy trustee should be able to abandon burdensome property.[3] Debtors-in possession and trustees have two additional powerful tools to use to modify obligations existing under executory contracts and unexpired leases for real and personal property,: (1) the right to assume a contract or lease by curing defaults, notwithstanding a provision in the affected contract or lease providing for termination due to a bankruptcy filing or other insolvency event, and (2) the right to assign such contract or lease, notwithstanding a provision restricting assignment.[4] However, the benefits of assumption and of assumption and assignment come at the cost of meeting the requirements for assumption and assignment to occur imposed by Section 365. ~~.~~Additionally, the non-debtor party, such as a lessee of personal or real property is entitled to "adequate assurance of future performance" of the debtor's ongoing obligations under the subject contract or lease. Also, a debtor-in-possession or trustee must cure existing defaults and pay damages arising from a breach under the contract or lease being assumed and then "live in accordance with the remaining provisions. . . ."[5]

Landlords of commercial real estate have certain protections under the Bankruptcy Code not generally ~~availavle~~available to other non-debtor counterparties.[6] Principally, commercial leases of non-residential real property must be assumed or rejected before the earlier of 120 days from the entry of an order for relief or confirmation of a Chapter 11 plan.[7] **In December 2020, in response to the economic dislocation engendered by the COVID-19 pandemic, Congress enacted the CAA,[8] which in part, amends Section 365(d)(4)(A) of the Bankruptcy Code to give the debtor-in possession or the trustee 210 days after the order for relief to assume an**

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[1] Bankruptcy Code § 365(a); 11 U.S.C. § 365(a).

[2] See Bankruptcy Code § 1107(a); 11 U.S.C. § 1107(a) ("a debtor in possession . . . shall perform all the functions and duties . . . of a trustee serving in a case under this chapter").

[3] United States v. Dewey Freight Systems, 31 F.3d 620, 621 (8th Cir. 1994) ("damage caused by rejection is a prepetition claim, so that it will not burden the reorganizing enterprise").

[4] Bankruptcy Code § 365(a)(6) and (f); 11 U.S.C. § 365(a)(6) and (f). See also, In re U.L. Radio Corp., 19 B.R. 537, 543 (Bankr. S.D.N.Y. 1982) (Section 365(f) gives the power to the courts to render unenforceable any provision in an agreement that has the sole effect of restricting assignment).

[5] In re Pine Oaks Apartments, 7 B.R. 364, 367 (Bankr. S.D. Tex. 1980) ("[T]he remaining rights of the non-debtor party to unexpired leases must be accorded the full benefit of their bargain.").

[6] See Bankruptcy Code § 365(d)(4); 11 U.S.C. § 365(d)(4).

[7] Bankruptcy Code § 365(d)(4)(A); 11 U.S.C. § 365(d)(4)(A).

[8] The amendments to the Bankruptcy Code are set forth in Sections 320 and 1001 of the Consolidated Appropriations Act. The Consolidated Appropriations Act also contains certain technical corrections to the Bankruptcy Code. See Consolidated Appropriations Act of 2021, Pub. L. No. 116-260 § 1001.

unexpired non-residential real property lease, thereby extending the period under prior law by an additional 90 days. This change applies to cases under all chapters, and it sunsets in two years on December 27, 2022.[9] Subject to the temporary change included in CCA, such 120-day period **(now 210)** may be extended for a period not to exceed 90 days for "good cause."[10] No further extensions beyond 210 days are permitted without the landlord's written consent.

Prior to assumption or rejection and after the filing of a bankruptcy case, executory contracts and unexpired leases entered into by a debtor prior to the filing of a bankruptcy case remain in existence and enforceable by the debtor-in-possession or trustee, but generally are not enforceable against the debtor-in possession or trustee.[11] Section 365 does impose certain performance oblivions on debtors-in-possession and trustees during this interim period. For example, with respect to leases for nonresidential real property, section 365(d)(3) provides that the trustee "shall timely perform all the obligations of the debtor" arising after the petition is filed and before the lease is assumed or rejected. Moreover, the Bankruptcy Code provides debtors-in-possession and trustees with the means to compel third parties to continue doing business with them when a bankruptcy filing might otherwise cause a non-debtor party to be reluctant to do so.[12]

[2]—Underlying Disputed Contract Issues

Any underlying disputed issue regarding the validity of a commercial lease, or whether a party has breached, at least in the Second Circuit, is not to be resolved in the context of a motion to assume or reject, since such motions are to be dealt with expeditiously.[13]

[3]—Is a Certain Lease or Contract "Executory" or "Unexpired" for the Purposes of Bankruptcy Code Section 365?

[a]—"Executory Contracts" and "Unexpired Leases"—No Statutory Definitions

The Bankruptcy Code neither defines nor attempts to define "executory contract" and "unexpired lease." However, the House report on Section 365 indicates that the term "generally includes contracts on which performance remains due to some extent on both sides."[14] The Supreme Court, citing the legislative history, has characterized an executory contract as one "on which performance is due to some extent on both sides."[15]

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[9] Bankruptcy Code § 365(d)(4)(B)(ii); 11 U.S.C. § 365(d)(4)(B)(ii).

[10] Bankruptcy Code § 365(o)(4)(B)(i); 11 U.S.C. § 365(o)(4)(B)(i).

[11] United States v. Dewey Freight Systems, 31 F.3d 620 (8th Cir. 1994).

[12] See In re Bridgeport Jai Alai, Inc., 215 B.R. 651 (Bankr. D. Conn. 1997).

[13] Orion Pictures Corp. v. Showtime Networks, Inc. (In re Orion Pictures Corp.), 4 F.3d 1095 (2d Cir. 1993), *cert. dismissed* 511 U.S. 1026 (1994). But see, e.g., In re National Sugar Refining Co., 21 B.R. 196 (Bankr. S.D.N.Y. 1982). "Any such underlying dispute may only be resolved in a separate plenary proceeding."

[14] *Id.* See H.R. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 6303–6304.

[15] NLRB v. Bildisco & Bildisco, 465 U.S. 513, 522 n.6, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984).

[b]—The Countryman Definition

The following definition, which has been adopted by many courts, is the most widely cited definition of "executory contract" for purposes of the Bankruptcy Code.[16] An executory contract is—

> "a contract under which the obligation of both the bankrupt and other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."[17]

Many courts have adopted the "Countryman" definition and have held various types of contracts to be executory, thereby allowing a debtor-in-possession or trustee to assume, assign or reject such contracts and leases.[18]

[c]—The Functional Approach

A number of courts have eschewed the Countryman definition as too rigid and have followed a more result-oriented approach.[19] Taking this approach, courts focus on whether the estate will benefit from the assumption or rejection.[20] Courts employing the "functional" approach consider the purpose behind permitting a debtor-in-possession or trustee to assume or reject a contract or lease, and, rather than focusing on the dictionary definition of "executory contract," analyze whether rejection or assumption will benefit the estate.[21] In addition to criticizing the rigidity of the Countryman definition, several courts have criticized its failure to further the goals of the Bankruptcy Code of maximizing the value of the estate assets.[22]

Employing this type of benefit/burden analysis, in many cases, will result in the same outcome as applying the Countryman analysis. For example, when rejecting an

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[16] See, e.g.: Countryman, "Executory Contracts In Bankruptcy: Part I," 57 Minn. L. Rev. 439, 460 (1973); Countryman, "Executory Contracts In Bankruptcy: Part II," 58 Minn. L. Rev. 479 (1974). See also, e.g., In re Knutson, 563 F.2d 916 (8th Cir. 1977) (adopts Countryman definition).

[17] *Id.*

[18] See, e.g.:

Second Circuit: In re Child World, Inc., 147 B.R. 847 (Bankr. S.D.N.Y. 1992).

Fifth Circuit: In re Murexco Petroleum, Inc., 15 F.3d 60 (5th Cir. 1994).

Ninth Circuit: In re Frontier Properties, Inc., 979 F.2d 1358, 1364 (9th Cir. 1992).

[19] In re Norquist, 43 B.R. 224 (Bankr. E.D. Wash. 1984) (the remaining material obligation on the part of the non-debtor served no useful purpose, and, although the contract could be executory, it need not be held to be, if its rejection would not further the objectives of the Code).

[20] Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 138 B.R. 687 (Bankr. S.D.N.Y. 1992).

[21] See:

Sixth Circuit: In re Monument Record Corp., 61 B.R. 866 (Bankr. M.D. Tenn. 1986).

Eleventh Circuit: In re Government Security Corp., 101 B.R. 343 (Bankr. S.D. Fla. 1989), *aff'd* 111 B.R. 1007 (S.D. Fla. 1990).

[22] See Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 138 B.R. 687 (Bankr. S.D.N.Y. 1992).

employment agreement would benefit the estate by avoiding the debtor's obligation to make a large severance payment, such a contract would be considered executory under the benefit/burden approach.[23]

However, in contrast to the application of the Countryman Definition, the use of the benefit/burden approach, may result in a finding that a contract is executory, even if one party has fully performed. Thus, when the buyer fully performed his obligations under a land sale contract, a court still found the contract capable of rejection, when the contract called for a $300,000 parcel of realty to be sold for $251,750.[24]

Similarly, a contract probably would not be executory using a benefit/burden analysis when parties to a land sale contract have significant obligations that would render the contract executory, since the estate would benefit from having the claim of the non-debtor treated as a lien against the estate rather than forcing the debtor to assume or reject the agreement.[25]

The Second Circuit, by way of example, has never expressly adopted the Countryman test; rather, the court has referred instead to the legislative history for the proper standard, stating that:[26]

> "A test less exclusive than Countryman's that takes into account the mutual performance requirement embodied in the legislative history should be substituted. Under this test, a contract is executory if each side must render performance, on account of an existing legal duty or to fulfill a condition, to obtain the benefit of the other party's performance. Weighing the relative benefits and burdens to the debtor is the essence of the decision to assume or reject; if each party must still give something to get something, the contract is executory, and the debtor must demonstrate whether assumption or rejection confers a net benefit on the estate. If the debtor has done everything it needs to do to obtain the benefit of its bargain, assumption serves no purpose, and the debtor may simply sue to enforce its rights. Similarly, if the other party has done everything necessary to require the debtor to perform, the debtor's performance adds nothing to the estate, the debtor will not assume the contract, and the other party can file a prepetition claim."[27]

The Fourth and Sixth Circuits, by way of a further example, have held that an executory contract is one that requires performance on both sides.[28]

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[23] *Id.* This contract would almost certainly be viewed as executory if the Countryman definition were to be applied.

[24] In re W&L Associates, Inc., 71 B.R. 962 (Bankr. E.D. Pa. 1987).

[25] In re Booth, 19 B.R. 53 (Bankr. D. Utah 1982).

[26] In re Ionosphere Clubs, Inc., 85 F.3d 992 (2d Cir. 1996).

[27] *Id.*, 85 F.3d at 998–999, quoting In re Riodizio, Inc., 204 B.R. 417, 424 (Bankr. S.D.N.Y. 1997).

[28] *Fourth Circuit:* RCI Tech. Corp. v. Sunterra Corp., 361 F.3d 257, 264 (4th Cir. 2004) (citing In re Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985)).

Sixth Circuit: Sloan v. Hicks, 761 F.2d 319 (6th Cir. 1985).

See also, In re Preston, 53 B.R. 589 (Bankr. M.D. Tenn. 1985).

[d]—Application of Section 365—Only to Contracts and Leases in Effect upon a Bankruptcy Filing

Section 365 of the Bankruptcy Code pertains only to executory contracts and unexpired leases in effect on the bankruptcy filing date.[29] If there is no term remaining on a commercial lease when a bankruptcy is filed, then such lease has expired by its own terms and cannot be said to be "unexpired" within the meaning of section 365. Similarly, if a contract was terminated prior to the commencement of a bankruptcy case, then the contract, by definition has been fully executed and there is nothing left to be assumed or rejected post-bankruptcy.[30]

The character of an agreement as either an executory contract or unexpired lease for real or personal ~~propertyordinarily~~property ordinarily is determined as of the bankruptcy filing date.[31]

For purposes of assumption or rejection, the legal status of a lease agreement as one that is executory or unexpired is governed by applicable state law.[32] However, where bankruptcy filing date events alter the nature of the contract, e.g., expiration of the term by the passage of time, the bankruptcy court may review such facts and act or refuse to do so.[33]

Stated differently, whether there are continuing obligations under a contract is something that is determined based on the fact as they existed on the bankruptcy filing date.[34]

Whether a lease was effectively terminated prior to the filing of the petition, or whether a termination has been waived is an issue that comes up repeatedly.[35] State

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[29] See Bankruptcy Code § 365(c); 11 U.S.C. § 365(c).

[30] Bankruptcy Code § 365(c); 11 U.S.C. § 365(c). P&J Marketing, Inc. v. Old Chepachet Village, Inc. (In re P&J Marketing, Inc.), 142 B.R. 608 (Bankr. D.R.I. 1992) (bankruptcy court's equitable powers did not confer upon it authority to revive expired lease).

[31] In re Riodizio, Inc., 204 B.R. 417 (Bankr. S.D.N.Y. 1997).

[32] *Second Circuit:* In re Reinhardt, 209 B.R. 183 (Bankr. S.D.N.Y. 1997); In re S.E. Nichols Inc., 120 B.R. 745 (Bankr. S.D.N.Y. 1990). In the case of In re Metro Air Northeast, 131 B.R. 555 (Bankr. W.D.N.Y. 1991), the court was faced with the issue of whether the lease was in effect. The court held that the debtor-lessee could not assume the lease since it had been terminated by the lessor prepetition. "In order for the debtor to be able to assume a lease, the lease must be in existence on the date the petition was filed." *Id.,* 131 B.R. at 556; In re Seven Stars Restaurant, Inc., 122 B.R. 213 (S.D.N.Y. 1990) (debtor-tenant was not entitled to cure defaults and resurrect terminated lease where landlord had terminated lease prepetition, after debtor failed to cure defaults subsequent to fifteen-day cure notice issued by landlord); In re Emilio Cavallini, Ltd., 112 B.R. 73 (S.D.N.Y. 1990).

Ninth Circuit: In re Windmill Farms, Inc., 841 F.2d 1467 (9th Cir. 1988).

[33] *Id.*

[34] See, e.g.:

Sixth Circuit: In re Shipley, 29 B.R. 13 (Bankr. W.D. Ky. 1983); In re Farrar McWill, Inc., 26 B.R. 313 (Bankr. W.D. Ky. 1982).

Eighth Circuit: Jenson v. Continental Financial Corp., 591 F.2d 477 (8th Cir. 1979).

[35] See, e.g., In re Family Showtime Theatres, Inc., 72 B.R. 38 (E.D.N.Y. 1987), *aff'd* 819 F.2d 1130 (2d Cir. 1987) (dispute arose over whether acceptance of rent payments after lease termination reinstated lease, although landlord's correspondence expressly reserved its rights with respect to the termination).

law governs whether a lease was validly terminated before the filing of a bankruptcy case.[36] For example, under New York law, a commercial lease may be terminated by the issuance of a warrant of eviction[37] or by the landlord's exercise of a conditional limitation provision in a commercial lease. Both methods of termination, if effected prior to the filing of a bankruptcy case, may keep the lease out of the debtor's bankruptcy estate, permitting the landlord to proceed with an eviction, subject ~~ot~~to any application of the automatic stay, even though a bankruptcy case was filed.[38] Time is of the essence for landlords, as, from a bankruptcy perspective, if a landlord is dealing with a tenant that has defaulted or is in financial distress, remedies are best exercised sooner rather than later, i.e., after a bankruptcy filing. In the current parlance, "If you snooze—you lose!"

Practice Pointer: The general rule is that termination of a commercial lease is "final" for purposes of Section 365 if the commercial lease is not subject to any form of equitable redemption or statutory grace period and all steps in the eviction process have been completed.[39] Other courts have held that the landlord and tenant relationship may be irreparably severed even if the eviction has not been completed under applicable non-bankruptcy law.[40]

Practice Pointer: When exercising remedies after a lease termination, a landlord seeking to evict must be aware that although a lease may have terminated, eviction may impact property of the bankruptcy estate (maybe personal property located in the leasehold), thereby implicating the automatic stay and the need for the landlord to seek relief from the automatic stay as a predicate to effecting an eviction.[41]

A debtor/tenant may seek to avoid a prepetition termination as a "fraudulent transfer" by arguing that such debtor/tenant did not receive "fair" or "reasonably equivalent" value in exchange for the termination.[42] It has been held, however, that Section 365(c)(3), which prohibits assumption of a lease of nonresidential real property that has been terminated prior to the filing of bankruptcy, takes precedence over an action

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[36] Butner v. United States, 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979).

[37] N.Y. Real Prop. Act. & Proc. § 749(3); Radol v. Centeno, 627 N.Y.S.2d 887, 165 Misc.2d 448 (N.Y. Civ. 1995) (automatic stay inapplicable where state court issued warrant prior to the filing of the bankruptcy petition).

[38] See In re Family Showtime Theatres, Inc., 72 B.R. 38 (E.D.N.Y. 1987), *aff'd* 819 F.2d 1130 (2d Cir. 1987), in which the court held that a standard New York lease termination clause created a conditional limitation that effectively terminated the lease prior to the tenant's bankruptcy filing. See also, Nadine Properties, Inc. v. Henry Bergmann & Co., 583 N.Y.S.2d 114, 153 Misc.2d 695 (N.Y. Civ. 1991) (Tenant, who filed for bankruptcy after a warrant of eviction was issued but before it was actually evicted, sought to be restored to the premises on the ground that the eviction was stayed by operation of the automatic stay. Because the warrant was issued before the commencement of the bankruptcy proceeding, the court held that the lease was validly terminated before the commencement of the bankruptcy proceeding. The lease, therefore, was not property of the estate and the automatic stay did not operate to prevent the eviction.).

[39] Executive Square Office Building v. O'Connor & Associates, 19 B.R. 143 (Bankr. N.D. Fla. 1981).

[40] In re Maxwell, 40 B.R. 231 (N.D. Ill. 1984).

[41] Bankruptcy Code §§363(a), 363(d); 11 U.S.C. §§363(a), 363(d).

[42] See 11 U.S.C. § 548.

under Bankruptcy Code Section 548(a) to avoid a fraudulent transfer.[43] Additionally, a "lease termination pursuant to the terms of the contract between the parties prior to the bankruptcy filing is not a transfer that may be avoided."[44]

A lease is not deemed to have expired merely because a debtor/tenant has defaulted prepetition giving rise to a landlord's right to terminate the lease.[45] A debtor may cure such defaults even after a bankruptcy is filed.[46]

Finally, Section 108(b) of the Bankruptcy Code provides, among other things, that the cure period available to a debtor is extended upon the filing of a petition to "the later of: (1) the end of such [cure] period, including any suspension of such [cure] period occurring on or after the commencement of the case; or (2) 60 days after the order for relief."[47]

> Practice Pointer: The termination of a commercial lease, including an office lease, prior to a bankruptcy filing ordinarily will be a desirable outcome for a commercial landlord. Early termination by such landlord, ahead of a bankruptcy filing, can prevent a lease from becoming "property of the bankruptcy estate and reduce the commercial landlord's exposure."[48]

The exception to the foregoing generality is that rejection damages may run from the earlier of a termination date that antedates a bankruptcy filing or the bankruptcy filing date and be subject to the damage cap on lease rejection claims set forth in Section 502(b)(6) of the Bankruptcy Code.[49]

From the landlord's perspective, notices of default and termination should be self-executing and effective on a date certain to avoid an outcome where notice is given and there is a bankruptcy filing before completion of the termination, including the elapse of any notice or notice and cure periods.[50]

[e]—Single or Multiple Agreements

The assumption of an unexpired commercial lease, coupled with the requirement that a lease or contract be assumed in its entirety, will result in the practitioner facing the question of whether a single document constitutes a unitary agreement or several agreements under applicable non-bankruptcy law. Whether a contract is unitary or severable is a question of intent to be determined from the language employed by the parties viewed in the light of the circumstances surrounding them at the time they contracted.[51] This concept is readily illustrated by a case where a document labeled as

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[43] Haines v. Regina C. Dixon Trust (In re Haines), 178 B.R. 471, 474–475 (W.D. Mo. 1995).

[44] *Id.*, 178 B.R. at 477.

[45] In re Pyramid Operating Authority, Inc., 144 B.R. 795 (Bankr. W.D. Tenn. 1992).

[46] *Second Circuit:* In re Masterwork, Inc., 100 B.R. 149 (Bankr. D. Conn. 1989).

Third Circuit: In re Independent Management Assoc., Inc., 108 B.R. 456 (Bankr. D.N.J. 1989).

[47] Bankruptcy Code § 108(b); 11 U.S.C. § 108(b).

[48] The term "property of the estate" refers to the statutory description in Code Section 541, and such term generally includes all forms of property owned or leased by a debtor.

[49] See Bankruptcy Code § 502(b)(6); 11 U.S.C. § 502(b)(6).

[50] Moody v. Amoco Oil Co., 734 F. 2d 1200 (7th Cir. 1984).

[51] See Prospero Associates v. Burroughs Corp., 714 F.2d 1022, 1026 (10th Cir. 1983). *Accord*, Christian v. Christian, 42 N.Y.2d 63, 73, 365 N.E.2d 849, 856, 396 N.Y.S.2d 817, 824 (1977) (citing 5 *Williston on Contracts* § 45:4 (4th ed. 2016)).

a restaurant lease included an obligation of the tenant, upon termination or expiration of the lease, to offer the tenants' liquor license to the landlord for $100,000, before the tenant would offer to sell the liquor license to a third-party. In that case, the court held that the document in question was an integrated agreement that could not be assumed in part and rejected in part. Thus, the tenant, by rejecting the lease, rejected the contractual right of first refusal with respect to the liquor license.[52]

An early case still widely cited on this issue, involves a trustee's effort to separate a contract modification from an underlying contract.[53] The Supreme Court refused to allow the trustee to assert form over substance by characterizing a modification (a provision for advance payments) of a coal supply contract as a separate contract to loan money. Instead, the Court held the trustee to "[t]he purpose of the parties" in the transaction.[54] Thus, the Court refused to allow the trustee to treat the document in question as multiple agreements and held that the bankruptcy left the legal and equitable obligations of the parties undisturbed.[55]

A land purchase and sale agreement that includes in the text of such document a brokerage commission agreement (in addition to the usual purchase and sale language) may be severable so that the purchase agreement may be assumed and the brokerage agreement rejected.[56] **In another instance, a master lease for numerous restaurant locations provided by its "plain terms" that the agreement was not severable under Illinois Law.** "Where a trustee rejects a severable contract containing both an executed and an executory agreement, such rejection is not equivalent to the breach or rescission of the executed agreement."[57]

[f]—True Real Estate Lease or "Something Else" in Disguise

A basic issue faced by the courts has been whether a document as drafted is a true lease or actually something else. For example:

Sections 365(d)(3) and (4) apply solely to "true" or "*bona fide*" leases. The designation of an agreement as a lease is not controlling. Instead, a court generally will look to the parties' intent to determine if the agreement is a lease, a financing agreement, a joint venture agreement, a mortgage, a management agreement, or another type of agreement.[58]

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[52] In re CB Holding Corp., 448 B.R. 684, 688 (Bankr. D. Del. 2011).

[53] Hurley v. Atchinson, Topeka & Santa Fe Railway Co., 213 U.S. 126, 29 S.Ct. 466, 53 L.Ed. 729 (1909).

[54] *Id.*, 213 U.S. at 133.

[55] *Id.*, 213 U.S. at 134–135.

[56] In re Gardinier, Inc., 831 F.2d 974 (11th Cir. 1971).

[57] Stewart Title Guaranty Co. v. Old Republic National Title Insurance Co., 83 F.3d 735, 742 (5th Cir. 1996).

[58] In re Chateaugay Corp., 102 B.R. 335 (Bankr. S.D.N.Y. 1989). "Safe harbor" leases entered into for the purpose of transferring tax benefits, were not true leases; accordingly, purchaser-lessor not entitled to be paid post-petition rent and leases not subject to assumption or rejection. In this case, the court was presented with a document involving several safe harbor leasing transactions or tax benefit transfer agreements. The court examined the documents and focused on the intent of the parties, the circumstances surrounding negotiations and the economic substance of the transactions and found that the agreements in question were true leases amendable to assumption or rejection. *Id.*

A debtor shareholder's ninety-nine-year proprietary lease for a cooperative apartment unit was not a true lease that needed to be assumed or rejected, as the debtor's interest was more in the nature of an ownership interest.[59] This analysis should apply in the nonresidential context as well, e.g., to commercial office cooperatives.

At least one bankruptcy court has held that the true intent of the parties must be determined by the "economic reality test."[60]

An agreement was found to be a financing vehicle and not a lease capable of assumption or rejection where the agreement in question purported to be a ~~long term~~ long-term lease.[61] Whether a lease is a true lease will depend on applicable state law.[62]

A purported lease was held not to be a true lease when the debtor paid rent directly to the lessor's purchase moneylender and its obligation to pay rent was not terminated by the lessor's default.[63] In another case, an agreement between a debtor and a landowner providing the debtor with the right to conduct logging activities on the landowner's property was not a lease that required assumption or rejection within sixty days.[64] In yet another case, a lease agreement permitting a debtor-lessor to construct and then sublease a commercial complex was a *bona fide* lease requiring assumption or rejection within sixty days; debtor was required to pay rent based on a *pro rata* share of the harbor area lease, with a minimum rent of $15,000 per floor.[65]

[4]—Assumption or Rejection of Commercial Leases by Debtor

[a]—Timing

An unexpired lease of nonresidential real property (commercial property) must be assumed in a Chapter 11 case within 120 days after the order for relief is entered or it is deemed rejected.[66] A debtor may seek to extend such 120-day period for an

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See also:

Second Circuit: In re Barney's Inc., 206 B.R. 328 (Bankr. S.D.N.Y. 1997); In re PCH Associates, 949 F.2d 585 (2d Cir. 1991) (purported lease held an equitable mortgage); In re Winston Mills, Inc., 6 B.R. 587 (Bankr. S.D.N.Y. 1980) (IDB financing agreements held not true leases and debtor obligations therefore not capped under Code Section 502(b)(7)).

Fifth Circuit: In re Atlanta Times, Inc., 259 F. Supp. 820 (N.D. Ga. 1966) (equipment lease a true lease, not a purchase agreement), *aff'd* Sanders v. National Acceptance Co. of America, 383 F.2d 606 (5th Cir. 1967).

[59] In re LeFrak, 223 B.R. 431 (Bankr. S.D.N.Y. 1998) (to acquire the cooperative interest, the debtor had to make a substantial down payment, as when purchasing an ownership interest in real property).

[60] In re Eureka Southern Railroad, Inc., 72 B.R. 813 (Bankr. N.D. Cal. 1987).

[61] In re LeFrak, 223 B.R. 431 (Bankr. S.D.N.Y. 1998) (to acquire the cooperative interest, the debtor had to make a substantial down payment, as when purchasing an ownership interest in real property).

[62] See, e.g., In re National Traveler, Inc., 110 B.R. 619 (Bankr. M.D. Ga. 1990).

[63] In re MCorp Financial, Inc., 122 B.R. 49 (Bankr. S.D. Tex. 1990).

[64] In re Harris Pine Mills, 862 F.2d 217 (9th Cir. 1988).

[65] In re Port Angeles Waterfront Associates, 134 B.R. 377 (B.A.P. 9th Cir. 1991).

[66] Bankruptcy Code § 365(d)(4)(B)(i); 11 U.S.C. § 365(d)(4)(B)(i).

additional ninety days for "good cause."[67] No further extensions are permitted, absent the landlord's written consent. In December 2020, in response to the economic dislocation engendered by the COVID-19 pandemic, Congress enacted the CAA[68], which in part, amends Section 365(d)(4)(A) of the Bankruptcy Code to give the debtor-in possession or the trustee 210 days after the order for relief to assume an unexpired non-residential real property lease, thereby extending the period under prior law by an additional 90 days. This change applies to cases under all chapters, and it sunsets in two years on December 27, 2022.

Practice Pointer: A court may extend the period for ninety days if extended "prior to the expiration of the 120-day period," suggesting the motion must be filed and heard before the 120-day period expires.[69] This may be a change from prior law.

In determining whether "cause" exists to extend the time to assume or reject non-residential leases of real property, courts have considered several factors, including whether the debtor has made its Section 365(d)(3) rent payments. The Second Circuit, prior to the effective date of the 2005 amendments to the Bankruptcy Code, identified the following factors, redacted from earlier decisions of various courts which factors should still apply:[70]

- whether the debtor has been paying for the use of the property,
- whether the debtor's continued use and occupancy of the leasehold could damage the lessor beyond the compensation available under applicable law,
- whether the lease is the debtor's primary asset,
- whether the debtor has had sufficient time to formulate a plan of reorganization,
- the complexity of the debtor's case,
- the number of leases the debtor must evaluate concerning assumption or rejection, and
- the need for a judicial determination of whether there is a lease in effect amenable to assumption or rejection.

It is important to note that the Second Circuit held also that a bankruptcy court may not base its decision to refuse to extend the time to assume or reject nonresidential leases of real property solely on the debtor's failure to remain current on its post-petition rent payments.[71] Many practitioners view this holding as a change from prior law (or at least what many practitioners assumed was prior law).

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[67] Bankruptcy Code § 365(d)(4)(A); 11 U.S.C. § 365(d)(4)(A). See, e.g., In re Duckwall-ALCO Stores, Inc., 150 B.R. 965 (D. Kan. 1993).

[68] The amendments to the Bankruptcy Code are set forth in Sections 320 and 1001 of the Consolidated Appropriations Act. The Consolidated Appropriations Act also contains certain technical corrections to the Bankruptcy Code. See Consolidated Appropriations Act of 2021 Pub. L. No. 116-260 § 1001.

[69] Bankruptcy Code § 362(d)(4); 11 U.S.C. § 362(d)(4).

[70] In re Burger Boys, Inc., 94 F.3d 755 (2d Cir. 1996).

[71] *Id.*

The above list of factors is not exhaustive, and courts have considered other factors in determining whether an extension is appropriate. A New York bankruptcy court, for example, also considered whether the debtor had already made its determination to assume or reject the lease in question.[72]

[b]—The Effect of Failure to Timely Assume, Reject, or Seek an Extension

If a debtor-in-possession or trustee fails to assume or reject a commercial real estate lease within the initial time period for making that decision contained in Section 365(d)(4)(A) or fails to seek an extension of such time before it expires, then the lease is deemed rejected and "the trustee shall immediately surrender such nonresidential real property to the lessor."[73]

Practice Pointer: As discussed above, in December 2020, in response to the economic dislocation engendered by the COVID-19 pandemic, Congress enacted the CAA, which in part, amends Section 365(d)(4)(A) of the Bankruptcy Code to give the debtor-in possession or the trustee 210 days after the order for relief to assume an unexpired non-residential real property lease, thereby extending the period under prior law by 90 days. This change applies to cases under all chapters, and it sunsets in two years on December 27, 2022.[74]

[c]—Waiver by Landlord

Prior to the effective date of the 2005 amendments, at least one court held that a landlord may have waived or was estopped from asserting that the lease was deemed rejected, where the landlord's conduct evidenced that the lease was continuing rather than terminated.[75]

[d]—Performance Prior to Assumption or Rejection

Section 365(d)(3) provides that the trustee "shall timely perform all the obligations of the debtor" arising after the petition is filed and before the lease is assumed or rejected. It does not, by its terms, condition the landlord's right to payment on the debtor's use of the property. The trustee or debtor-in-possession is required only to comply with the tenant's lease obligations (i.e., pay rent) in a timely fashion during the post-petition/pre-rejection or assumption period. Notwithstanding the apparently clear language of the statute, issues have arisen, among other things, regarding the

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[72] See, e.g., In re Wedtech, 72 B.R. 464 (Bankr. S.D.N.Y. 1987).

[73] Bankruptcy Code § 365(d)(4); 11 U.S.C. § 365(d)(4).

[74] The amendments to the Bankruptcy Code are set forth in Sections 320 and 1001 of the Consolidated Appropriations Act. The Consolidated Appropriations Act also contains certain technical corrections to the Bankruptcy Code. See Consolidated Appropriations Act of 2021, Pub. L. No. 116-260 § 1001.

[75] In re VMS National Properties, 148 B.R. 942 (Bankr. C.D. Cal. 1992). *Cf.*, Burger Boys, 94 F.3d at 763 ("waiver requires the intention to relinquish a right"). (Citations omitted.)

amount of the payments due the landlord during such period and timing of such payments.[76]

The majority view is that a landlord is entitled to payment of the rent reserved by the lease for the period commencing with the filing of a bankruptcy case and prior to rejection or assumption of the lease, whether the debtor-in-possession or trustee has vacated the property.[77] This view is predicated on a plain reading of the statute and on considerations of fairness to the landlord, as the landlord is forced to allow the tenant to occupy its leasehold whether it is office space or other retail space, and pay expenses, despite the continuing non-payment by the tenant. According to this view, if the trustee or debtor-in-possession vacates a leasehold, but fails to reject a lease, the estate is liable for rent until the lease is rejected.[78] In many cases, a trustee will seek to avoid a rent claim by asserting that the lease was terminated by the landlord's actions prior to the filing of the petition or by advocating a minority view that stands for the proposition that payments due to landlords to be collectable as scheduled by a lease must meet the criteria for administrative expenses set out in Bankruptcy Code Section 503(b)(1).[79]

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[76] There is a split of authority as to whether § 365(d)(3) compels a debtor to pay all rent and other charges that become due after filing and prior to assumption or rejection, or only the rent allocable to that period. In re Montgomery Ward Corp., 268 F. 3d 205 (3d Cir. 2001) (collecting cases and refusing to prorate charges payable post-petition that may have arisen partly prepetition and partly post-petition). See also, In re McCrory Corp., 210 B.R. 934 (S.D.N.Y. 1997) (prorating taxes billed post-petition pre-rejection that came due during such period).

[77] See, e.g.:

Second Circuit: In re C.A.F. Bindery, Inc., 199 B.R. 828 (Bankr. S.D.N.Y. 1996).

Fourth Circuit: Norritech v. Geonex Corp., 204 B.R. 684 (D. Md. 1997) (post-petition rent payable as an administrative expense without regard to benefit to estate), *aff'd* 120 F.3d 261 (4th Cir. 1997); In re Cardian Mortgage Corp., 127 B.R. 14 (Bankr. E.D. Va. 1991) (landlord entitled to recover rent even though debtor had vacated premises prior to filing of petition).

Seventh Circuit: Paul Harris Stores, Inc. v. Mabel L. Salter Realty Trust, 148 B.R. 307 (S.D. Ind. 1992).

Eighth Circuit: In re Liberty Outdoors, Inc., 205 B.R. 414 (Bankr. E.D. Mo. 1997) (landlord is entitled to recover rent as an administrative expense).

Ninth Circuit: In re Pacific-Atlantic Trading Co., 27 F.3d 401 (9th Cir. 1994) (trustee must pay rent, as an administrative expense, during the post-petition/pre-rejection period).

Eleventh Circuit: In re Potomac Systems Engineering, Inc., 208 B.R. 561 (Bankr. N.D. Ala. 1997).

[78] The issue arises because the surrender of space by a tenant does not generally have the effect of terminating a lease under state law. If a trustee is not alert to the possible existence of an unterminated lease for space a debtor is not currently using, the estate may face a claim for rent from the date of the filing until the date of rejection (which occurs automatically 120 days after the filing if the trustee takes no action to assume).

[79] See, e.g.:

Fourth Circuit: In re Merry-Go-Round Enterprises, Inc., 1996 WL 69688 (Bankr. D. Md. Jan. 23, 1996).

Eleventh Circuit: In re Potomac Systems Engineering Inc., 208 B.R. 561 (Bankr. N.D. Ala. 1997).

Notwithstanding such arguments by debtor/tenants, the majority of the courts faced with the issue have held that nonresidential lessors are entitled to immediate payment of an amount equal to the rent reserved and not to the "actual or necessary" cost of preserving the estate during a pre-assumption or rejection period, even if the rent reserved is above or below market.[80]

When a tenant files a voluntary case, payment of post-petition rent is one of the first issues facing the parties with respect to an unexpired lease.

As discussed below, debtor tenants generally are required to pay their rent after a bankruptcy is filed. Section 365(d)(3) of the Bankruptcy Code requires a debtor to pay full contract rent when due (as well as fulfill other obligations under the lease, including those regarding maintenance, repair, taxes, and insurance) until the court enters an order approving the rejection of the lease. However, bankruptcy courts have tools that they use to permit a debtor tenants to delay meeting the statutory obligation to pay rent when it falls due.

There is a growing acceptance by bankruptcy courts of a debtor's ability to defer payment of post-bankruptcy lease obligations to their landlords for at least 60 days following a bankruptcy filing and potentially longer on equitable grounds, despite the statutory language that would seem to bar the latter outcome. A limited exception to the pay as you go rule of Section 365(d)(3) permits a bankruptcy court to allow a debtor to defer payment of its post-petition date obligations until after the 60th day of the case. Specifically, Section 365(d)(3) states

The COVID-19 pandemic has led several bankruptcy courts to permit deferrals beyond 60 days, apparently in contravention of the 60-day limitation contained in Section 365(d)(3). To do so, these courts have relied on their equitable authority under Section 105(a) of the Bankruptcy Code stating that there is no feasible alternative to the relief sought by the affected debtor, when all such debtor's brick and mortar stores are closed. In using Section 105(a) to extend payment deferrals beyond 60-days, these courts have found that the obligation to timely perform under a lease does not

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The leading minority case, and the one usually cited, is In re Orvco, Inc., 95 B.R. 724 (9th Cir. 1989). *Orvco* held that a post-petition claim for rent would be allowed only if the criteria of Section 503(b)(1) were met. Although *Orvco* has been effectively overruled in its own circuit (the Ninth Circuit) with respect to that proposition (see In re Pacific-Atlantic Trading Co., 27 F.3d 401 (9th Cir. 1993)), the case continues to be followed by some courts. See, e.g.:

Fifth Circuit: In re Mr. Gatti's Inc., 164 B.R. 929 (Bankr. W.D. Tex. 1994) (rent payable by estate during the pre-rejection period only to extent it benefits the estate).

Eighth Circuit: In re JAS Enterprises, Inc., 180 B.R. 210 (Bankr. D. Neb. 1995), aff'd 113 F.3d 1238 (8th Cir. 1997) (pre-rejection rent may be paid as an administrative expense only if the estate is benefited).

See, e.g., In re Myrtle Beach Golf & Yacht Club, 118 B.R. 406 (Bankr. D.S.C. 1990).

[80] In re P.J. Clarke's Restaurant Corp., 265 B.R. 392 (Bankr. S.D.N.Y. 2001); In re Pudgie's Development of New York, Inc., 202 B.R. 832 (Bankr. S.D.N.Y. 1996); Manhattan King David Restaurant, Inc. v. Levine, 163 B.R. 36 (S.D.N.Y. 1993) (citations omitted.); In re Coastal Dry Dock & Repair Corp., 62 B.R. 879, 882 (Bankr. E.D.N.Y. 1986); In re T.F.P. Resources, Inc., 56 B.R. 112, 114 (S.D.N.Y. 1985). *See also*, In re C.A.F. Bindery, Inc., 199 B.R. 828 (Bankr. S.D.N.Y. 1996) (concluding lessor would be entitled to relief from stay unless debtor-tenant paid all unpaid post-petition rent).

automatically provide a landlord with the right to compel payment. Rather, these courts have taken the view that the affected landlord will be provided with an allowed administrative claim for the deferred post-petition rent, reasoning that compelling a debtor to pay immediately would elevate a landlord's claim above those claims of similarly situated administrative expense claimants.

In addition to seeking relief under the Bankruptcy Code, several debtors have raised *force majeure*, arguing that the payment obligation under a subject lease has been suspended so that the debtor, even though it is not paying monthly rent, is meeting its performance obligation under Section 365 of the Bankruptcy Code. Of course, different courts will almost certainly have different views regarding the applicability of such clauses.

There is no way to know at this time whether the twin trends engendered by the effects of the COVID-19 pandemic of (1) allowing a debtor to defer post-petition date lease obligations for 60 days and (2) allowing extensions beyond 60 days, will continue when the crisis engendered by the COVID-19 pandemic passes.

Section 365(d)(3) of the Bankruptcy Code provides that a commercial debtor /tenant must timely perform all of its lease obligations pending the debtor's decision to assume or reject the lease.[81] This provision allows ~~debtors-in-possession~~debtors-in-possession or trustees to request a 60-day rent deferral after the bankruptcy filing date before requiring them to begin paying post-petition rent (i.e., rent after the bankruptcy case commences). Typically, this extension is granted by the court for cause. However, the Consolidated Appropriations Act[82] temporarily amends this section for two years to allow debtors who are experiencing coronavirus-related financial hardship to defer their rent to the earlier of 120 days or the debtor's assumption or rejection of the lease. [7] As a result, debtors have more flexibility in paying their rent at the landlord's expense of providing an involuntary extension of credit. However, the amendment provides a silver lining for landlords as any claims arising from the extension will be treated as an administrative expense (which receives priority payment).

As a rule, debtor/tenants are required to timely perform their post-bankruptcy obligations under their commercial leases, subject to being granted relief from such obligation by a presiding bankruptcy court.[83] Should a tenant file a bankruptcy petition mid-month, such filing has the effect of splitting the month in two. First, there is the portion of the month elapsing prior to the filing, and, second, there is the portion of the month elapsing while such debtor/tenant and its assets are subject to the jurisdiction of the bankruptcy court. Courts are divided on the issue of the "stub period" after a filing—that is when the filing of a bankruptcy occurs mid-month. The "stub rent" issue has been heavily litigated in various jurisdictions.[84] One line of cases provides

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[81] Bankruptcy Code § 365(d)(3); 11 U.S.C. § 365(d)(3).

[82] The amendments to the Bankruptcy Code are set forth in Sections 320 and 1001 of the Consolidated Appropriations Act. The Consolidated Appropriations Act also contains certain technical corrections to the Bankruptcy Code. See Consolidated Appropriations Act of 2021, Pub. L. No. 116-260 § 1001.

[83] See Bankruptcy Code § 365(d)(3); 11 U.S.C. 365(d)(3). See also, Kothari, "A Conceptual View of Proration," 13 Am. Bankr. Inst. L. Rev. 297 (Spring 2005).

[84] *Compare* (applying "proration" approach):

First Circuit: In re All For a Dollar, Inc., 174 B.R. 358 (Bankr. D. Mass. 1994).

that the landlord is entitled to a full month of rent, even though the Chapter 11 debtor rejected and vacated the subject leasehold on the second day of such month.[85] Two Delaware[86] courts and one Southern District of New York[87] court illustrate the two main approaches employed with regard to the "stub rent" issue. The two approaches often are referred to as the "billing date" approach (sometimes referred to as the "performance" approach) and the "proration" approach. However, as discussed below, even courts applying the "billing date" approach differ concerning the entitlement of a landlord to the timely payment of "stub rent."[88]

The "billing date" focuses on the due day on which the rent falls due.[89] Under this approach, if rent is due on the first of the month and the tenant files later in the month, none of the rent for the affected month is considered a post-petition obligation subject to the "pay as you go" requirement of Section 365(d)(3). Thus, courts employing the "billing date" approach will reason that if the rent is due on the first day of the month, and a bankruptcy filing occurs mid-month, the landlord is not entitled to the immediate payment of the "stub rent" pursuant to Section 365(d)(3) for the portion of the month elapsing after a bankruptcy has been filed. In contrast, courts employing the "proration" approach will find that the monthly rental obligation is to be allocated on a per diem basis for each day of the affected month. Thus, a bankruptcy filing on the fifteenth day of a month would create "stub rent" immediately payable under Section 365(d)(3) for the second half of such month.[90] Generally, landlords favor the "proration" approach and tenants that are attempting to husband their cash prefer the "billing date" approach.[91]

Seventh Circuit: In re Handy Andy Home Improvement Centers, Inc., 144 F.3d 1125 (7th Cir. 1998).

Tenth Circuit: In re Furr's Supermarkets, Inc. 283 B.R. 60 (B.A.P. 10th Cir. 2002).

With (applying the "billing date" approach):

Sixth Circuit: Koenig Sporting Goods, Inc. v. Morse Road Co. (In re Koenig Sporting Goods, Inc.), 203 F.3d 986 (6th Cir. 2000).

Seventh Circuit: HA-LO Industries v. CenterPoint Properties Trust, 342 F.3d 794 (7th Cir 2003).

Compare, In re Stone Barn, LLC, 398 B.R. 359 (Bankr. S.D.N.Y. 2008), *with* In re Goody's Family Clothing, Inc., 392 B.R. 604, 609 (Bankr. D. Del. 2008).

[85] In re Koenig Sporting Goods, Inc., 203 F.3d 986 (6th Cir. 2000).

[86] In re Sportsman's Warehouse, Inc., 436 B.R. 308 (Bankr. D. Del. 2009); In re Goody's Family Clothing, Inc., 392 B.R. 604 (Bankr. D. Del. 2008), *aff'd* 401 B.R. 656 (D. Del. 2009), *aff'd* 610 F.3d 812 (3d Cir. 2010).

[87] In re Sportsman's Warehouse, Inc., 436 B.R. 308 (Bankr. D. Del. 2009); In re Goody's Family Clothing, Inc., 392 B.R. 604 (Bankr. D. Del. 2008), *aff'd* 401 B.R. 656 (D. Del. 2009), *aff'd* 610 F.3d 812 (3d Cir. 2010).

[88] *Compare*, In re Sportsman's Warehouse, 436 B.R. 308 (Bankr. D. Del. 2009), *with* In re Goody's Family Clothing, Inc., 392 B.R. 604 (Bankr. D. Del. 2008).

[89] *Id.*

[90] There are instances when the landlord will favor the "billing rate" approach, e.g., in context of *ad valorum* taxes that are paid annually and which become payable by the tenant in arrears under the lease on date subsequent to the bankruptcy filing. Goody's, Family Clothing, Inc., 392 B.R. 604, 609 (Bankr. D. Del. 2008).

[91] Bankruptcy Code § 503(b)(1); 11 U.S.C. § 503 (b) (1); In re Goody's Family Clothing, Inc., 392 B.R. 604 (Bankr. D. Del. 2008).

All may not be lost for landlords finding themselves before courts that employ the "billing date" approach. Section 503(b)(1) provides for the allowance of administration expense claims for "the actual, necessary costs and expenses of preserving the [bankruptcy] estate."[92] Some courts have directed a debtor to immediately pay "stub rent," not under the Section 365(d)(3) regime, but under the administrative claim section of the Bankruptcy Code—Section 503(b).[93] On the other hand, other courts have refused to require the immediate payment of stub rent under the "cost of administration" analysis.[94] Rather, one court imposed significant evidentiary burdens on the landlord and its effort to timely collect the "stub rent" as a cost of administration—effectively defeating the effort.[95]

Generally, administrative expense claims are paid only in successful chapter 11 cases, and, absent appropriate circumstances, such claims are not be paid until confirmation or consummation of a chapter 11 plan, i.e., the end of the case.[96] "Appropriate circumstances" generally are instances where a vendor has the leverage of not providing goods or services that are otherwise unavailable to a debtor. Courts that are unsympathetic to landlords may not be willing to view the landlord/tenant relationship to support a landlord's request for an early payment of "stub rent."

Should the trustee or debtor-in-possession assume a lease, all past due rents for the post-petition and pre-petition periods must be paid,[97] including the stub period rent.[98] On the other hand, if the debtor rejects the lease, under Section 502(d), claims (the "rejection claims") will be treated as amounts becoming due before the petition date and, therefore be given general unsecured claim status.[99]

Finally, a landlord may be able to recover the stub rent as an administrative claim if the landlord can show that the continued occupancy of the space after the filing date provided an actual benefit to the estate and that the stub pay was necessary to preserve the value.[100] Thus, even in the most restrictive sense, a landlord may quality for administrative treatment under Section 502(b)(1) of the Bankruptcy Code to allow for recovery of this stub rent.

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[92] See In re Goody's Family Clothing, Inc., 392 B.R. 604 (Bankr. D. Del. 2008).

[93] In re Sportsman's Warehouse, Inc., 436 B.R. 308 (Bankr. D. Del. 2009).

[94] *Id.*

[95] Bankruptcy Code §§ 503(b)(1), 507(a)(2) and 1129(a)(9); 11 U.S.C. §§ 503(b)(1), 507 (a)(2) and 1129(a)(9).

[96] Bankruptcy Code § 365(b)(1)(A); 11 USC § 365(b)(1)(A).

[97] In re Handy Andy Home Improvement Centers, Inc., 111 F.3d 1125 (7th Cir. 1998).

[98] *Id.*

[99] Bankruptcy Code § 502(b)(1); 11 U.S.C. § 502(b)(1) See also, In re Goody's Family Clothing Inc., 610 F.3d 812 (3d Cir. 2010). In the *Goody's* case, the landlord was entitled to a reasonable stub rent as an actual and necessary expense for the benefit of the estate of a bankrupt retailer whose liquidation agent continued to occupy a number of stores in various shopping centers. *Id.*

[100] *Second Circuit:* Adelphia Business Solutions, Inc., 482 F.3d 602 (2d Cir. 2007).

Third Circuit: In re Chi-Chi's, Inc., 305 B.R. 396 (Bankr. D. Del. 2004) (holding that court had power to order a retroactive rejection, and rejecting retroactively to the date the tenant surrendered the premises, rather than the date the petition was filed); In re New Valley Corporation, 2000 WL 1251858 (D.N.J. Aug. 31, 2000) (court may order rejection retroactively where landlord exercised complete control of property).

Although Bankruptcy Code Section 365(d)(3) requires a tenant to pay all obligations arising after the filing of the petition and prior to assumption or rejection, the tenant may seek to shorten the period during which a post-petition obligation accrues by seeking an order from the bankruptcy court authorize the debtor-in-possession or trustee to reject the lease retroactively to an earlier date, such as the date when the motion to reject was filed or the bankruptcy filing date. Retroactive rejection can be an effective tool in a tenant's arsenal because if the lease is rejected retroactive to the bankruptcy filing date, the landlord loses its right to collect rent under Bankruptcy Code Section 365(d)(3). Although there is an issue as to whether the courts may exercise such power in light of the express statutory requirement set out in Section 365(d)(3) of the Bankruptcy Code that the landlord be paid, a number of courts have held that they have the power to order a retroactive rejection, if the equities militate in favor of retroactive rejection. In a 2007 case, the Second Circuit held that the landlord waived its right to object to retroactive rejection, but expressly reserved decision on whether a bankruptcy court has equitable authority to order retroactively rejection.[101] There is a division of authority on the timing of when the rent reserve must be paid to the landlord. Many courts take the view that the rent must be paid as it becomes due, even if the estate is insolvent (i.e., will be unable to pay all administrative claims at the end of the case), as the statute requires timely payment.[102] Courts following this view have expressed a concern about the possible windfall to the trustee or debtor-in-possession if the trustee/debtor-in-possession is able to avoid the statutory timely payment requirement simply by failing to pay rent, leaving the landlord to collect the rent as an administrative expense from a possibly insolvent estate at the end of a case.[103]

Other courts take the view that the rent should be paid immediately only if it appears the estate will have sufficient assets to pay administrative claims in full.[104] According to this view, if an estate may be administratively insolvent so that all post-bankruptcy claims may not be paid in full, the landlord may not be paid its post-petition/pre-re-

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[101] *Second Circuit:* In re Caldor, Inc., 217 B.R. 116 (Bankr. S.D.N.Y. 1998) (real estate tax payments due under lease are payable immediately during post-petition period); In re C.A.F. Bindery, Inc., 199 B.R. 828 (Bankr. S.D.N.Y. 1996); In re New Almacs, Inc., 196 B.R. 244 (Bankr. N.D.N.Y. 1996).

Eighth Circuit: In re Exchange Resources, Inc., 214 B.R. 366 (Bankr. D. Minn. 1997) (debtor has obligation to timely pay rent).

[102] *Id.*

[103] *Fifth Circuit:* In re Amber's Stores, Inc., 193 B.R. 819 (Bankr. N.D. Tex. 1996).

Seventh Circuit: Paul Harris Stores, Inc. v. Mabel L. Salter Realty Trust, 148 B.R. 307 (S.D. Ind. 1992).

Eighth Circuit: In re Liberty Outdoors, Inc., 205 B.R. 414 (Bankr. E.D. Mo. 1997).

Ninth Circuit: In re MS Freight Distribution, Inc., 172 B.R. 976 (Bankr. W.D. Wash. 1994).

Tenth Circuit: In re Dawson, 162 B.R. 329 (Bankr. D. Kan. 1993) (rent claim during pre-rejection period is payable as an ordinary administrative expense, on a parity with other administrative expenses).

See also, In re MJ 500, Inc., 217 B.R. 93 (Bankr. D. Mass 1998) (although post-petition/pre-rejection rent is ordinarily payable immediately, if other administrative claimants have provided services that generate the funds available for payment of such rent, the rent will be paid on a parity with such administrative claims).

[104] In re Tobago Bay Trading Co. 142 B.R. 528, 533 (Bankr. N.D. Ga. 1991).

jection rent as scheduled by a lease; rather the landlord should only be paid at the conclusion of the case, on a *pro rata* basis with other administrative expenses out of the assets available for distribution.[105] Courts adhering to this line of thought generally have relied on the: (1) absence of any explicit super-priority language in the statute that would catapult the landlord's claim for rent in front of other administrative expenses, and (2) availability of a number of effective remedies to the landlord if the debtor/trustee fails to pay post-petition/pre-rejection rent, including a motion to compel payment of rent, a motion to require the bankrupt to surrender the premises, a motion to lift the automatic stay to allow the landlord to proceed with an eviction action, and a motion to convert the case to a Chapter 7 proceeding.[106]

A third view is rent is payable as specified in a lease, but the landlord may be required to disgorge post-petition/pre-rejection payment of rent if the estate is administratively insolvent at the end of the case.[107]

Once a tenant actually has vacated a leasehold and a lease has been rejected, there is a strong trend to lump the rent with the other administrative expenses payable at the conclusion of the case.[108] As a practical matter, where the tenant has successfully extended its time to assume or reject a lease and the tenant remains in possession, the courts have been sympathetic to landlord requests for immediate payment of rent.[109] Whatever the view of the presiding court, it is clear that a landlord whose tenant has filed for bankruptcy and defaulted in paying rent in the period between the filing of the case and lease rejection should immediately move to compel payment and/or seek relief from the automatic stay so that the landlord can commence a state court eviction action. If the landlord allows a post-petition rent claim to accrue, such landlord is

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[105] See, e.g.:

First Circuit: In re J.T. Rapps, Inc., 225 B.R. 257 (Bankr. D. Mass. 1998) (court refused to give landlord super-priority status vis-à-vis other administrative claimants with respect to an insolvent estate, noting that the landlord had adequate remedies if the debtor or trustee failed to timely pay its rent obligations).

Second Circuit: In re Microvideo Learning Systems, 254 B.R. 90 (S.D.N.Y. 1999).

[106] See In re Bryant Universal Roofing, Inc., 218 B.R. 948 n.3 (Bankr. D. Ariz. 1998) (reviewing cases requiring immediate payment, cases delaying payment, and cases requiring disgorgement of payments if there are insufficient funds to pay the administrative claimants at the end of the case).

[107] See, e.g.:

Fourth Circuit: In re Merry-Go-Round Enterprises, Inc., 1996 WL 69688 (Bankr. D. Md. Jan. 23, 1996) (if the landlord is not providing services to the debtor on an ongoing basis, its claim for rent during the pre-rejection/assumption period, is paid with other administrative expenses).

Fifth Circuit: In re Amber's Stores, Inc., 193 B.R. 819 (Bankr. N.D. Tex. 1996).

[108] See, e.g., In re Burger Boys, Inc., 94 F.3d 755 (2d Cir. 1996).

[109] In re Pudgie's Development of New York, 223 B.R. 421 (Bankr. S.D.N.Y. 1998) (a landlord who seeks immediate relief from a rent default is at the head of the line if the rental obligation is ongoing—i.e., the lease is continuing and has not been rejected; but if the landlord allows a rent claim to accrue, he has no super-priority over other administrative claims), *aff'd* 239 B.R. 688 (S.D.N.Y. 1999). Note that if a debtor/trustee defaults and the landlord obtains a court order compelling payment of the rent, which the debtor/trustee violates, the landlord can argue that the estate must pay the full amount of the rent, regardless of whether the estate is insolvent, by virtue of the order itself. In re Rich's Department Stores, Inc., 209 B.R. 810 (Mass. 1997).

proceeding at his, her or its own peril, as a court in such circumstances is apt to treat a claim for post-petition date rent arrearages as an administrative expense at the end of the case on a parity with other administrative claimants, at which point there may be insufficient funds to pay the landlord's claim for post-petition rent.[110]

Practice Pointer: Again, "if you snooze—you lose" as a landlord with a financially distressed tenant **should act to protect its interest in post-petition rents**.

There is a split of authority regarding attorneys' fees incurred by a landlord acting to compel a debtor/tenant to timely pay rent accruing during the post-petition/pre-rejection period. The legal issue that the courts focus on is whether such fees are deemed to be rent or additional rent under the provisions of the lease.[111] In light of the express statutory language requiring a trustee to comply with a debtor's lease obligations, and the ability of the trustee or debtor-in-possession to avoid liability for attorneys' fees by

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[110] *Compare*:

First Circuit: In re Narragansett Clothing Co., 119 B.R. 388 (Bankr. D.R.I. 1990) (where trustee repeatedly violated court orders to pay rent to landlord during pre-rejection/assumption period, and lease provided for recovery of interest and attorneys' fees, landlord was entitled to recover interest and attorneys' fees incurred to compel trustee to pay rent as required by statute under Section 365(d)(3); the court noted, however, that it would not ordinarily permit recovery of such fees and costs), *aff'd* 210 B.R. 493 (B.A.P. 1st Cir. 1997).

Second Circuit: In re Pudgie's Development of New York, Inc., 202 B.R. 832 (Bankr. S.D.N.Y. 1996) (landlord may not recover attorneys' fees incurred to compel trustee to pay post-petition/pre-rejection rent under Code § 363(c)(1), even if such fees are recoverable as rent under the lease).

Seventh Circuit: In re Entertainment, Inc., 223 B.R. 141 (Bankr. E.D. Ill. 1998).

Eighth Circuit: In re Exchange Resources, Inc., 214 B.R. 366 (Bankr. D. Minn. 3d Div. 1997) (the landlord may recover post-petition attorneys' fees incurred to compel debtor to pay post-petition/pre-rejection rent, if lease calls for reimbursement of fees as rent).

Ninth Circuit: In re MS Freight Distribution, Inc., 172 B.R. 976 (Bankr. W.D. Wash. 1994) (to extent lease provided for recovery of interest, late fees and attorneys' fees, landlord may recover them as part of pre-rejection rent).

[111] See, e.g.:

Second Circuit: In re Ames Department Stores, Inc., 150 B.R. 107 (S.D.N.Y. 1993).

Third Circuit: In re GC Companies, Inc., 261 B.R. 594, 596–597 (Bankr. D. Del. 2001) (summarizing majority and minority decisions).

Seventh Circuit: Handy Andy Home Improvement Centers, Inc., 144 F.3d 1125 (7th Cir. 1998).

Cf., In re Rose's Stores, Inc., 155 F.3d 560 (4th Cir. 1998) (late rent payment made by bankrupt's estate after filing of petition, which payment related to periods before the filing, should not have been paid and was recoverable as a voidable transfer).

In re Pudgie's Development of New York, 223 B.R. 421 (Bankr. S.D.N.Y. 1998) (a landlord who seeks immediate relief from a rent default is at the head of the line if the rental obligation is ongoing—i.e., the lease is continuing and has not been rejected; but if the landlord allows a rent claim to accrue, he has no super-priority over other administrative claims), *aff'd* 239 B.R. 688 (S.D.N.Y. 1999). Note that if a debtor/trustee defaults and the landlord obtains a court order compelling payment of the rent, which the debtor/trustee violates, the landlord can argue that the estate must pay the full amount of the rent, regardless of whether the estate is insolvent, by virtue of the order itself. In re Rich's Department Stores, Inc., 209 B.R. 810 (Bankr. D. Mass. 1997).

complying with the statute, the better view, at least from the landlord's perspective, will be to allow recovery of such attorneys' fees as an administrative expense.

Another issue arising with respect to amounts under a lease that are labeled as "additional rent" concerns the payment of taxes, common charges, percentage ~~rent and~~rent and similar charges that may have accrued prior to the filing of a bankruptcy petition but are billed after the filing date. Are these expenses to be treated as obligations incurred after the bankruptcy filing that must be paid in full under Bankruptcy Code Section 365(d)(3) (based on the "billing" or "performance" date), or are they to be treated as part of the landlord's prepetition claim for damages (based on the period to which the charges relate, i.e., based on the accrual date and not the payment due date)? Courts historically have opted to prorate such charges according to the period to which they related, without regard to the billing date.[112] The Third and Seventh Circuits are in conflict on the issue.[113]

The analysis by so-called "proration" courts focuses on considerations of fairness, and specifically on the reason that it would be unfair to permit a landlord to recover pre-petition damages simply because they are billed during the period between the bankruptcy filing and lease rejection, when other creditors are not protected in the same way.[114] Such courts take the view that Bankruptcy Code Section 365(d)(3) is inapplicable, as the obligation in question arose prior to the filing of the bankruptcy case.[115] The burden is being placed on a landlord under such circumstances to pay unfunded bankruptcy filing date operating expenses, while additional operating expenses are accruing post-petition, without any assurances that the tenant/debtor will actually ever pay either the pre-bankruptcy or post-bankruptcy expenses actually incurred by the landlord.

"Billing date" courts take a more literal approach to Section 365(d)(3) and reason that if a lease requires payment of such charges during the post-petition/pre-rejection period, the debtor/trustee is required to make such payments.[116] This approach seems more consonant with the purposes of Section 365(d)(3), which was adopted to ensure that landlords receive the rent to which they are entitled during the post-filing/pre-rejection period, as they are forced by law (rather than their own independent business decision) to continue to lease space to the bankrupt tenant. Practitioners should note that the billing date approach does not always work in favor of the landlord, as discussed below.

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[112] *Compare*:

Third Circuit: In re Montgomery Ward Holding Corp., 268 F.3d 205 (3d Cir. 2001) (rejecting proration arguments).

Seventh Circuit: In re Handy Andy Home Improvement Centers, Inc., 144 F.3d 1125 (7th Cir. 1998) (accepting proration arguments).

[113] See Judge Manssman's dissent in In re Montgomery Ward Holding Corp., 268 F.3d 205 (3d Cir. 2001) (viewing the prepetition accrued charges as a "sunk cost").

[114] *Id.*

[115] See, e.g., In re Ernst Home Centers Inc., 209 B.R. 955 (Bankr. W.D. Wash. 1997).

[116] See In re CCI Wireless, LLC, 279 B.R. 590 (Bankr. D. Colo. 2002) (where tenant filed for bankruptcy on February 8, court held that the February rent, which was due February 1, was entirely a prepetition obligation and refused to prorate it between the prepetition and post-petition periods, thus preventing the landlord from recovering rent for the period February 8–February 28).

The same issue (billing date vs. proration) will arise with respect to fixed rent, if the tenant rejects the lease shortly after the date the fixed rent becomes due in any monthly or other applicable period. Should the landlord receive pre-petition rent for the full month during which a bankruptcy case is filed or just a *pro-rated* amount calculated by a employing ratios with denominators equal to the number of days of the month in question and numerators equal to the number of days of the month that occurred before and after the bankruptcy filing? In this situation, courts are more likely to follow the billing date approach.[117]

A related question is what happens if the tenant files its bankruptcy case immediately after the base rent payment date (e.g., rent due December 1, tenant files December 2). Is the landlord limited to a prepetition damage claim for that entire monthly period or can the landlord recover a *pro rata* portion of the rent for that month as an administrative expense (i.e., from December 2 through December 31) rather than prepetition damages? The landlord cannot seek payment under Section 365(d)(3) if the billing date approach applies, even though the tenant continues to occupy the premises. In that situation, some courts have held that the landlord is entitled to make a claim for the *pro rata* portion of the rent for the month in which the filing occurs as an administrative expense under Section 503(b)(1).[118]

As a landlord's claim for post-petition administrative rent, if the lease is not being assumed, generally ends when a lease is rejected, litigation regularly arises over the timing of rejection. Faced with a landlord's claim for rent accruing after the filing date and before rejection, a trustee who has failed to promptly reject a lease for unused space will generally argue that rejection occurred when the trustee or debtor first evinced the intention to reject (or when the debtor vacated the premises) or to seek a court order providing for a retroactive rejection date. Some courts permit retroactive rejection and others do not. The landlord will generally argue that rejection occurs only at the end of the 120-day period (temporarily 210-days under the CAA) (if the trustee fails to assume)[119], or when the court issues an order of rejection (if the order is issued earlier than the expiration of the 120-day period).[120]

Practice Pointer: A landlord concerned about receiving rent payments during the 120-day (temporarily under the CAA 210-days) period during which the debtor is deciding whether to assume or reject should bring a motion to compel assumption or rejection by the debtor prior to the expiration of the 120-day (temporarily under the CAA 210-days) period or, in the alternative, to provide some

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[117] In re Koenig Sporting Goods, Inc., 203 F.3d 986, 989 (6th Cir. 2000) (tenant liable for rent for the entire month in which rejection occurred).

[118] The amendments to the Bankruptcy Code are set forth in Sections 320 and 1001 of the Consolidated Appropriations Act. The Consolidated Appropriations Act also contains certain technical corrections to the Bankruptcy Code. See Consolidated Appropriations Act of 2021, Pub. L. No. 116-260 § 1001.

[119] See:

Third Circuit: In re Garden Ridge Corp., 321 B.R. 669 (Bankr. D. Del. 2005).

Eleventh Circuit: In re Rhodes, 321 B.R. 80 (Bankr. N.D. Ga. 2005).

[120] The amendments to the Bankruptcy Code are set forth in Sections 320 and 1001 of the Consolidated Appropriations Act. The Consolidated Appropriations Act also contains certain technical corrections to the Bankruptcy Code. See Consolidated Appropriations Act of 2021, Pub. L. No. 116-260 § 1001.

assurances that current rent will be paid. Such a motion will usually result in a stipulation that current rent will be paid until the lease is assumed or rejected and that such rent constitutes an administrative expense claim allowable under Bankruptcy Code Section 503(b).[121]

The risk in waiting for 120 days (or temporarily under the CAA 210 days)[122] to pass is that the trustee or debtor-in-possession may reject the lease and leave the landlord with an unpaid administrative expense claim that either may never be paid or may only be paid at the end of the case, after a protracted delay and subject to other claims with a higher distribution priority, rather than in the ordinary course.[123]

Practice Pointer: **If, for example,** a lease requires a landlord to pay a construction or TI allowance for improvements to be made after the filing of a bankruptcy petition, the landlord should consider: (1) moving for relief from the automatic stay to allow it to terminate the lease and evict the tenant, and (2) oppose any motion by the debtor-in-possession or trustee to assign the lease. The *ipso facto* provisions of Section 365(e)(1) (that invalidate any provision of an executory contract or lease purporting to permit a termination of the agreement because of the debtor's insolvency or financial condition) do not apply to agreements to loan money or extend financial accommodations to a trustee or debtor-in-possession. This has been construed to apply to a lease that included an executory agreement by the landlord to pay a tenant a construction allowance. Section 365(c)(2) of the Bankruptcy Code, which provides that the trustee may not assume or assign a contract to make a loan or to extend financial accommodations, has also been construed to apply to a TI provision.[124]

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[121] The amendments to the Bankruptcy Code are set forth in Sections 320 and 1001 of the Consolidated Appropriations Act. The Consolidated Appropriations Act also contains certain technical corrections to the Bankruptcy Code. See Consolidated Appropriations Act of 2021, Pub. L. No. 116-260 § 1001.

[122] *In* re J.T. Rapps, Inc., 225 B.R. 257 (Bankr. D. Mass. 1998) (setting forth policy reasons for landlords to act promptly to secure their rights to post-petition rents). See also, In re Adams, 65 B.R. 646 (Bankr. E.D. Penn. 1986) (in which the court described the landlord's actions in shutting off the tenant's electricity as an illegal eviction that violated state law).

[123] *Id.*

[124] *Id.*

§ 28.04 Assumption and Its Effects on Landlords and Tenants

[1]—Assumption of the Lease by the Tenant—Adequate Assurance

[a]—General Rule

A trustee or debtor-in-possession may assume an executory contract or unexpired lease after a tenant default only if, at the time of assumption, the trustee or debtor-in-possession: (1) cures or provides "adequate assurance" that the default will be cured "promptly"; (2) compensates or provides "adequate assurance" that the trustee will "promptly" compensate the landlord for any "actual pecuniary loss . . . resulting from such default"; and (3) provides "adequate assurance" of future performance under such lease.[1] Bankruptcy and insolvency related defaults need not be cured, as they are unenforceable "*ipso facto*" provisions.[2] For example, a clause providing that a tenant will be in default if it commences either a bankruptcy or an insolvency proceeding is not enforceable against a trustee or debtor-in-possession/tenant, once a bankruptcy case is filed.[3]

[b]—Prompt Cure

The Bankruptcy Code requires a trustee or debtor-in-possession to cure defaults upon assumption of a lease, if such defaults are not cured at the time of assumption, the trustee or debtor-in-possession must provide "adequate assurance" that the defaults will be cured "promptly." Courts generally have allowed a trustee or debtor-in-possession significant leeway and provided them with the time needed for the payment of cure based on anticipated cash flow or other factors.

"The debtor-in-possession or trustee must provide adequate assurance" that defaults will promptly be cured. This requires a nonspeculative and sufficiently substantive foundation to assure the landlord it will receive the defaulted amount.[4]

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[1] Bankruptcy Code § 365(e)(2)(b); 11 U.S.C. § 365(e)(2)(b).

[2] Bankruptcy-related defaults include those defaults which relate to:

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

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

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

"(D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the . . . unexpired lease."

Bankruptcy Code § 365(b)(2); 11 U.S.C. § 365(b)(2).

I addition, a lease may not be terminated or modified solely because of a bankruptcy related provision in the lease. Bankruptcy Code § 365(e)(1); 11 U.S.C. § 365(e)(1).

[3] *Third Circuit:* In re Joshua Slocum, Ltd., 922 F.3d 1081 (3d. Cir. 1990); In re FLYi, Inc. 377 B.R. 140 (Bankr. D. Del. 2007).

Seventh Circuit: Lyons Sav. & Loan Assoc. v. Westside Bancorporation, Inc., 828 F.2d 387 (7th Cir. 1987).

[4] In re Skylark Travel, Inc., 120 B.R. 352 (Bankr. S.D.N.Y. 1990); In re Masterworks, Inc., 100 B.R. 149 (Bankr. D. Conn. 1989); In re World Skating Center, Inc., 100 B.R. 147 (Bankr. D.

Among other things, courts take into consideration the amount of money at stake, the degree of assurance that the default will be cured, the debtor's past acts (for example, the debtor's failure to pay rent during the post-petition/pre-assumption period), and the length of the cure period proposed by the tenant as compared to the time remaining on the lease term.[5] Immediate cure may not be required, as opposed to "cure" within a reasonable period of time.[6]

Courts often establish a procedural deadline for the filing of cure amount claims. Failing to timely file a cure amount claim in response to a notice delivered by a trustee or debtor-in-possession may have dire consequences for a landlord, as a tenant may assume a lease and the landlord may be barred from recovering unpaid past due rent.[7]

Practice Pointer: If you are a landlord, or counsel to a landlord, pay attention to motions being filed by a tenant that has filed for bankruptcy relief, to avoid missing a deadline that may estop a landlord from recovering monetary defaults under an unexpired lease that is being assumed. Such notification may be included in a motion file by the trustee or debtor-in-possession pursuant to Section 365 to assume, or it may be included in a standalone form of notice of a claims bar date.

[c]—What Must Be Cured

After enactment of the 2005 amendments to the Bankruptcy Code, a debtor/tenant must cure not only monetary defaults, as was the case under prior law, but also is required to cure any curable nonmonetary defaults.[8] **Nonmonetary defaults often involve historical breaches that cannot be cured—e.g., failure to perform an obligation within a certain time period or failure to maintain operations or licenses.[9]**

Conn. 1989) (assertion by debtor that arrearages will be paid is not sufficient when debtor's present finances are precarious).

[5] See In re PRK Enterprises, Inc., 235 B.R. 597 (Bankr. E.D. Tex. 1999).

[6] In re Berkshire Chemical Haulers, Inc., 20 B.R. 454 (Bankr. D. Mass. 1982) (payments of default amounts over eighteen months held not to constitute adequate assurance of prompt cure under Section 365(b)(1)).

[7] See, e.g.:

Second Circuit: In re Embers 86th Street Inc., 184 B.R. 892 (Bankr. S.D.N.Y. 1995) (debtor's plan for a twenty-nine-month payout of arrears in excess of $183,000 rejected where plan was deemed speculative).

Third Circuit: In re Whitsett, 163 B.R. 752 (Bankr. E.D. Pa. 1994) (residential tenant of federally subsidized housing given two years to cure default).

Fourth Circuit: In re Flugel, 197 B.R. 92 (Bankr. S.D. Cal. 1996) (plan to cure a $14,961 arrearage over a ten-year period rejected; the court summarizes the case law).

Fifth Circuit: In re PRK Enterprises, Inc., 235 B.R. 597 (E.D. Tex. 1999) (debtor given four months to pay arrears in approximate amount of $8,800).

Seventh Circuit: In re Ontario Entertainment Corp., 237 B.R. 460 (Bankr. N.D. Ill. 1999) (bankruptcy court refused debtor's request for an eighteen-month cure period with respect to an accrued rental default in the amount of $360,925, giving the tenant thirty days to cure both the rent default and an illegal sublease).

[8] Bankruptcy Code § 365(b)(1)(A); 11 U.S.C. § 365(b)(1)(A).

[9] See:

First Circuit: In re Bankvest Capital Corp., 360 F.3d 291, 296 (1st Cir. 2004) (failure to deliver certain equipment was a nonmonetary default).

Prior to the 2005 amendments, courts disagreed on whether Section 365(b)(2)(D) exempted nonmonetary defaults from Section 365(e)(2)(B)'s cure requirement when the nonmonetary default cannot possibly be cured.[10]

The 2005 amendments resolved the split among the courts regarding Section 365(b)(2)(D), by providing that only "penalty rates" and "penalty provisions" are excluded from Section 365(b)(1)(A)'s requirement that the trustee or debtor-in-possession must cure all monetary and nonmonetary defaults. However, Section 365(b)(1)(A) was also amended to protect real property leases, allowing the trustee or debtor-in-possession to assume a lease despite an uncured nonmonetary default if the trustee or debtor-in-possession cannot cure the default "by performing nonmonetary acts at or after the time of assumption."[11] **Therefore, the trustee or debtor-in-possession must cure all monetary defaults, including all rent arrears and actual pecuniary losses, along with any curable nonmonetary defaults. However, a nonmonetary default that cannot be cured does not prevent assumption of a lease.**

[d]—Actual Pecuniary Loss

Actual pecuniary loss may include late charges, damages incurred in reliance on the default provisions in an agreement and actual expenses involved in retaking and reletting, as provided in the lease.[12] As discussed below, actual pecuniary loss may also include the landlord's attorneys' fees, third-party damages, and interest on delinquent rent.

[e]—Can the Landlord Recover Attorneys' Fees?

The landlord's ability to recover attorneys' fees, especially those incurred in connection with the bankruptcy, is an issue that may arise with respect to lease assumption.

Second Circuit: In re 1633 Broadway Mars Restaurant Corp., 388 B.R. 490, 497 n.11 (Bankr. S.D.N.Y. 2008) (noting that the prototype incurable historical default is the violation of a provision "requiring the lessee to remain open continuously or to meet certain sales targets").

[10] *Compare,* Bankvest Capital Corp., 360 F.3d 291, 300–302 (1st Cir. 2004) (allowing debtor to assume equipment leases, in which the debtor was the lessor, without curing incurable nonmonetary default of failing to deliver certain equipment), with In re Claremont Acquisition Corp., 113 F.3d 1029, 1034–1035 (9th Cir. 1997) (disallowing assumption of lease where nonmonetary default could not be cured).

[11] Bankruptcy Code § 365(b)(1)(A); 11 U.S.C. § 365(b)(1)(A). See:

Second Circuit: 1633 Broadway Mars Restaurant Corp., 388 B.R. 490, 497–498 (Bankr. S.D.N.Y. 2008).

N Circuit: In re Hathaway, 401 B.R. 477, 484–485 (Bankr. W.D. Wash. 2009).

[12] See:

Third Circuit: In re Crown Books Corp., 269 B.R. 12, 15 (Bankr. D. Del. 2001); In re Joshua Slocum, Ltd., 103 B.R. 601, 609–610 (Bankr. E.D. Pa. 1989).

Fifth Circuit: In re Eagle Bus Manufacturing, 148 B.R. 481 (Bankr. S.D. Tex. 1992).

Seventh Circuit: In re Entertainment, Inc., 223 B.R. 141, 150–151 (Bankr. N.D. Ill. 1998).

Ninth Circuit: In re F&N Acquisition Corp., 152 B.R. 304, 307 (Bankr. W.D. Wash. 1993).

Eleventh Circuit: Kachler v. Taylor, 849 F. Supp. 1503, 1520 (M.D. Ala. 1994).

(The issue also arises in connection with computing the landlord's damages if the lease is rejected and in determining the liability of a trustee or debtor-in-possession for rent during the post-petition/pre-rejection period if attorneys' fees are incurred by the landlord in connection with a default by the debtor or trustee that occurs during that period.[13]) Although some bankruptcy courts have refused to authorize attorneys' fees as a matter of principle, the statute requires cure of the tenant's defaults as a condition to assumption (or adequate assurance) and makes no exception for attorneys' fees. Accordingly, if the debtor's lease provides for recovery of attorneys' fees, the landlord should be able to include its attorneys' fees in the computation of its pecuniary loss.[14]

Would a provision specifically permitting a landlord to recover attorneys' fees incurred in connection with a bankruptcy case be enforceable? The "*ipso facto*" provisions of the Bankruptcy Code invalidate any lease provision that would prohibit an assignment of a lease in a bankruptcy proceeding, or cause a termination or modification of a lease by reason of a tenant's bankruptcy.[15] These provisions have been

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[13] See, e.g., In re Shangra-La, Inc., 167 F.3d 843 (4th Cir. 1999), in which the court stated that a landlord could recover attorneys' fees, as part of its pecuniary loss, IF (1) the attorneys' fees were incurred in connection with a default, and (2) the attorneys' fees resulted from the default, and (3) the attorneys' fees were recoverable under both the lease and applicable state law.

[14] Bankruptcy Code Section 365(b)(1)(B) provides that if there has been a default in a lease, the trustee may assume the lease only if, among other things, at the time of assumption, the trustee "compensates, or provides adequate assurance that the trustee will promptly compensate . . . for any actual pecuniary loss . . . resulting from such default. . . ." Bankruptcy Code § 365(b)(1)(B); 11 U.S.C. § 365(b)(1)(B).

S Mid American Oil, Inc., 255 B.R. 839 (Bankr. M.D. Tenn. 2000), where the court found that Code Section 365(b)(1)(B) does not establish an independent right of recovery for attorneys' fees, but permits a landlord to recover attorneys' fees if either the terms of the lease or state law authorize such recovery. Here, recovery of attorneys' fees was denied because the applicable provisions of the lease did not permit recovery under the circumstances presented. The lease permitted the successful party to recover attorneys' fees: (1) in an action or proceeding, (2) involving a provision of the lease or a default under the lease. The landlord sought to recover attorney's fees in connection with investigating the existence of a possible default by the tenant under the lease. Since there was no actual default under the lease, the court refused to order payment as a condition to assumption of the lease in the bankruptcy proceeding.

[15] Section 365(b)(2) provides that 365(b)(1), which requires the trustee to cure defaults as a condition to assumption of the lease, does not apply to defaults relating to (1) the insolvency or financial condition of the debtor, (2) the commencement of a bankruptcy case, (3) the appointment of a receiver, or (4) the satisfaction of any penalty provision arising from the debtor's failure to comply with nonmonetary provisions of the lease. Bankr. Code § 365(b)(2); 11 U.S.C. § 365(b)(2). Section 365(e)(1) provides that an unexpired lease may not be terminated by reason of a lease provision relating to (1) the insolvency or financial condition of the debtor, (2) the commencement of a bankruptcy case, or (3) the appointment of a receiver. Bankr. Code § 365(e)(1); 11 U.S.C. § 365(e)(1).

Section 365(f)(1) provides that a trustee may assign a lease, notwithstanding "a provision in an . . . unexpired lease . . . that prohibits, restricts, or conditions the assignment of such . . . lease. . . ." Bankr. Code § 365(f)(1), 11 U.S.C. § 365(f)(1).

S 365(f)(3) provides that "[n]otwithstanding a provision in an . . . unexpired lease . . . that terminates or modifies, or permits a party other than the debtor to terminate or modify,

broadly interpreted, and it is arguable that a provision specifically requiring payment of attorneys' fees in a bankruptcy proceeding would not be enforceable as a "modification" of the lease triggered by the bankruptcy filing. One possible solution for a landlord may be to draft broad attorneys' fees and indemnity clause covering, among other things, attorneys' fees incurred by landlords in connection with all collection and bankruptcy proceedings.

According to at least two courts, reasonable attorneys' fees incurred as a result of a debtor's default may constitute actual pecuniary loss.[16] However, other courts have held that if a contract or lease does not provide for attorneys' fees to be paid upon default, the non-debtor party is not entitled to recover such fees since there is no independent right in favor of the non-debtor to recover attorneys' fees.[17]

[f]—Third-Party Damages

When a debtor turned over premises to a third-party prepetition and before the lease had expired, the trustee could assume the lease provided that he reimbursed the third party for funds advanced to cure the debtor's defaults.[18]

[g]—Interest on Delinquent Rent

If a contract or lease does not provide for payment of interest on delinquent rent, then the debtor need not pay such interest in order to cure.[19] If, however, state law requires interest on delinquent rent, then the debtor must pay such interest in order

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such . . . lease or a right or obligation under such . . . lease, such . . . lease, right or obligation may not be terminated or modified under such provision because of the assumption or assignment of such . . . lease by the trustee." Bankr. Code § 365(f)(3); 11 U.S.C. § 365(f)(3).

[16] *Sixth Circuit:* In re BAB Enterprises, Inc., 100 B.R. 982, 984 (Bankr. W.D. Tenn. 1989).

N Circuit: In re Westworld Community Healthcare, Inc., 95 B.R. 730 (Bankr. C.D. Cal. 1989) (attorneys' fees may be awarded even if contract does not require debtor pay them upon breach).

[17] Bankruptcy Code § 365(b)(1)(B); 11 U.S.C. § 365(b)(1)(B).

See:

Second Circuit: In re M. Fine Lumber Co., 383 B.R. 565, 569 (Bankr. E.D.N.Y. 2008); In re Best Products, Co., 148 B.R. 413, 414 (Bankr. S.D.N.Y. 1992).

Third Circuit: In re Rowland, 292 B.R. 815, 819 (Bankr. E.D. Pa. 2003).

Fourth Circuit: Three Sisters Partners, L.L.C. v. Harden (In re Shangra-La, Inc.), 167 F.3d 843, 849 (4th Cir. 1999).

Sixth Circuit: In re Mid American Oil, Inc., 255 B.R. 839, 841 (Bankr. M.D. Tenn. 2000).

Eighth Circuit: In re Ryan's Subs, Inc., 165 B.R. 465, 468 (Bankr. W.D. Mo. 1994).

Ninth Circuit: In re Westside Print Works, Inc., 180 B.R. 557, 564 (B.A.P. 9th Cir. 1995) (disapproving Westworld Community Healthcare, Inc., 95 B.R. 730 (Bankr. C.D. Cal. 1989)).

Eleventh Circuit: In re Hillsborough Holdings, Corp., 126 B.R. 895 (Bankr. M.D. Fla. 1991).

[18] In re Christopher Michaels Ristorante, Inc., 9 B.R. 149 (Bankr. S.D. Fla. 1981).

[19] Bankruptcy Code § 365(b)(1)(A); 11 U.S.C. § 365(b)(1)(A). See In re Eagle Bus Manufacturing, Inc., 148 B.R. 481 (Bankr. S.D. Tex. 1992).

to satisfy the requirement of compensating the landlord for "actual pecuniary loss."[20] In a 1998 Illinois case, the bankruptcy court held that interest on prepetition lease charges continued to run at the 18% rate set forth in the lease and had to be paid as a condition of assumption.[21]

After the 2005 amendments, debtors/trustees must "cure" defaults under a "continuous operation" clause, although the statute makes clear that an unexpired lease may be assumed even if nonmonetary defaults exist that are impossible to cure.[22]

[h]—The Concept of Adequate Assurance

The Bankruptcy Code provides that landlords are entitled to "adequate assurance of future performance" by a tenant upon assumption by the tenant of its interest in a lease.[23] The Bankruptcy Code does not define "adequate assurance."[24] One standard adopted by some bankruptcy courts is that: (1) the debtor must show a firm commitment to make all payments, and have a reasonably demonstrable capacity to do so (e.g., evidence of profitability), and (2) the plan or reorganization must have a foundation that is not speculative.[25] The debtor's or trustee's investment of a substantial amount of money in improvements in the premises may be deemed adequate assurance of future performance.[26] Financial evidence also may be important.[27] Failure to comply with lease obligations during the post-petition/pre-assumption period should also be a factor.[28]

To provide adequate assurance of future performance, a debtor or trustee must prove the ability to satisfy its future financial obligations under the contract.[29] However, some courts have adopted a more relaxed standard with respect to adequate assurance of future performance.[30]

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[20] Bankruptcy Code § 365(b)(1)(B); 11 U.S.C. § 365(b)(1)(B).

[21] In re Entertainment, Inc., 223 B.R. 141 (Bankr. N.D. Ill. 1998).

[22] Bankruptcy Code § 365(b)(1)(A); 11 U.S.C. § 365 (b)(1)(A); In re Hathaway, 401 B.R. 477 (Bankr. W.D. Wash. 2009). See also, In re Patriot Place, Ltd., 486 B.R. 773 (Bankr. W.D. Tex. 2013).

[23] Bankruptcy Code § 365(b)(1)(C); 11 U.S.C. § 365(b)(1)(C).

[24] *Id.*

[25] *Second Circuit:* In re Embers 86th Street Inc., 184 B.R. 892 (Bankr. S.D.N.Y. 1995).

Fifth Circuit: In re PRK Enterprises, Inc., 235 B.R. 597 (Bankr. E.D. Tex. 1999).

[26] In re Prime Motor Inns, Inc., 123 B.R. 104 (Bankr. S.D. Fla. 1990) (debtor's investment of $1.5 million in court-ordered repairs was viewed as providing adequate assurance of performance; court noted that debtor need only show that performance is "likely") (or more probable than not) and that debtor's investment gave it a strong incentive not to default in the future).

[27] In re PRK Enterprises, Inc., 235 B.R. 597 (Bankr. E.D. Tex. 1999).

[28] In re Flugel, 197 B.R. 92 (Bankr. S.D. Cal. 1996).

[29] In re Silent Partner, Inc., 119 B.R. 95 (E.D. La. 1990) (debtor did not provide adequate assurance of future performance where its ability to fulfill contract was contingent upon several uncertain variables including third-party approval of suppliers and reliance upon receipt of progress payments).

[30] See, e.g.:

Second Circuit: In re MF Global Inc., 2011 Bankr. LEXIS 5101 (Bankr. S.D.N.Y. Dec. 20, 2011); In re Wills Motors, 133 B.R. 297 (Bankr. S.D.N.Y. 1991).

[2]—Legal Standards Governing Assumption; Procedural and Evidentiary Matters

[a]—Business Judgment

When reviewing a motion to assume or reject, a court sits as an overseer of the wisdom with which the debtor's estate is being managed by the debtor or trustee and not as the arbiter of disputes between a creditor and the debtor or trustee.[31]

The business judgment rule requires a showing that an assumption or rejection of an executory contract or unexpired lease will benefit the estate.[32]

The debtor or trustee must demonstrate net benefit to the estate to obtain court approval of the assumption or rejection of an executory contract.[33]

[b]—Burden of Proof

The party seeking to assume an executory contract or lease has the burden of proof.[34] The debtor or trustee must show: (1) the contract is subject to assumption, and (2) all requirements for assumption have been met.

A debtor or trustee may assume or reject an executory contract or unexpired lease by a motion or by providing for assumption or rejection in a plan of reorganization.[35] Conduct alone probably is insufficient.[36]

[c]—Assumption and Assignment

Bankruptcy Code Section 365(f) addresses the assignment of executory contracts and unexpired leases. A trustee or debtor-in-possession may assign a contract or lease only after assumption. To assume, the trustee or debtor-in-possession must cure defaults or provide adequate assurance that the defaults will be cured. Additionally, the proposed assignee must provide adequate assurance of its future performance of the tenant's obligations under the subject lease. "Adequate assurance," as discussed above, is not defined by the Bankruptcy Code, leaving this critical issue to the courts to consider on a case-by-case basis. However, it should be noted that there is no requirement that the assignee be as creditworthy as the debtor was when the debtor entered into the

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Third Circuit: In re Filene's Basement, LLC, 2014 Bankr. LEXIS 2000 (Bankr. D. Del. Apr. 29, 2014);In re Shelco, Inc., 107 B.R. 483 (Bankr. D. Del. 1989) (Chapter 11 debtor permitted to assume lease where there was a realistic possibility of effective reorganization, provided existing defaults were cured).

[31] Bankruptcy Code § 365; 11 U.S.C. § 365.

[32] See, e.g.: Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 138 B.R. 687, 697–699 (Bankr. S.D.N.Y. 1992); L.J. Hooker International, Inc. v. Gelina (In re Hooker Investments, Inc.), 131 B.R. 922 (Bankr. S.D.N.Y. 1991). Contra, In re Spectrum Information Techs, 193 B.R. 400 (Bankr. E.D.N.Y. 1996).

[33] In re Riodizio, Inc., 204 B.R. 417 (Bankr. S.D.N.Y. 1997).

[34] In re Truffles of Sarasota, Inc., 30 B.R. 666 (Bankr. M.D. Fla. 1983).

[35] 11 U.S.C. §§ 365(f), 1123(b)(2) and 1322(b)(7); Fed. R. Civ. Proc. 6006(a) and 9014.

[36] See In re Burger Boys, Inc., 94 F.3d 755, 763 (2d Cir. 1996). ("We vacate the district court's order, however, to the extent it allowed Burger Boys to assume the lease without making a formal motion. . . . By allowing Burger Boys to assume or reject the lease by filing an election and without providing an opportunity for South Street to oppose a motion to assume, the district court erred.").

lease as a new tenant. Thus, there is a real risk that the landlord will get an assignee that may not be as creditworthy as the landlord would normally accept for the space subject to the lease being assigned. In fact, the landlord could end up in the same, if not a worse, situation than it was in with the debtor.

[3]—Invalidity of Restrictions on Assignment

Subject to Bankruptcy Code Section 365(b), the trustee or debtor-in-possession may assign the tenant's interest in a lease, even if the lease contains provisions that prohibit or restrict assignment.[37] Any provision that purports to allow the landlord to terminate or modify a lease, if the lease is assigned, is void with respect to any assumption or assignment of the lease by the trustee or debtor-in-possession.[38] The Bankruptcy Code has been interpreted to invalidate any number of restrictions on assignment.[39] The landlord, however, may require the assignee to provide a security deposit "substantially the same as would have been required by the landlord upon the initial leasing to a similar tenant."[40]

However, a provision providing for an increase in rent from the contract rate to market rate upon assignment has been held to be unenforceable.[41]

[4]—Contesting a Proposed Assignment of the Commercial Lease

Practice Pointer: A landlord's most effective objection to a proposed assignment ordinarily is that the proposed assignee is not creditworthy, and the trustee or debtor-in-possession cannot provide evidence of "adequate assurance" of future performance.

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[37] Bankruptcy Code § 365(f)(1); 11 U.S.C. § 365(f)(1).

[38] Bankruptcy Code § 365(f)(3); 11 U.S.C. § 365(f)(3).

[39] See:

First Circuit: Robb v. Schindler, 142 B.R. 589 (Bankr. D. Mass. 1992) (refusing to enforce a profit recapture clause, citing cases invalidating various restrictions On transfer, including narrowly crafted use clauses and clauses that increased rents to market rate upon assignment); In re Mr. Grocer, Inc., 77 B.R. 349 (Bankr. N.H. 1987) (invalidating clause giving a landlord right of first refusal with respect to any bankruptcy sale of lease).

Second Circuit: In re Jamesway Corp., 201 B.R. 73, 78 (Bankr. S.D.N.Y. 1996) ("profit sharing provision regarding payments received by debtor is consideration for a lease assignment held to be unenforceable as an anti-assignment provision"); 410 Park Ave. Assocs., L.P. v. Am. Banknote Corp. (In re Am. Banknote Corp.), 2000 WL 815910 (S.D.N.Y. June 22, 2000) (invalidating a lease provision prohibiting the bankrupt tenant's assignment of the lease to another tenant in the building); In re Boo.Com North America Inc., 2000 WL 1923949 (Bankr. S.D.N.Y. Dec. 15, 2000) (invalidating lease provision giving landlord the right to all profits generated by an assignment).

Fifth Circuit: In re Office Products of America, Inc., 140 B.R. 407 (Bankr. W.D. Tex. 1992) (court held provision in lease requiring tenant to pay landlord the equivalent of sale proceeds of leasehold assignment in consideration for landlord's consent invalid as a de facto anti-assignment clause).

Ninth Circuit: In re Standor Jewelers West, Inc., 129 B.R. 200 (B.A.P. 9th Cir. 1991) (invalidating profit recapture clause).

[40] Bankruptcy Code § 365(1); 11 U.S.C. § 365(1).

[41] In re David Orgell, 117 B.R. 574 (Bankr. C.D. Cal. 1990).

A debtor must show that the proposed assignee's general financial circumstances and ability to satisfy the obligations under the contract or lease are no less than that of the debtor on the date the petition was filed.[42] A court is not required to prequalify a bidder as an acceptable assignee for the debtor's interest as a tenant in a real property lease.[43] When denying a motion would doom the estate and when an assignee would infuse $200,000 of new capital into the business, a court found adequate assurance of future performance existed even though the proposed assignee's ability to meet the tenant's obligations under the lease in question was in doubt.[44]

"Assignment by the trustee to an entity of a contract or lease assumed under [Section 365] relieves the trustee and the estate from any liability for any breach of such contract or lease occurring after such assignment."[45] The assignee picks up the liability for the tenant's obligations under the lease, as if the debtor/assignor never existed.[46]

[5]—Appealing an Assignment

If the landlord desires to appeal the assignment of its lease, it should obtain a stay of the assignment pursuant to Bankruptcy Rule 8005 pending the appeal. This is because Bankruptcy Code Section 363(m) provides that a sale of the bankrupt debtor's property, if authorized by a trustee and if made to a good faith purchaser, will be valid even if the trustee's authorization is reversed or modified on appeal unless the sale is stayed pending appeal.[47] For the reasons set forth above, an entity acquiring a bankrupt tenant's lease should request that the trustee or bankruptcy court include in its order a specific determination that the purchasing entity is a good faith purchaser.[48] It is not certain that 363(m) protects assignees who have taken an assignment pursuant to Section 365.

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[42] III. Inv. Trust N. 92-7163 v. Allied Waste Indus. (In re Res. Tech Corp), 624 F.3d 376 (7th Cir. 2010) (good financial standing one factor in adequate assurance). See also, In re Brentano's, Inc., 29 B.R. 881 (Bankr. S.D.N.Y. 1983) (proposed assignee's good financial standing constituted adequate assurance of future performance).

[43] In re Food Barn Stores, Inc., 107 F.3d 558 (8th Cir. 1997).

[44] In re Sunrise Restaurants, Inc., 135 B.R. 149 (Bankr. M.D. Fla. 1991).

[45] Bankruptcy Code § 365(k); 11 U.S.C. § 365(k).

[46] *Id.*

[47] See, e.g.:

First Circuit: In re Stadium Mgmt. Corp., 895 F.2d 845, 847–848 (1st Cir. 1990).

Second Circuit: In re Gucci, 126 F.3d 380, 388 (2d Cir. 1997).

Fourth Circuit: In re Adamson Co. Inc., 159 F.3d 896 (4th Cir. 1998).

Sixth Circuit: In re Nashville Sr. Living, LLC, 620 F.3d 584, 591 (6th Cir. 2010).

Eighth Circuit: In re Polaroid Corp., 611 F.3d 438, 440–441 (8th Cir. 2010).

Tenth Circuit: In re C.W. Mining Co., 641 F.3d 1235, 1238–1239 (10th Cir. 2011).

[48] Code § 363(m); 11 U.S.C. § 363(m).

§ 28.05 Rejection and Its Effect on Landlords and Tenants

[1]—Character of Rejected Contracts or Leases

Claims arising from the rejection of an executory contract or an unexpired lease are treated as prepetition claims by Section 365(g) of the Bankruptcy Code.[1]

Rejection of an executory contract or unexpired lease does not invalidate, repudiate, repeal or avoid a contract or lease; rather, the effect of rejection is that the contract can no longer be assumed and the nondebtor party cannot seek payment of an administrative expense from the debtor's estate if the debtor fails to make required rent payments or otherwise breaches.[2]

Similarly, rejection is not rescission.[3] Moreover, the Bankruptcy Code lacks clarity with regard to the effect of rejection and a variety of terms are used to describe the effect of rejection. If a debtor/tenant under a nonresidential lease does not assume its interest by the statutory deadline to do so, the lease is deemed rejected and the trustee is required to immediately surrender the premises;[4] if a tenant rejects a lease, the lease is treated as *breached* as of the date immediately before the filing of the petition;[5] and the landlord's *lease termination* damages are capped,[6] as will be discussed below.[7]

The ambiguity of the statutory framework has led to a case law split regarding the effect of rejection. Among other things, some courts have held that the lease is deemed terminated or rescinded upon rejection and others have held that the lease is merely deemed to have been breached.[8]

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[1] Medical Malpractice Ins. Ass'n v. Hirsch (In re Lavigne), 114 F.3d 379, 389 (2d Cir. 1997).

[2] In re Day, 208 B.R. 358, 365 (Bankr. E.D. Pa. 1997).

[3] In re Rudaw/Empirical Software Products, Ltd., 83 B.R. 241, 245 (Bankr. S.D.N.Y. 1988).

[4] Bankruptcy Code § 365(d)(4); 11 U.S.C. § 365(d)(4).

[5] Bankruptcy Code § 365(g)(1); 11 U.S.C. § 365(g)(1).

[6] Bankruptcy Code § 502(b)(6); 11 U.S.C. § 502(b)(6).

[7] See § 28.05[3][c] *infra* for a more complete discussion.

[8] See, e.g.:

Fourth Circuit: Fed. Realty Inv. Trust v. Park (In re Park), 275 B.R. 253, 256 (Bankr. E.D. Va. 2002) (court concluded that the rejection of a lease that occurred when the trustee failed to assume or reject within the statutory period did not terminate the debtor's rights under the lease).

Eighth Circuit: al. Pub. Employees' Retirement System v. Stanton (In re CP Holdings, Inc.), 349 B.R. 189, 192 (B.A.P. 8th Cir. 2006) (holding that a bankrupt tenant's rejection of a lease does not terminate the lease for purposes of determining whether the landlord's mortgagee held a security interest in the landlord's lease rejection claim).

State Courts:

California: Syufy Enterprises, L.P. v. City of Oakland, 104 Cal. App. 4th 869, 886–887 (Cal. App. 2002) (rejection of master lease terminates debtor-tenant's right to possession and, accordingly, subtenant's right to possession).

Missouri: Block Properties Co., Inc. v. American National Insurance Co., 998 S.W.2d 168, 175 (Mo. App. 1999) (rejection of master lease did not terminate underlying lease).

The issue becomes critical for a subtenant whose sublandlord has rejected an underlying primary lease, as the termination of the underlying primary lease generally will collapse the sublease. Additionally, the issue is critical for leasehold lenders, as the termination of a commercial lease securing repayment destroys the lender's collateral. In light of the uncertainty in the law, the subtenant should seek to obtain a non-disturbance, attornment or recognition agreement from the landlord of the underlying primary lease (which generally will provide that, upon termination of the primary lease, the subtenant will be recognized by the landlord of the primary lease as a direct tenant of such landlord and that the subtenant will pay the landlord of the primary lease rent at the higher of: (1) the sublease rent, and (2) the underlying base lease rent). The leasehold lender should obtain the agreement of the landlord of the primary lease to enter into a new lease with the lender upon termination of the old lease or its rejection in bankruptcy.

Somewhat as an aside, lenders to commercial landlords should consider the impact of rejection by the landlord's tenants, who may file for bankruptcy relief.[9] For example, losing an anchor tenant is almost certain to impair the value of a real estate asset that may constitute a mortgagees' collateral, as well as impair the mortgagor's cash flow and, therefore, its ability to service its debt.

[a]—Mortgage Lender Protection

In order to protect themselves, a mortgagee with an assignment of rents should protect itself by filing a proof of claim when a borrower's tenant files for bankruptcy relief, since the claim is likely to be a part of the mortgage lender's collateral, especially if the mortgagor has assigned rents to the mortgagee.

If a lease is rejected by the debtor/tenant, the landlord has a claim for damages based on breach of the lease.[10] If the tenant has subleased its premises or pledged the lease as security for a loan, the effect of rejection on the subtenant or lender is less clear.

[b]—Surrender of Premises

A number of courts have found the language of Bankruptcy Code Section 365(d)(4) to require a debtor/tenant and any subtenants who claim an interest in a leasehold to immediately surrender the leasehold upon rejection of a lease, without the necessity of an eviction proceedings under state law.[11] Other courts have

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[9] See In re CP Holdings, Inc., 349 B.R. 189, 192 (B.A.P. 8th Cir. 2006) (The landlord's mortgagee filed a claim in the tenant's bankruptcy for the landlord's lease rejection damages as assignee under an Assignment of Rents. Then the landlord filed for bankruptcy and tried to recover the bank's claim on the ground that since the bankrupt tenant's lease had been terminated by the tenant's bankruptcy, the claim for lease termination damages had been converted into a contract claim as to which the lender had no security interest. The court held the lease was not terminated for these purposes and upheld the bank's claim.).

[10] Bankruptcy Code § 365(g)(1); 11 U.S.C. § 365(g)(1).

[11] See:

First Circuit: In re Criadores De Yabucoa, Inc., 75 B.R. 96, 97 (Bankr. D.P.R. 1987).

disagreed.[12]

If after a lease is rejected the debtor/tenant remains in possession, it continues to be liable for rent under Bankruptcy Code Section 503(b)(1).[13] The reasonable value of such use and occupancy of the premises by a holdover tenant has been found by many courts to be the rent reserved under the lease.[14] Courts have reasoned that it would be inequitable to permit the debtor/tenant to have a rent obligation less burdensome during its holdover tenancy than when it was properly occupying the nonresidential real estate during the Section 365(d)(4) 120-day period.[15]

[2]—Effect of Rejection on Subtenants and Leasehold Mortgages

Rejection of the prime lease prior to or simultaneously with the rejection of the sublease by the lessee/sublessor/debtor results in the rejection of the sublease and deprives the sublessee of any right to occupy the leasehold following such rejection notwithstanding the protections afforded a tenant when its landlord rejects that are available under Section 365(h) of the Bankruptcy Code, including the right to stay in

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Second Circuit: In re Kong, 162 B.R. 86, 97-98 (Bankr. E.D.N.Y. 1993); In re O.P. Held, Inc., 77 B.R. 388, 391 (N.D.N.Y. 1987); In re Westview 74th Street Drug Corp., 59 B.R. 747, 752 (S.D.N.Y. 1986).

Sixth Circuit: In re Hurst Lincoln-Mercury, Inc., 70 B.R. 815, 817 (Bankr. S.D. Ohio 1987).

Ninth Circuit: In re Elm Inn, Inc., 942 F.2d 630, 633-634 (9th Cir. 1991); In re Southwest Aircraft Service, Inc., 53 B.R. 805, 809-810 (C.D. Cal. 1985), *aff'd* 66 B.R. 121 (B.A.P. 9th Cir. 1986), *rev'd on other grounds* 831 F.2d 848 (9th Cir. 1987), cert. denied 487 U.S. 1206 (1988).

Tenth Circuit: In re Duckwall-Alco Stores, Inc., 150 B.R. 965, 972 (D. Kan. 1993).

Eleventh Circuit: In re The Deli Den, LLC, 425 B.R. 725, 727 (Bankr. S.D. Fla. 2010); In re 6177 Realty Associates, Inc., 142 B.R. 1017 (Bankr. S.D. Fla. 1992).

[12] See, e.g.:

Third Circuit: In re Adams, 65 B.R. 646, 648-49 (Bankr. E.D. Pa. 1986).

Eleventh Circuit: In re Williams, 171 B.R. 420, 421 (Bankr. S.D. Ga. 1994).

[13] See:

Third Circuit: In re William H. Herr, Inc., 61 B.R. 252, 254 (Bankr. E.D. Pa. 1986).

Fifth Circuit: In re Braniff Airways, Inc., 783 F.2d 1283, 1285–1286 (5th Cir. 1991).

But see In re Macomb Occupational Health Care, LLC, 300 B.R. 270, 295 (Bankr. E.D. Mich. 2003).

[14] See:

First Circuit: In re Rare Coin Galleries, Inc., 72 B.R. 415, 417 (D. Mass. 1987).

Second Circuit: Farber v. Wards Co. Inc., 825 F.2d 684, 689–690 (2d Cir. 1987).

Fifth Circuit: In re Braniff Airways, Inc., 783 F.2d 1283, 1285 (5th Cir. 1991).

Seventh Circuit: In re Longua, 58 B.R. 503, 506 (Bankr. W.D. Wis. 1986).

But cf., In re Grant Broadcasting of Philadelphia, Inc., 71 B.R. 891 (E.D. Pa. 1987).

[15] In re Gillis, 92 B.R. 461, 470 (Bankr. D. Haw. 1988). See also, In re Rare Coin Galleries, Inc., 72 B.R. 415, 417 (D. Mass. 1987).

possession.[16] If, however, the debtor or trustee were to assume the primary lease and simultaneously or thereafter reject the sublease, the subtenant would have the benefit of Section 365(h) of the Bankruptcy Code and its right to possession would be protected.[17]

A further discussion of Section 365(h) of the Bankruptcy Code is appropriate at this point. This Bankruptcy Code provision was included in the statute for the express purpose of preserving a tenant's possessory interests when a debtor/landlord is a party to a rejected lease.[18]

Section 365(h) permits the nondebtor/tenant to remain in possession of the leasehold and offset against the rent reserved under the lease damages caused by the rejection. Alternatively, the tenant may treat the lease as "terminated" and vacate the premises and assert a claim for the damages caused by the rejection.[19] Although a number of courts have concluded that the provisions of Section 365(h) are the exclusive remedies of a debtor/lessor,[20] other courts have held that Section 365(h) does not limit a debtor/lessor's right to sell property free and clear of a lease under Section 363(f).[21] If the tenant chooses to remain in possession, it may offset any damages caused by the landlord's subsequent nonperformance of lease covenants against the reserved rent.[22]

For a subtenant or lender, there is considerable controversy as to whether the lease, if rejected by the debtor/tenant, remains "alive" or is effectively terminated.[23] If the lease is terminated, any sublease predicated on that lease will collapse (absent any contrary agreement between the landlord and the subtenant). If a lease that has been pledged as security is terminated, the leasehold lender's security is lost.

This is a problem in theory that can be easily solved in practice. As to the theoretical issue, the case law is divided. In terms of practice, the problem can be solved by using a recognition agreements (in the case of a secured leasehold lender) and non-disturbance agreement (in the case of a subtenant). Pursuant to the terms of these types of agreements, the landlord under the master lease agrees to recognize the lender's or subtenant's rights if the primary lease is terminated because of the primary lessee's default.

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[16] See:

Second Circuit: In re Child World, Inc., 142 B.R. 87, 89 (Bankr. S.D.N.Y. 1992). *Third Circuit:* Chatlos Systems, Inc. v. Kaplan, 147 B.R. 96, 100 (D. Del. 1992).

[17] In re Child World, Inc., 142 B.R. 87, 89 (Bankr. S.D.N.Y. 1992)

[18] *Id.*

[19] *Id.*

[20] *First Circuit:* In re Haskell L.P., 321 B.R. 1, 9 (Bankr. D. Mass. 2005).

Fourth Circuit: In re Taylor, 198 B.R. 142, 164 (Bankr. D.S.C. 1996).

[21] *Seventh Circuit:* Precision Industries, Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 548 (7th Cir. 2003) (Section 365(h) does not limit debtor's right to sell property free and clear of leases under Section 363(f)).

Eleventh Circuit: In re MMH Automotive Group, LLC, 385 B.R. 347, 366 (Bankr. S.D. Fla. 2008) (same).

[22] In re Stein, 281 B.R. 845, 850 (Bankr. S.D.N.Y. 2002).

[23] See § 28.05[1] *supra*.

If a prospective subtenant cannot obtain a non-disturbance agreement from the prime lease landlord (which is likely if the master lessee failed to negotiate for the right in the master lease) and has doubts about the continued solvency of its landlord (the prime lease lessee), the prospective subtenant should attempt to obtain an assignment of the underlying lease rather than a sublease. An assignment obviates the risk that a bankrupt sublessor will reject the master lease on which the prospective subtenant's tenancy is based.

If a landlord wishes to recover control of leased premises after a tenant's rejection of the tenant's interest in the lease in bankruptcy without having to litigate the entitlement to possession, the landlord will be well served by including a provision in its form of lease stating that the right to possession terminates if the lease is rejected by a debtor/tenant in any bankruptcy or other insolvency proceeding.[24]

If a lease is rejected and the bankruptcy case is subsequently dismissed, a plain reading of Section 349(b) of the Bankruptcy Code would appear to dictate that the lease is revived. [NTD - See if you can find a case].

[a]—Legal Standards Governing Lease Rejection

Most courts have held that an executory contract or unexpired lease may be rejected where the debtor's business judgment indicates that rejection will benefit the bankruptcy estate.[25] Some courts examine the impact of rejection on the debtor only.[26] Other courts determine business judgment by reviewing the effect of rejection on the recovery that may be available to the general unsecured creditors.[27]

Proper reasons for rejection include the following: (1) the contract is uneconomical to complete according to its terms; (2) the contract is financially burdensome to the estate; (3) rejection will make the debtor more attractive to prospective purchaser or investor; (4) rejection will result in a large claim against the estate; and (5) in the case of a stock option contract, the debtor can market shares and receive a higher or better price than by virtue of the option agreement.[28]

[b]—Refusal to Authorize Rejection

Although the decision to assume or reject is governed by the "business judgment" rule, there are times when the courts have refused to authorize rejection. Some courts have refused to authorize rejection and, in fact, have dismissed the bankruptcy peti-

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[24] See Block Properties Co., Inc. v. American Nat'l Ins. Co., 998 S.W.2d 168, 175 (Mo. App. 1999) (rejection of leases was mere breach, not termination, so provision in sublease providing that sublease terminated upon termination of master lease was not triggered).

[25] See, e.g., Borman's Inc. v. Allied Supermarkets Inc., 706 F.2d 187, 189 (6th Cir. 1983), *cert. denied* 464 U.S. 908 (1983) (the court only need determine "whether disaffirmance is advantageous to the debtor").

[26] In re Federated Department Stores, Inc., 131 B.R. 808, 813-814 (S.D. Ohio 1991) (where unsecured creditors could be paid even when rejection would not be authorized, court allowed debtor to reject lease because it benefited the debtor).

[27] In re Audra-John Corp., 140 B.R. 752, 756 (Bankr. D. Minn. 1992) (debtor would be allowed to reject franchise agreement when rejection would allow debtor to generate a small profit freeing up money for general unsecured creditors).

[28] In re Riodizio, Inc., 204 B.R. 417, 425 (Bankr. S.D.N.Y. 1997).

tion when the debtor files the petition for the sole purpose of rejecting an executory contract.[29] Still other courts have refused to consider the motives for filing a petition where the sole issue before the court is assumption or rejection.[30]

[c]—Effective Date of Rejection

A debtor or trustee is no longer obligated to pay the rent reserved upon rejection. Most courts that have opined on the issue have held the effective date of rejection to be the date the bankruptcy court enters its order approving rejection.[31] At least one court has held that rejection is effective when the lessor receives unequivocal notice of the trustee's or DIP's intent to reject.[32] Those cases appear to be outliers. Thus, as a general rule, (a) if a lease or contract is being rejected by virtue of motion practice, then the date of "rejection" will be either the date rejection is so ordered by a court or such earlier date as the court directs, and, in the event the statutory period to assume or reject has expired in the absence of a court order extending such time, the rejection date will be the expiration date.[33]

[d]—Landlord as Debtor

There are situations when the landlord is the debtor. A landlord filing for Chapter 11 relief may reject any lease, subject to bankruptcy court approval.[34] Under Section 365(h), the tenant then has the right either to: (1) treat the lease as terminated and vacate the space, or (2) remain in possession for the balance of the term of the lease

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[29] In re Southern California Sound System, Inc., 69 B.R. 893, 900 (Bankr. S.D. Cal. 1987).

[30] In re W & L Associates, Inc., 71 B.R. 962, 967-968 (Bankr. E.D. Pa. 1987).

[31] See:

First Circuit: In re Thinking Machines Corp., 67 F.3d 1021 (1st Cir. 1995).

Fifth Circuit: In re Cafeteria Operators, L.P., 299 B.R. 384, 394 (Bankr. N.D. Tex. 2003).

Sixth Circuit: In re Revco D.S., Inc., 109 B.R. 264, 267 (Bankr. N.D. Ohio 1989).

Eighth Circuit: In re Twin Cities Stores, Inc., 421 B.R. 522, 523–524 (Bankr. D. Minn. 2009); In re Worths Stores Corp., 130 B.R. 531 (Bankr. E.D. Mo. 1991).

Tenth Circuit: In re National Oil Co., 80 B.R. 525 (Bankr. D. Col. 1987).

But see:

First Circuit: In re GCP CT School Acquisition, LLC, 429 B.R. 817, 832 (B.A.P. 1st Cir. 2010) (recognizing court's equitable authority to order that rejection operates retroactively).

Third Circuit: In re DBSI, Inc., 409 B.R. 720, 734 n.4 (Bankr. D. Del. 2009) (court had authority, in appropriate circumstances, to enter a lease rejection order with an effective date earlier than the order's entry).

Fifth Circuit: In re Amber's Stores, Inc., 193 B.R. 819 (Bankr. N.D. Tex. 1996) (effective date of rejection is the date the court enters the order approving rejection; nonetheless, the court in that case concluded that the effective date of rejection would be the date the motion was filed based on the equities of the case).

Eleventh Circuit: In re Manis Lumber Co., 430 B.R. 269, 277 (Bankr. N.D. Ga. 2009) (court had discretion to approve retroactive rejection).

[32] In re 1 Potato, 2 Potato, Inc., 58 B.R. 752, 754-755 (Bankr. D. Minn. 1986).

[33] In re Florida Lifestyle Apparel Inc., 221 B.R. 897, 900 (Bankr. M.D. Fla. 1997).

[34] Bankruptcy Code § 365(h); 11 U.S.C. § 365(h).

and any renewal or extension. The right to remain in possession is subject to the tenant's continuing obligation to pay rent. In the case of bankruptcy, such payments are made to the estate. While the tenant is permitted to offset rent against any damages occurring after the date of the rejection caused by the landlord/debtor's nonperformance of its obligations, this is the tenant's only right against the landlord's estate for damages.

Section 365(h) provides that the lessee may retain those rights in the lease that are appurtenant to the real property, including those relating to the amount and timing of rent payments and those relating to use, possession, quiet enjoyment, subletting, assignment or hypothecation. Accordingly, it is clear that a rejected lease may be assigned or sublet. In addition, with respect to shopping center leases, provisions relating to exclusivity, use, and tenant mix, as well as radius and location clauses, remain enforceable despite the rejection of the lease by the landlord.

Although Section 365(h)(1) specifically protects the tenant's occupancy and lease rights in a landlord bankruptcy when a lease is rejected, debtor-landlords have successfully avoided its operation through the use of Sections 363(b) and (f) which, taken together, authorize a court ordered sale of the debtor-landlord's property free and clear of all encumbrances and interests if certain conditions are met.

Section 363(b)(1) authorizes the trustee to use, sell or lease a debtor's property outside of the ordinary course of business after notice and a hearing. Section 363(f)(1) permits such a sale to be "free and clear of any interest in such property" if: (1) state law permits the sale of such property free and clear of such interest, (2) the holder of the interest consents, (3) such interest is a lien and the price at which the property is to be sold is greater than the aggregate value of all liens, (4) the interest is in *bona fide* dispute, or (5) the holder of the interest could be compelled to accept a money satisfaction of such interest. Section 365(h)(1), however, provides that: "If the trustee rejects an unexpired lease of real property under which the lessor is the debtor and . . . if the term of such lease has commenced, the lessee may retain its rights under such lease. . . ." The question that arises is whether a landlord-debtor can use Section 363(f) to terminate a lease when Section 363(h)(1)(A) evinces congressional intent to preserve the tenant's leasehold interest in a landlord bankruptcy.

The case law suggests that a lease is an "interest" within the meaning of Section 363.[35] However, there is a split in authority as to whether a court-ordered sale of the debtor-landlord's property free and clear of any interest pursuant to Section 363(f) can effect the termination of a tenant's lease. Where tenants have made timely application for protection, courts have held or suggested that they will not permit a debtor-landlord to effect a backdoor termination of a lease through a court-ordered sale of the

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[35] See:

Second Circuit: In re Downtown Athletic Club of New York City, Inc., 2000 WL 744126 (S.D.N.Y. June 9, 2000).

Fourth Circuit: In re Taylor, 198 B.R. 142, 162 (Bankr. D.S.C. 1996).

Seventh Circuit: Precision Industries, Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537 (7th Cir. 2003).

See also Levitan and Lepsis, "Recent Cases Interpret Sec. 363 'Free and Clear' Asset Sales Broadly," New York Law Journal, p. 21, col. 2 (Aug. 25, 2003).

debtor-landlord's property free of all leases.[36] In *In re Taylor*, the tenant objected to the sale of the property.[37] In *In re Churchill Properties III, Limited Partnership*, the tenant objected after the court-ordered sale of the property free of all encumbrances and after the landlord rejected the lease, but in that case the tenant had indicated its intent to respond to the rejection motion prior to the court order of the sale and rejection.[38] The *Churchill* Court held that the tenant's motion should be granted to the extent of permitting the tenant to retain its rights under Section 365(h)(1), reasoning that the specific tenant protections contained in Section 365(h)(1) trumped Section 363(b) and (f)'s general authorization of a sale of the debtor's property free and clear of any interest.[39] The *Taylor* Court indicated that a tenant's rights under Section 365(h)(1) could not be negated through a sale of the landlord's property pursuant to Section 363(f).[40]

Taylor and *Churchill* have been criticized;[41] and other courts have reached a different result.[42] In both *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*[43] and *In re Downtown Athletic Club of New York City, Inc.*,[44] the tenant was on notice of the proposed sale and asserted its claims to the property after the sale had been effected. In each case, the tenant failed to appeal the sale order within the applicable time limits. Also, in each case, the court refused to allow the tenant subsequently to assert that its lease survived the sale. In *Taylor*, the court indicated that the sale was proper under Section 363(f)(4) because there was a *bona fide* dispute as to whether the tenant had any possessory rights. In *Precision Industries*, the tenant apparently failed to contest the debtor-landlord's statement that, leaving aside the issue of whether Section 365(h)(1) trumps Section 363(f), the sale was authorized under Section 363(f). Although

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[36] See:

Fourth Circuit: In re Taylor, 198 B.R. 142 (Bankr. D.S.C. 1996). In the *Taylor* case, the court considered a range of issues raised by the tenant, including: (1) whether a pre-confirmation sale was appropriate under the circumstances [no], (2) whether the sale of the land free of the leases effected a sale of property that did not belong to the bankrupt's estate [no], (3) whether the leases at issue were liens (rather than true leases) that could be disposed of pursuant to a Section 363(f)(3) [no], (4) whether the existing disputes between landlord and tenant as to the amount of rent owed and the payment of taxes into escrow justified the sale of the property under Section 363(f)(4) [no]—the court suggesting that a doubtful or curable dispute should not be used as a wedge by the landlord prior to the actual sale of the property.

[37] In re Taylor, 198 B.R. 142, 162 (Bankr. D.S.C. 1996).

[38] In re Churchill Properties III, Limited Partnership, 197 B.R. 283 (N.D. Ill. 1996).

[39] *Id.*

[40] In re Taylor, 198 B.R. 142, 162 (Bankr. D.S.C. 1996).

[41] Haydon and March, "Sale of Estate Property Free and Clear of Leasehold Interests Pursuant to § 363(f): An Unwritten Limitation?," 19 Am. Bankr. Inst. J. 20 (July/Aug. 2000).

[42] Haydon and March, "Sale of Estate Property Free and Clear of Leasehold Interests Pursuant to § 363(f): An Unwritten Limitation?," 19 Am. Bankr. Inst. J. 20 (July/Aug. 2000), (discussing cases). See also Precision Industries, Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 548 (7th Cir. 2003). In light of the position taken by the courts in the Downtown Athletic Club and Precision Industries cases, a tenant's lawyer clearly should monitor the landlord's bankruptcy and be prepared to oppose any motion by the landlord to sell the building free of the tenant's lease.

[43] Precision Industries, Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 548 (7th Cir. 2003).

[44] In re Downtown Athletic Club of New York City, Inc. 2000 WL 744126 (S.D.N.Y. June 9, 2000).

Downtown Athletic Club and *Precision Industries* could possibly be viewed as products of the failure to timely assert rights, in each case the court unequivocally stated that Section 365(h)(1) does not preclude a sale of the landlord's property free of leases under Section 363(f) if one of the conditions of Section 363(f) is met. The *Precision Industries* Court also noted that the tenant is entitled to "adequate protection" of its interest under Section 363(e), and that such requirement would entitle the tenant to be compensated for the value of its leasehold—typically from the proceeds of the sale.[45]

In light of the position taken by the courts in the *Downtown Athletic Club* and *Precision Industries* cases, a tenant's lawyer clearly should monitor the landlord's bankruptcy and be prepared to oppose any motion by the landlord to sell the building free of the tenant's lease.

Sections 363(f) and 365(h)(1) arguably are not inconsistent, as Section 363(f) permits sales free of interests only under narrowly defined circumstances. However, in light of Congress' clear intent to protect tenant interests (as evidenced by Section 365(h)(1)), courts should not stretch the boundaries of Section 363(f) to permit sales free of leases except in those cases when the requirements of Section 363(f) have been clearly and unequivocally met. Of course, there is no assurance that a court on a given set of facts may ignore the so-called clear intent and stretch the boundaries.

[3]—Rejection Damages

[a]—Nature of Rejection Damages

After rejection, executory contracts and unexpired leases are treated as if they had been breached by the debtor immediately before the petition was filed.[46] The non-debtor party to the agreement will be able to assert a general unsecured claim for any damages suffered due to the breach.[47] However, courts have to be payment streams due under various agreements to the present value of the income stream that would have been generated.[48]

[b]—Quantifying Rejection Damages

While state law governs the calculation of breach claims,[49] a landlord's rights to damages *resulting from the termination of the lease* are also limited by operation of the Bankruptcy Code[50] as follows:

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[45] Precision Industries, Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 548 (7th Cir. 2003).

[46] Bankruptcy Code §§ 365(g) and 502(g); 11 U.S.C. §§ 365(g) and 502(g).

[47] *Id.* In re Child World, Inc., 161 B.R. 349 (Bankr. S.D.N.Y. 1993) (damage claims for rejection are treated as if the claim had arisen before the bankruptcy filing date).

[48] See:

Second Circuit: In re O.P.M. Leasing Services, Inc., 79 B.R. 161 (S.D.N.Y. 1987).

Sixth Circuit: In re Highland Superstores, 154 F.3d 573, 579 (6th Cir. 1998).

Tenth Circuit: In re Shane Co., 464 B.R. 32, 37 (Bankr. D. Col. 2012).

[49] *Id.*

[50] In re Lavigne, 114 F.3d 379 (2d Cir. 1997). But see Adelphia Business Solutions, Inc. v. Abnos, 482 F.3d 602 (2d Cir. 2007).

Prepetition Damages. The unpaid rent due under the lease (determined without reference to any acceleration provision) computed as of the earlier of (a) the date the petition was filed, or (b) the date the landlord repossessed, or the tenant surrendered, the premises.[51] Timing issues can arise in the calculation of prepetition rent, just as they arise with respect to other provisions of the Bankruptcy Code.[52]

Reserved Rent. The landlord may also file a claim for lease termination damages equal to the sum of the greater of: (a) one year's rent (calculated without reference to any acceleration of rents provision), and (b) the rent reserved by the lease for 15%, not to exceed three years, of the remaining term of the lease. The calculations of the damages are discussed at length below.

A landlord's claim for lease termination damages generally is unsecured and, accordingly, is paid out of the assets of the bankrupt's estate available for distribution to the unsecured creditors.[53] However, a landlord should be able to apply any security deposit against its damages on either a set-off theory[54] or on grounds that the landlord has a perfected security interest in the tenant's security deposit.[55]

Once the petition is filed, the landlord will be unable to apply the balance of any cash security deposit against the tenant's obligations until the automatic stay is lifted (which will occur at the end of the case, or earlier if the court vacates the stay as to the landlord).[56] However, a landlord who has mishandled a security deposit may lose his

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[51] Bankruptcy Code § 502(b)(6)(B); 11 U.S.C. § 502(b)(6)(B).

[52] See In re Vause, 886 F.2d 794 (6th Cir. 1989) (where lease rent was paid annually in arrears on December 1 and tenant both filed for bankruptcy and rejected lease on November 27 before rent became payable, court allowed landlord's claim for 361 days of prepetition rent on grounds that the rent was owed, if not yet due, for the prepetition period).

[53] In re Treesource Industry, Inc., 363 F.3d 994 (9th Cir. 2004).

[54] Bankruptcy Code Section 553 permits the landlord, under applicable nonbankruptcy law, to offset the tenant's claim against the landlord for the security against the landlord's claim against the tenant for rent, but only (1) after the court vacates the automatic stay, and (2) to the extent the landlord has an allowable claim. Bankruptcy Code § 553; 11 U.S.C. § 553. In addition, Code Section 553 bars offset if the landlord obtained the security deposit during the ninety-day period preceding the bankruptcy filing when the debtor was insolvent (and Code Section 553(c) creates a presumption that the debtor/tenant was insolvent during the ninety-day period). Section 506 of the Code makes the landlord a secured creditor to the extent of its setoff right. Bankruptcy Code § 506; 11 U.S.C. § 506.

Although it has been said that the right to setoff is within the discretion of the court, exercised under principles of equity, it has also been said that the legislative history of the Code clearly indicates that the tenant's security deposit is to be applied against the landlord's allowable claim. In re Communicall Central, Inc., 106 B.R. 540 (Bankr. N.D. Ill. 1989).

[55] If the lease provides that the tenant is to provide cash security for the tenant's obligations and the landlord has possession of the cash, the landlord arguably has a perfected security interest in the security deposit as long as it has possession of the deposit. See, e.g., N.Y. U.C.C. § 9-313(b), which provides: "A security interest in money may only be perfected by the secured party's taking possession. . . ." See also, In re Atlanta Times, Inc., 259 F. Supp. 820, 827-828 (N.D. Ga. 1966). It is not entirely clear from the case law if a cash security deposit, held in a bank account, is deemed "money."

[56] See Bankruptcy Code § 362(a)(7); 11 U.S.C. § 362(a)(7), which provides, in part, that the filing of the bankruptcy petition "operates as a stay . . . of . . . the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor. . . ."

perfected status as to such security.[57] Use of a letter of credit as security should avoid the application of the automatic stay and the delay engendered by the requirement to lift the stay as a prerequisite to recovery of the security deposit. However, as a letter of credit, arguably, represents the obligation of the bank (not the tenant) to the landlord, a draw should not be subject to the automatic stay, as the letter of credit itself is not an asset of the tenant's estate. Accordingly, the landlord may draw on the letter of credit to cure the tenant's defaults without violating the automatic stay because the automatic stay does not affect property that is not "property of the estate."[58]

Another issue that arises is whether a security deposit is applied against the landlord's entire claim (which would generally leave the landlord's capped claim for damages in the bankruptcy court intact, since the landlord's entire claim usually substantially exceeds the capped claim), or against the landlord's allowable claim (i.e., the landlord's capped claim for damages). Cash security deposits are applied against the landlord's capped claim for damages.[59] There is an issue as to whether a letter of credit that serves as security should be applied against the landlord's gross claim for damages or capped claim for damages. The resolution of the question may depend on, among other things, whose assets secure repayment of a draw on the letter of credit to the issuing bank and whether the landlord has filed a proof of claim in bankruptcy. The trend, however, appears to be to apply the letter of credit proceeds against the landlord's capped claim.

[c]—Calculations on Rejection Damages Claims—Nonresidential Real Property

All damages for rejected leases available under state law are allowed under the Bankruptcy Code but are capped at the amount of any unpaid rent due under the lease without acceleration on the earlier of the date of the petition or the date of surrender; plus the greater of:

- Rent due under the lease for one year; or
- 15% of the rent due under the lease for the remainder of the term, but no more than three years.[60]

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[57] For example, in Matter of Ideal Reliable Sundries, Inc., 374 N.Y.S.2d 10, 49 A.D.2d 852 (App. Div. 1st Dep't 1975), a landlord who failed to comply with a statutory requirement to segregate security deposits was required to return the amount of the security deposit to an insolvent tenant's estate, where it was subject to the general claims of creditors.

[58] See § 28.02[4] *supra* for a more complete discussion.

[59] Oldden v. Tonto Realty Corp., 143 F.2d 916, 962–963 (2d Cir. 1944). See also In re AB Liquidating Corp., 416 F.3d 961, 964–965 (9th Cir. 2005); In re Mayan Networks Corp., 306 B.R. 295, 305 (B.A.P. 9th Cir. 2004).

[60] Bankruptcy Code § 502(b)(6); 11 U.S.C. 502(b)(6).

In re McLean Enterprises, Inc., 105 B.R. 928, 936 (Bankr. W.D. Mo. 1989) (Damages allowable are determined under applicable non-bankruptcy law, § 502(b)(6) merely caps those damages.).

See also In re Bob's Sea Ray Boats, Inc., 143 B.R. 229, 231 (Bankr. D.N.D. 1992). Section 502(b)(6) "is designed to compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditor s from recovering a dividend from the estate." H.R. Rep. No. 595, 95th Cong., 1st Sess. 352 (1977).

Most courts hold that rent payments made by the debtor are not deductible from the damages the landlord may recover after the cap of Section 502(b)(6) is applied to the landlord's claim.[61]

Section 502(b)(6) does not require reduction of capped claims for damages resulting from rejection to its present net value.[62] However, a landlord's claims for physical damage to leasehold and for repair and maintenance are not subject to the Section 502(b)(6) cap because they are damages for breaches of covenants to repair and maintain, which constitute unpaid prepetition rent arising as a result of the lease termination.[63]

Some courts include costs incurred in reletting the property, such as attorneys' fees, brokers' fees, taxes and costs for remodeling and reconstruction in the damages capped by Section 502(b)(6) of the Bankruptcy Code.[64] However, other courts have held that the damage cap under Section 502(b)(6) only limits damages incurred in connection with the tenant's failure to complete the lease term and does not include damages wholly collateral to termination such as waste, destruction or removal of leasehold property.[65]

In a recent decision, the United States Bankruptcy Court for the District of Delaware held that §502(b)(6)(A) includes not only base rent, but, also, all fees, costs and expenses arising from the termination of a non-residential lease.[66] This interpretation of §502(b)(6) means all of the landlord's costs and expenses had to be tested to determine whether they arose prior to, or as a result of, the termination of the least, and all such expenses were subject to the §502(b)(6) cap.[67]

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[61] See:

First Circuit: In re All For A Dollar, Inc., 191 B.R. 262, 264 (Bankr. D. Mass. 1996).

Second Circuit: In re Financial. News Network, Inc., 149 B.R. 348, 350–353 (Bankr. S.D.N.Y. 1993).

Ninth Circuit: In re First Alliance Corp., 140 B.R. 531, 533 (B.A.P. 9th Cir. 1992).

But see, In re Stewart's Properties, Inc., 41 B.R. 353, 355 (Bankr. D. Haw. 1984) (post-petition payment allowed as deduction).

[62] In re Allegheny International, Inc., 145 B.R. 823, 827 (Bankr. W.D. Pa. 1992).

[63] See:

Sixth Circuit: In re Energy Conversion Devices, Inc., 483 B.R. 119, 125 (Bankr. E.D. Mich. 2012).

Seventh Circuit: In re Atlantic Container Corp., 133 B.R. 980, 986–987 (N.D. Ill. 1991).

But see:

Third Circuit: In re Foamex International, Inc., 368 B.R. 383, 394 (Bankr. D. Del. 2007) (holding that Section 502(b)(6) limits damages for failure to perform maintenance and repair obligations).

[64] *Seventh Circuit:* In re Goldblatt Brothers, Inc., 66 B.R. 337, 344–345 (Bankr. N.D. Ill 1986).

Eighth Circuit: In re McLean Enterprises, Inc., 105 B.R. 928, 936–937 (Bankr. W.D. Mo. 1989).

Tenth Circuit: In re Storage Technology Corp., 77 B.R. 824, 825 (Bankr. D. Col. 1986).

[65] *Second Circuit:* In re International Coins & Currency, Inc., 18 B.R. 335, 338 (Bankr. D. Vt. 1982).

Seventh Circuit: In re Atlantic Container Corp., 133 B.R. 980 (Bankr. N.D. Ill. 1991).

Eighth Circuit: In re Bob's Sea Ray Boats, Inc., 143 B.R. 229, 232 (Bankr. D.N.D. 1992).

[66] *In re RGN-Grp. Holdings, LLC*, 2022 Bankr. LEXIS 394, at *5–8 (Bankr. D. Del. Feb. 17, 2022)

[67] *Id.* at *8–9

The amount of the rent is determined by examining the lease in question. Thus, additional charges are considered rent only if expressly called such under the lease and only when the charges are fixed, regular and periodic.[68]

According to a Michigan bankruptcy court, deferred rent is a prepetition claim and not limited by Section 502(b)(6) cap.[69] The court rejected the debtors' argument that the deferred rent amount did not accrue in the prepetition period and that, but for the lease rejection, would not be owing until several years later. The court discussed the meaning of the undefined term "due" used in Section 502(b)(6) and concluded that "due" means "owing."[70]

In terms of measuring damages, the Sixth Circuit has held that damages are to be calculated under the lease and under state law without application of any discount rate to account for present value.[71]

A landlord's claim for rejection damages is subject to a defense by the debtor for landlord's failure to mitigate the damages arising from the lease rejection.[72] Landlord's claim was not reduced, as it made reasonable efforts to mitigate damages.[73]

Note that state law will govern regarding the requirement that a nonresidential landlord mitigate and the substantive requirements governing such mitigation efforts.[74]

Damages relating to failure to make repairs, however, usually are not included in the calculation of the cap.[75] Reletting proceeds generally are applied to reduce the landlord's actual damages, which are then limited by the statutory cap.[76]

"Any rents received in consequence of re-letting are not, however, applied toward satisfaction of the § 502(b)(6) claim after making the statutory calculations, rather

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[68] In re Conston Corp., 130 B.R. 449, 455-456 (Bankr. E.D. Pa. 1991).

[69] In re Gantos, Inc., 181 B.R. 903, 908-909 (Bankr. W.D. Mich. 1995) (citing In re Vause, 886 F. 2d 794 (6th Cir. 1989)).

[70] *Id.*

[71] In re Highland Superstores, Inc., 154 F.3d 573, 581 (6th Cir. 1998).

[72] See, e.g.:

Third Circuit: In re of TIE/Communications, Inc., 163 B.R. 435, 439 (Bankr. D. Del. 1994).

Eighth Circuit: R & O Elevator Co. Inc. v. Harmon, 93 B.R. 667, 671 (Bankr. D. Minn. 1988).

[73] In re Heck's, Inc., 123 B.R. 544, 546 (Bankr. S.D.W. Va. 1991).

[74] See In re Highland Superstores, Inc., 154 F.3d 573, 578–579 (6th Cir. 1998).

[75] See, e.g., In re New Valley Corp., 2000 WL 1251858, at *10 (D.N.J. Aug. 31, 2000) (claims for repairs subject to, but not included in calculation of, statutory cap). But see In re Best Products Co., Inc., 229 B.R. 673 (Bankr. E.D. Va.1998) (claim for cost of repairs not subject to Section 502(b) cap because not a claim for damages resulting from lease termination).

[76] See:

First Circuit: In re All For A Dollar, Inc., 191 B.R. 262, 264–265 (Bankr. D. Mass 1996).

Second Circuit: In re Financial News Network, Inc., 149 B.R. 348, 350–353 (Bankr. S.D.N.Y. 1993).

Third Circuit: In re Fifth Avenue Jewelers, 203 B.R. 372, 376–377 (Bankr. W.D. Pa. 1996) (rent recoverable by landlord during pre-rejection period is reduced by net reletting proceeds); In re Community Health Net, 333 B.R. 308, 309 (Bankr. W.D. Pa. 2005).

Seventh Circuit: In re Atlantic Container Corp., 133 B.R. 980, 989–990 (Bankr. N.D. Ill. 1991); In re Goldblatt Brothers, Inc., 66 B.R. 337, 347–348 (Bankr. N.D. Ill. 1986).*Eighth Circuit:* In re McLean Enterprises, Inc., 105 B.R. 928, 937 (Bankr. W.D. Mo. 1989).

Tenth Circuit: In re Shane Co., 464 B.R. 32, 44 (Bankr. D. Colo. 2012).

such payments are deducted from the landlord's total actual lease termination damages, before the § 502(b)(6) cap is applied."[77] The Section 502(b)(6) damages cap does not apply to damages "wholly collateral to the termination event—such things as waste, destruction or removal of leasehold property."[78] The statutory cap applies even when the lessor is solvent.[79]

When a landlord does not submit proof of mitigation, the court will apply the federal damage rule. This rule calculates damages as the difference between the lease's value for the remainder of the term and the present fair market value for the remainder of the term to determine landlord's damage claim.[80]

In 2007, the Ninth Circuit found that the statutory cap does not apply to a "tort-like" claim based on physical damages to the leased premises. In that case, the debtor, a mining company, left one million tons of wet clay "goo" on the leased property following the rejection of lease.[81] The landlord sought $23 million in damages based on the cost of removal. The debtor argued that the damages cap applied to the claim, as the condition in which the tenant left the premises violated covenant in the lease, which would have reduced the landlord's entire claim to approximately $336,000.[82]

The Ninth Circuit determined that the statutory cap only applies to damages based on the landlord's loss of future rental income, not to tort-like claims.[83] The court distinguished rent damages from tort damages because the formula for the statutory cap is based on a calculation regarding future rent. Thus, the Ninth Circuit reasoned, it "made sense" that the cap did not cover damages bearing at most a weak correlation to the amount of future rent reserved.[84] The Ninth Circuit found additional support for its holding in the plain language of the Code Section 502(b)(6), which applies to damages "resulting from" lease rejection.[85] In effect, the landlord's claims for waste, nuisance and trespass did not "result from" a lease rejection, but rather from the debtor's leaving a mess. The Ninth Circuit articulated the following test for whether damages "result from" rejection of the lease: "[a]ssuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it?"[86] The Ninth Circuit also found that policy concerns favored not applying the statutory cap to non-rent damages because: (1) that result avoided giving a debtor a "perverse incentive"[87] to reject otherwise desirable leases in order to reduce overall exposure to liability, particularly if the tenant had damaged the leased property; and (2) extending the cap to collateral damages would eliminate any incentive for a debtor not to damage a premises, as the tenant would know it could incur no liability in excess of the statutory cap.

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[77] In re Bob's Sea Ray Boats, Inc., 143 B.R. 229, 231 (Bankr. D.N.D. 1992) (citing In re Goldblatt Brothers, Inc., 66 B.R. 337 (Bankr. N.D. Ill. 1986)).

[78] *Id.*

[79] In re Federated Department Stores, Inc., 131 B.R. 808, 818 (S.D. Ohio 1991).

[80] In re J. Bildner & Sons, Inc., 106 B.R. 8, 13 (Bankr. D. Mass. 1989).

[81] In re El Toro Materials Company, Inc.), 504 F.3d 978, 979 (9th Cir. 2007), *cert. denied* 522 U.S. LEXIS 1311 (2008).

[82] *Id.* 504 F.3d at 981–982.

[83] *Id.*

[84] *Id.*, 504 F.3d at 980.

[85] *Id.* See Bankruptcy Code § 502(b)(6); 11 U.S.C. § 502(b)(6).

[86] In re El Toro Materials Company, Inc., 504 F.3d 978, 981 (9th Cir. 2007).

[87] *Id.*

Practice Pointers: Debtors and landlords will argue over the application of the statutory cap to claims for physical damage to the leasehold. A key battle line will be drawn over whether "tort-like" damages are deemed to arise from rejection of a lease or from the independent breach of a covenant under the lease. Tenants will argue that such damage claims duplicate claims for rent and should be disallowed. Landlords will attempt to distinguish damage claims from claims for the rent reserved by the lease that are subject to the cap.

[d]—Risks from Post-Rejection Sale of Leased Property

In a Delaware bankruptcy case,[88] the tenant rejected its lease for real property. Subsequently, the landlord sold the property. In the bankruptcy case, the landlord filed a claim for lease rejection damages exceeding $2 million. The debtor objected, claiming that the landlord's sale of the former leasehold eliminated the landlord's claim for lease rejection damages for any rent that would have accrued after the sale.

The Bankruptcy Court sustained the debtor's objection, reasoning that real property rights are governed by state law and the parties' agreement.[89] Under Virginia law (although the suit was brought in Delaware, the leased premises were in Virginia), a landlord has three options upon a tenant's breach of a lease. The landlord can: (1) re-enter the premises and terminate the lease; (3) re-enter for the limited purpose of re-letting without terminating the lease; or (3) refuse to re-enter and instead initiate an action for accrued rents.[90] The Bankruptcy Court found the third option inapplicable as the landlord had re-entered the premises. In determining which of the first two options applied, the court relied on authority holding that a sale of property subject to a lease was "so inconsistent with the tenant's estate as to allow for no other interpretation than that the landlord had reentered in order to accept a surrender."[91] Thus, the landlord's sale of the property was found to constitute the "exercise of sufficient dominion" over the former leasehold to evidence the acceptance by the landlord of the tenant's abandonment of such leasehold.[92] This led the court to its conclusion that no further rent was due.

After concluding that under applicable state law the landlord's conduct amounted to the acceptance of a surrender of the leasehold vitiating the landlord's right to future rent payments, the court sought to determine whether the parties had contracted around such result. The court found that lease provisions potentially overriding state law should be strictly construed and held the lease provisions relied on by the landlord supported the proposition that the landlord's conduct did not alter the rights of the parties or override the applicable state law provision.[93] Alternatively, the court found that a lease provision authorizing the landlord to collect all rent if the lease was terminated as a result of a bankruptcy would be an unenforceable ipso facto clause under Section 365(e)(1) of the Bankruptcy Code.[94]

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[88] In re Fly I, Inc., 377 B.R. 140 (Bankr. D. Del. 2007).
[89] *Id.*
[90] *Id.* 377 B.R. at 143.
[91] *Id.* 377 B.R. at 144 (quoting Wilson v. Ruhl, 356 A.2d 544, 547 (Md. 1976)).
[92] *Id.* 377 B.R. at 144.
[93] *Id.,* 377 B.R. at 145
[94] *Id.*, 377 B.R. at 146.

Similarly, in a Minnesota bankruptcy case, the debtor rejected a leasehold, and the landlord subsequently sold the property.[95] The landlord cited multiple cases holding that a landlord has no duty to attempt to re-let leased premises following the tenant's abandonment under the applicable state law. The landlord also argued that state law did not require the landlord to mitigate, and, therefore, a sale should reduce the rejection damages claim. The court found that although a landlord does not have a duty to mitigate following a tenant's abandonment, after *termination* of a lease, a landlord does have a duty to mitigate.[96] The court then found that the sale of the leased property was unequivocal proof that the landlord intended to accept the tenant's surrender.[97] Accordingly, the court held that the sale of the property after rejection constituted mitigation of the landlord's damages such that the landlord had no right to future lease rejection damages accruing after the sale.[98]

Practice Pointers: Considering the rationale used by the Delaware and Minnesota courts, a landlord should fully consider the impact of a sale of a property on a rejection damages claim arising after the rejection of a lease. Conversely, the debtor must check its facts when objecting to a lease rejection claim to determine whether the underlying property has been sold by the landlord. The sales price should be analyzed to determine what future rent stream the sales price reflects, with only that imputed rent stream to be credited against the landlord's future damages claim (prior to application of the statutory cap),[99] the cases seem to require elimination of the landlord's entire rejection claim to the extent based on rent that would have accrued post-sale.

Additionally, a landlord may be able to mitigate the risk to a future lease rejection claim by careful drafting. For example, a landlord may include language such as "notwithstanding anything contained in this Lease to the contrary, the sale of the Premises by Landlord shall not constitute Landlord's acceptance of Tenant's abandonment of the Premises or rejection of the Lease or in any way impair Landlord's rights upon Tenant's default, including, without limitation, Landlord's right to damages." Such language is crafted to express the unequivocal intent of the parties that a sale after a lease rejection in bankruptcy would not constitute an acceptance of the tenant's abandonment. Such language may serve to inform a bankruptcy court of the intent of the parties and reduce the risk that the court will disallow a rejection damage claim.

[e]—Third-Party Credit Support and the Section 502(b)(6) Damage Cap

Landlords should be aware that bankruptcy courts may apply the Bankruptcy Code to limit remedies against guarantors to an unexpected degree. The Code Section 502(b)(6) places a cap on a landlord's claim for lease termination damages. The landlord's claim against a tenant's guarantor similarly is capped if the guarantor has filed for

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[95] In re Timber Lodge Steakhouse, Inc., 377 B.R. 604 (Bankr. D. Minn. 2007).

[96] *Id.*, 377 B.R. 606.

[97] *Id.*, 377 B.R. at 607.

[98] *Id.*

[99] See In re Ames Department Stores, Inc., 173 B.R. 80, 82 (Bankr. S.D.N.Y. 1994) (applying the statutory cap to limit landlord's rejection damages claim).

Chapter 11 protection.[100] That is, the landlord's claim against the bankrupt guarantor is capped at the greater of one year's rent or 15% of the rent due for the remaining term of the lease (not to exceed three years). A Fourth Circuit case capped a landlord's claim against the debtor-guarantor even though the tenant was not itself in bankruptcy (although it was insolvent).[101]

These cases do not limit the liability of a lease guarantor who is not in bankruptcy. However, a guarantor's liability for lease obligations can create a crushing liability that will force an individual guarantor to file for bankruptcy. Accordingly, in negotiating with a guarantor after a tenant default, the landlord and guarantor should bear in mind that the landlord's claim against the guarantor, if the guarantor files for Chapter 7 relief, may be limited.

The majority of the courts addressing the issue have held that guarantors of nonresidential leases that have not filed under the Bankruptcy Code do not benefit from the Section 502(b)(6) damage cap to limit such guarantors' liability.[102]

Where both tenant and guarantor have filed under the Bankruptcy Code, the Section 502(b)(6) cap will benefit both debtors.[103]

However, if the guarantor files for bankruptcy relief and the tenant does not, the Section 502(b)(6) cap protects the debtor/guarantor to limit its guaranty obligation. Section 502(b)(6) limits lease rejection claims against debtors, without distinguishing between debtor/tenants and debtor/guarantors.[104]

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[100] In re Radio Keith-Orpheum, 91 F.2d 753, 756 (2d Cir. 1937), *cert. denied* 302 U.S. 748 (1937).

But see:

Fourth Circuit: Bel-Ken Associates Ltd. Partnership v. Clark, 83 B.R. 357, 358–359 (D. Md. 1988).

Sixth Circuit: Things Remembered, Inc. v. BGTV, Inc., 151 B.R. 827, 831 (Bankr. N.D. Ohio 1993).

Eighth Circuit: In re Modern Textile Inc., 900 F.2d 1184, 1191 (8th Cir. 1990).

[101] In re Lindsey, 30502 WL 705435 (4th Cir. Nov. 7, 1997).

[102] See:

Fourth Circuit: Bel-Ken Associates Ltd. Partnership v. Clark, 83 B.R. 357, 358–359 (D. Md. 1988).

Sixth Circuit: Things Remembered, Inc. Inc. v. BGTV, 151 B.R. 827, 831 (Bankr. N.D. Ohio 1993).

Eighth Circuit: In re Modern Textiles, Inc., 900 F.2d 1184 (8th Cir. 1990).

[103] See:

Sixth Circuit: In re Revco D.S., Inc., 138 B.R. 528, 532 (Bankr. N.D. Ohio 1991).

Tenth Circuit: In re Rodman, 60 B.R. 334, 335 (Bankr. W.D. Okla. 1986).

[104] *Second Circuit:* In re Episode U.S.A., Inc., 202 B.R. 691, 695–696 (Bankr. S.D.N.Y. 1996).

Third Circuit: In re Flanigan, 374 B.R. 568, 575-576 (Bankr. W.D. Pa. 2007).

Sixth Circuit: In re Thompson, 116 B.R. 610, 613 (Bankr. S.D. Ohio 1990).

Ninth Circuit: In re Anden, 176 F. 3d 1226, 1227 (9th Cir. 1999).

Eleventh Circuit: In re Henderson, 305 B.R. 581, 582 (Bankr. M.D. Fla. 2003), *aff'd,* 143 F. App'x 292 (11th Cir. 2005).

But see In re Dronebarger, 2011 452 WL 350479 at *17 (Bankr. W.D. Tex. Jan. 31, 2011) (holding that Section 502(b)(6) cap did not apply to debtor-guarantor).

[f]—Use of Letters of Credit to Assure Payment of a Tenant Lease Obligation[105]

Applying the "independence theory" regarding letters of credit under the Uniform Commercial Code,[106] it has been the thought process of many landlords that letters of credit could be used in lieu of guaranties or security deposits to avoid the limitation on rejection damage claims imposed by Section 502(b)(6). However, many courts, correctly or not, have applied the cap to letters of credit taken by landlords to secure a tenant's performance. In one case, the Third Circuit determined that the cap on a landlord's damages is determined first, then the letter of credit is applied to the cap, with the landlord only being able to assert a claim for the balance against the debtor.[107] The court treated the letter of credit as a security deposit, finding, among other things, that the intent of the parties was to treat such letter of credit as a security deposit.

The Fifth Circuit, in contrast, has held that a landlord may draw on a letter of credit and retain proceeds—even in excess of the Section 502(b)(6) cap—as the damage cap of Section 502(b)(6) does not apply to limit the draw on a letter of credit, nor the landlord's ability to recover damages from the proceeds of a letter of credit, unless and until the lessor makes a claim against the estate.[108] The Fifth Circuit reasoned that the landlord: (1) had drawn on the letter of credit; (2) did not file a proof of claim against the debtor; and (3) Section 502 (b)(6) is not a self-effectuating avoiding power.[109]

Practice Pointer: Consider the use of a letter of credit issued by a special purpose entity that is unlikely to file for bankruptcy relief, as opposed to a holding company or other affiliate that may be more likely to file for bankruptcy relief.

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[105] See § 4A.02[3] *supra* for further, detailed discussion of the impact of bankruptcy filings on letters of credit.

[106] UCC § 5-103(d).

[107] In re PPI Enterprises (U.S.), Inc., 324 F.3d 197, 210 (3d Cir. 2003).

[108] In re Stonebridge Technologies, 430 F.3d 260, 270 (5th Cir. 2005).

[109] For an interesting discussion of the independence issue and the application of letter of credit proceeds, see In re Mayan Networks Corp., 306 B.R. 295 (B.A.P. 9th Cir. 2004).

Application of Bankruptcy Code Section 502(b)(6) to Letters of Credit and Guaranties, by Circuit

	§ 502(b)(6) Caps Liabiilty of Guarantor as a Debtor		§ 502(b)(6) Caps Liability of Guarantor as a Third Party		§ 502(b)(6) Caps Liability of Third Party Providing Letter of Credit	
Circuit	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**
1st						
2nd	*In re Episode USA* , 202 B.R. 691, 694-96 (Bankr. S.D.N.Y. 1996)					
3rd	*In re Flanigan* , 374 B.R. 568, 576 (Bankr. W.D. Pa. 2007)				*In re PPI Enter. (U.S.), Inc.* , 324 F.3d 197, 208-10 (3d Cir. 2003)	
4th	*In re Lindsey* , 199 B.R. 580, 585 (E.D. Va. 1996)			*Cromwell Field Assocs, v. May Dep't Stores Co.* , 5 Fed. App'x 186, 189 (4th Cir. 2001) (unpublished opinion)		
				Bel-Ken Assocs. Ltd. P'ship v. Clark , 83 B.R. 357, 358 (D. Md. 1988)		
5th				*Wainer v. A.J. Equities* , 984 F.2d 679, 684 (5th Cir. 1993)		*In re Stonebridge Techs.* , 430 F.3d 260, 270-71 (5th Cir. 2005)
6th	*In re Revco D.S., Inc.* , 138 B.R. 528, 531-32 (Bankr. N.D. Ohio 1991)			*Things Remembered, Inc. v. BGTV, Inc.* , 151 B.R. 827, 831 (Bankr. N.D. Ohio 1993)		
	In re Thompson , 116 B.R. 610, 612-13 (Bankr. S.D. Ohio 1990)					

7th	*In re Farley, Inc.*, 146 B.R. 739, 745 (Bankr. N.D. Ill. 1992)					
8th	*In re Interco, Inc.*, 137 B.R. 1003, 1006-07 (Bankr. E.D. Mo. 1992)			*In re Modern Textile, Inc.*, 900 F.2d 1184, 1191 (8th Cir. 1990)		
9th	*In re Arden*, 176 F.3d 1226, 1229 (9th Cir. 1999)				*In re Connectix Corp.*, 372 B.R. 488, 495 (Bankr. N.D. Cal. 2007)	
					In re AB Liquidating Corp., 416 F.3d 961, 965 (9th Cir. 2005)	
					In re Mayan Networks Corp., 306 B.R. 295, 301 (B.A.P. 9th Cir. 2004)	
10th	*In re Rodman*, 60 B.R. 334, 334-35 (Bankr. W.D. Okla. 1986)			*In re Western Real Estate Fund, Inc.*, 922 F.2d 592, 601 (10th Cir. 1990)		
11th	*In re Henderson*, 297 B.R. 875, 885-86 (Bankr. M.D. Fla. 2003)	*In re Danrik, Ltd.*, 92 B.R. 964, 972 (Bankr. N.D. Ga. 1988)				
	In re Clements, 185 B.R. 895, 901 (Bankr. M.D. Fla. 1995)					
D.C.						
Federal						

Case Analysis Reflecting Treatment of Certain Payments under Bankruptcy Code Section 502(b)(6)

		Case Authority Approving	Case Authority Disapproving
Step 1: Determine which occurs earlier- the "Surrender / Repossession" date or the "Bankruptcy Petition" date	General consensus that "surrender" or "repossession" is defined by applicable state law. A tenant who simply vacates the leased property without the landlord's acknowledgment has not "surrendered" the lease and will still be liable for pre-surrender/petition damages under 502(b)(6)(B), to which the "Cap" does not apply	***In re Blatstein***, 1997 U.S. Dist. LEXIS 13376 (E.D. Pa. Aug. 26, 1997)	
		In re Smith, 249 B.R. 328, 335 (Bankr. S.D. Ga. 2000)	
		In re Fifth Ave. Jewelers, 203 B.R. 372, 378 (Bankr. W.D. Pa. 1996)	
		In re Iron-Oak Supply Corp., 169 B.R. 414, 418-19 (Bankr. E.D. Cal. 1994).	

	Amounts Included	Amounts Offsetting	Case Authority Approving	Case Authority Disapproving
	Insurance		***In re Crown Books Corp.***, 291 B.R. 623, 627 (Bankr. D. Del. 2003); ***In re Fifth Ave. Jewelers***, 203 B.R. 372, 381 (Bankr. W.D. Pa. 1996); ***Heck's, Inc. v. Cowron & Co.***, 123 B.R. 544, 546 (Bankr. S.D. W. Va. 1991)	
	Taxes		***In re Crown Books Corp.***, 291 B.R. 623, 627 (Bankr. D. Del. 2003); ***In re Fifth Ave. Jewelers***, 203 B.R. 372, 381 (Bankr. W.D. Pa. 1996); ***Heck's, Inc. v. Cowron & Co.***, 123 B.R. 544, 546 (Bankr. S.D. W. Va. 1991)	
	Attorneys' Fees		***In re PPI Enters. (U.S.) Inc.***, 228 B.R. 339, 349 (Bankr. D. Del. 1998)	***In re Lindsey***, 199 B.R. 580, 586 (E.D. Va. 1996)

Step 2: Calculate the "Claim" Amount based upon the date determined in Step 1	CAM charges		***In re Crown Books Corp.***, 291 B.R. 623, 627 (Bankr. D. Del. 2003); ***In re Fifth Ave. Jewelers***, 203 B.R. 372, 381 (Bankr. W.D. Pa. 1996); ***Heck's, Inc. v. Cowron & Co.***, 123 B.R. 544, 546 (Bankr. S.D. W. Va. 1991); ***In re Andover Togs, Inc.***, 231 B.R. 521, 542 (Bankr. S.D.N.Y. 1999); ***In re Ames Dept. Stores, Inc.***, 173 B.R. 80, 82 (Bankr. S.D.N.Y. 1994); ***In re Blatstein***, 1997 U.S. Dist. LEXIS 13376 (E.D. Pa. Aug. 26, 1997)	
	Service charges & Re-letting costs		***In re McLean Enterprises, Inc.***, 105 B.R. 928, 936 (Bankr. W.D. Mo. 1989); ***In re Goldblatt Bros., Inc.***, 66 B.R. 337, 347 (Bankr. N.D. Ill. 1986)	
	Maintenance and Repairs		***In re New Valley Corp.***, 2000 U.S. Dist. LEXIS 12663, at *27 (D.N.J. Aug. 31, 2000); ***In re Mr. Gatti's, Inc.***, 162 B.R. 1004, 1014 (Bankr. W.D. Tex. 1994);	***In re El Toro Materials Co., 504 F.3d 978, 980-81 (9th Cir. 2007); In re Best Prods. Co., 229 B.R. 673, 678 (Bankr. E.D. Va. 1998); In re Bob's Sea Ray Boats, 143 B.R. 229 (Bankr. D. N.D. 1992); In re Atlantic Container Corp., 133 B.R. 980, 988 (Bankr. N.D. Ill. 1991); In re Q-Masters, Inc., 135 B.R. 157, 160-61 (Bankr. S.D. Fla. 1991)***
		Mitigation by re-letting	***In re PPI Enters.(U.S.) Inc., 324 F.3d 197, 208 (3d Cir. Del. 2003); In re Fifth Ave. Jewelers, 203 B.R. 372, 381 (Bankr. W.D. Pa. 1996); In re Atlantic Container Corp., 133 B.R. 980, 989 (Bankr. N.D. Ill. 1991); In re Iron-Oak Supply Corp., 169 B.R. 414, 420 (Bankr. E.D. Cal. 1994)***	
		Post-petition rent payments by Trustee or Debtor-in-Possession	***In re Atlantic Container Corp.***, 133 B.R. 980, 989-90 (Bankr. N.D. Ill. 1991); ***In re Goldblatt Bros., Inc.***, 66 B.R. 337, 347 (Bankr. N.D. Ill. 1986)	

	Rent Method	Time Method
Step 3: Apply 502(b)(6)(A) "Cap" to Claim amount Calculated in Step 2	***In re Andover Togs, Inc.***, 231 B.R. 521, 547 (Bankr. S.D.N.Y. 1999)	***In re Connectix Corp.***, 372 B.R. 488, 494 (Bankr. N.D. Cal. 2007)
	In re Gantos, Inc., 176 B.R. 793, 795-96 (Bankr. W.D. Mich. 1995)	***In re Iron-Oak Supply Corp.***, 169 B.R. 414, 420 (Bankr. E.D. Cal. 1994)
	In re Communicall Central, Inc., 106 B.R. 540, 544 (Bankr. N.D. Ill. 1989)	***In re Blatstein***, 1997 U.S. Dist. LEXIS 13376 (E.D. Pa. Aug. 26, 1997)
	In re McLean Enterprises, Inc., 105 B.R. 928, 937 (Bankr. W.D. Mo. 1989) (calculating in part based on share of tenant's estimated income)	***Sunbeam-Oster Co. v. Lincoln Liberty Ave., Inc.***, 145 B.R. 823, 828 (W.D. Pa. 1992)
	In re Q-Masters, Inc., 135 B.R. 157, 160 (Bankr. S.D. Fla. 1991)	***In re Allegheny Int'l, Inc.***, 136 B.R. 396, 402 (Bankr. W.D. Pa. 1991)

			Case Authority Approving	Case Authority Disapproving
Step 4: Subtract any other offsetting amount from allowable "Capped" Claim amount in Step 3		Security Deposits	***In re PPI Enters.(U.S.)***, 324 F.3d 197, 208 (3d Cir. Del. 2003)	
		Letter of Credit Draws	***In re PPI Enters.(U.S.)***, 324 F.3d 197, 210 (3d Cir. Del. 2003); ***In re Connectix Corp.***, 372 B.R. 488, 495-96 (Bankr. N.D. Cal. 2007); ***In re Mayan Networks Corp.***, 306 B.R. 295, 301 (B.A.P. 9th Cir. 2004)	

			Case Authority Approving	Case Authority Disapproving
Step 5: Calculate Unpaid "Rent" Prior to the Date determined in Step 1	Insurance			
	Taxes		***In re Bob's Sea Ray Boats, Inc.***, 143 B.R. 229, 232 (Bankr. D.N.D. 1992); ***In re Q-Masters, Inc.***, 135 B.R. 157, 160 (Bankr. S.D. Fla. 1991); ***In re Titus & McConomy, LLP***, 375 B.R. 165, 174 (Bankr. W.D. Pa. 2007)	
	Attorneys' Fees		***In re Titus & McConomy, LLP***, 375 B.R. 165, 175 (Bankr. W.D. Pa. 2007)	
	CAM charges		***In re Peters***, 2004 Bankr. LEXIS 787 (Bankr. E.D. Pa. May 7, 2004)	
	Maintenance and Repairs			
		Mitigation by re-letting		
		Security deposits		
		Letter of Credit draws		
Step 6: Combine Amounts from Step 3 and Step 5	**Self-Explanatory**			

[g]—Effect of Assumption and Post-Assumption Rejection

Claims for future rents arising out of assumed leases are administrative expenses of the debtor's estate, so long as the lease is not subsequently rejected. If a lease is assumed, rent must be paid at the contract rate.[110]

In the event of a rejection after assumption, the claim of the nondebtor/landlord is an administrative expense claim under Section 502(b),[111] with a statutory cap of two years on such administrative claims.[112] Under Section 503(b)(7), the amount of the administrative claim is limited to "all monetary obligations" arising after the later of rejection or actual turnover, with any balance subject to the Section 502(b)(6) cap.[113] The balance of such a claim is afforded general unsecured claim status.[114]

Assumption, therefore, does not eliminate a landlord's uncertainty regarding the disposition of a lease; only confirmation has that effect in a Chapter 11 case. This differs from prior law as now there can be rejection after assumption and a limit on the whole dollar claim for damages for the rent reserved by the lease in question. Previously, once a debtor assumed, it was liable for the entirety of the unpaid rent under the affected lease.

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[110] Bankruptcy Code § 365(b)(1)(A); 11 U.S.C. § 365(b)(1)(A). In re Mid-Region Petroleum, Inc., 1 F.3d 1130, 1132 (10th Cir. 1993).

[111] In re Klein Sleep Products, 78 F.3d 18, 27–28 (2d Cir. 1996).

[112] Bankruptcy Code § 503(b)(7), 11 U.S.C. § 503(b)(7).

[113] In re Rosenhouse, 453 B.R. 50, 56 n.8 (Bankr. E.D.N.Y. 2011).

[114] *Id.*

§ 28.05A Bankruptcy Risks Associated with Prefiling Date Lease Restructuring and Termination Agreements

A carefully negotiated prebankruptcy resolution of the rights of a landlord and its commercial tenant can help both sides avoid pitfalls should the tenant subsequently file for bankruptcy protection. For instance, a landlord may want to recapture a leasehold. In such a situation, the parties can attempt to agree on a peaceful and consensual termination of the lease at issue, which would allow the landlord to regain possession on terms that are in the best interests of the landlord and the tenant.

A landlord entering into a lease termination agreement with a tenant experiencing financial distress must consider the risks associated with a subsequent bankruptcy filing by the tenant. These landlord risks include whether the prebankruptcy termination of the lease will be upheld, and, if the agreement provides for a termination payment, whether the landlord will be permitted to retain the payment in a later bankruptcy of the tenant. In addition to these direct risks, a landlord also will face the litigation costs associated with defending its position.

[1]—The Risk that an Entire Transaction Memorialized in a Termination Agreement Will Be Voided in a Subsequently Filed Bankruptcy Case as a Preferential or Fraudulent Transfer

Some of the cases have held that prepetition terminations should be avoided as fraudulent transfers and others have taken the opposite approach. In one case, the court avoided a pre-bankruptcy settlement agreement and reinstated the underlying lease, allowing a debtor to assume and assign the lease to a third party.[1] In contrast, there are a number of cases holding that a prepetition lease termination cannot be avoided as a fraudulent transfer (although this group of cases generally covers nonconsensual terminations).[2]

Section 547(b) of the Bankruptcy Code provides that the trustee may[3] avoid any "transfer" by a debtor within 90 days of filing for bankruptcy (or up to one year, if the transferee is an insider) if: (1) the transfer was to a creditor on account of an antecedent debt; (2) the debtor was insolvent or was rendered insolvent due to the transfer; and (3) the creditor, by reason of the transfer, receives more than it would

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[1] In re Edward Harvey Co., Inc., 68 B.R. 851 (Bankr. D. Mass. 1987).

Accord:

Third Circuit: In re Indri, 126 B.R. 443 (Bankr. E.D. Pa. 1988).

Sixth Circuit: In re Queen City Grain, Inc., 51 B.R. 722 (Bankr. S.D. Ohio 1985).

[2] See, e.g.:

Second Circuit: Durso Supermarkets, Inc. v. D'Urso (In re Durso Supermarkets, Inc.), 193 B.R. 682 (Bankr. S.D.N.Y. 1996).

Third Circuit: In re Egyptian Brothers Donut, Inc., 190 B.R. 26 (Bankr. D.N.J. 1995).

Seventh Circuit: Haines v. Regina C. Dixon Trust (In re Haines), 178 B.R. 471 (Bankr. W.D. Mo. 1995).

[3] A debtor-in-possession in a Chapter 11 case will have the power of a trustee. Bankruptcy Code § 1107; 11 U.S.C. § 1107.

have received if, assuming the transfer had not been made, the debtor were liquidated in Chapter 7.[4]

Section 548(a)(1) of the Bankruptcy Code authorizes the trustee to avoid any "transfer" of an interest of the debtor in property or any obligation incurred by the debtor within the two years preceding a bankruptcy filing if: (1) the transfer was made, or the obligation was incurred, "with actual intent to hinder, delay, or defraud" any creditor; or (2) the transaction was constructively fraudulent because the debtor was insolvent and received "less than a reasonably equivalent value in exchange for such transfer or obligation."[5]

Section 550 of the Bankruptcy Code authorizes the trustee or DIP, in the event that a transfer is avoided under Section 547 or 548 (among other provisions of the Bankruptcy Code), to recover the property transferred or its value from the transferee(s).[6]

"Transfer" is defined in Section 101(54) of the Bankruptcy Code (as amended in 2005) as "the creation of a lien; . . . the retention of title as a security interest; . . . the foreclosure of a debtor's equity of redemption; or . . . *each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with . . . property; or . . . an interest in property.*"[7]

Employing a broad definition of "transfer," some courts have held that the termination of a lease or contract is a transfer subject to avoidance under Sections 547 and 548.[8] Other courts have ruled to the contrary, reasoning that Section 365 of the Bankruptcy Code specifically governs executory contracts and unexpired leases so that the concept of a "transfer" under any of the avoidance power sections of the Bankruptcy Code are "trumped" by Section 365.[9]

In a 2016 case, the Seventh Circuit reversed a bankruptcy court decision and held that the termination of a lease may be avoided either as a fraudulent transfer or a preferential transfer.[10] The Seventh Circuit explained that the definition of "transfer" under the Bankruptcy Code is broad, including any transfer of an interest in proper-

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[4] See Bankruptcy Code § 547(b); 11 U.S.C. § 547(b).

[5] Bankruptcy Code § 548(a)(1); 11 U.S.C. § 548(a)(1).

[6] Bankruptcy Code § 550; 11 U.S.C. § 550.

[7] Bankruptcy Code § 101(54); 11 U.S.C. § 101(54). (Emphasis added.)

[8] See, e.g.:

First Circuit: In re Harvey Co., Inc., 68 B.R. 851 (Bankr. D. Mass. 1987); In re Fashion World, Inc., 44 B.R. 754 (Bankr. D. Mass. 1984).

Third Circuit: In re Indri, 126 B.R. 443 (Bankr. D.N.J. 1991).

Sixth Circuit: In re Queen City Grain, Inc., 51 B.R. 722 (Bankr. S.D. Ohio 1985).

[9] See, e.g.:

Seventh Circuit: Sullivan v. Willock (In re Wey), 854 F.2d 196 (7th Cir. 1988).

Third Circuit: Edwards v. Federal Home Loan Mortgage Corp. (In re LiTenda Mortgage Corp.), 246 B.R. 185 (Bankr. D.N.J. 1999); In re Egyptian Bros. Donut, Inc., 190 B.R. 26 (Bankr. D.N.J. 1995); In re Coast Cities Truck Sales, Inc., 147 B.R. 674 (D.N.J. 1992).Haines v. Regina C. Dixon Trust (In re Haines), 178 B.R. 471 (Bankr. W.D. Mo. 1995); In re Jermoo's, Inc., 38 B.R. 197 (Bankr. W.D. Wis. 1984).

[10] *Official Committee of Unsecured Creditors of Great Lakes Quick Lube LP v. T.D. Investments I, LLP* (*In re Great Lakes Quick Lube LP*), 816 F.3d 482 (7th Cir. 2016).

ty.[11] The Seventh Circuit reasoned that the relevant termination agreement transferred the tenant's interest in the leases in question to the landlord. Accordingly, the termination of the leases could be avoided if the debtor received less than reasonably equivalent value for the terminated leases (a fraudulent transfer theory) or if the landlord received more as a result of the termination than it would have otherwise received in bankruptcy (a preferential transfer theory). The Seventh Circuit also stated that Section 365(c)(3) of the Bankruptcy Code is not in conflict with the potential avoidance of a prebankruptcy termination of a lease.[12] Accordingly, the Seventh Circuit reversed the judgment of the Bankruptcy Court and remanded with instructions for the Bankruptcy Court to determine the value of the terminated leases and/or whether the landlord had any defenses to the preference and fraudulent conveyance claim arising from the prefiling date lease terminations.

[2]—The Preferential Transfer Risk—Payments

If a tenant files a bankruptcy case (or an involuntary case is filed against a tenant) within ninety days of making a termination payment, in a subsequently filed bankruptcy case such payment could be characterized as a preferential transfer. Under Section 547 of the Bankruptcy Code, a debtor or trustee can "reach back" and recover a transfer made up to ninety days before a bankruptcy is filed for the bankruptcy estate. This preference avoidance power is intended to maximize the funds available to pay creditors and furthers the Bankruptcy Code policy of equitable distribution among similarly situated creditors. While few courts have had occasion to rule on this topic, at least one Circuit Court of Appeals has ruled that a lease termination payment is indeed recoverable as preferential transfer.[13]

[3]—Forbearance and the "New Value" Defense

What about untimely lease payments made before a bankruptcy case is filed if the landlord has agreed not to evict? After all, it would appear at first blush that the landlord by not terminating the lease immediately upon default provided new value, i.e., the tenant was left in possession of the leasehold.[14] Assuming no additional consideration, i.e., additional lease space or a rent reduction is granted to the tenant as part of a lease restructuring transaction, the issue then becomes whether mere forbearance constitutes "new value."

New value is defined as money or money's worth in goods, services or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of property, but does not include an obligation substituted for an existing obligation.[15]

The courts are split when it comes to the issue of whether forbearance alone constitutes "new value." Some courts are holding that forbearance alone does not constitute

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[11] *Id.*

[12] *Id.*

[13] See Midwest Holding #7, LLC v. Anderson (In re Tanner Family, LLC), 556 F.3d 1194 (11th Cir. 2009).

[14] Bankruptcy Code § 547(a)(2); 11 U.S.C. § 547(a)(2).

[15] *Id.*

new value. In *Bernstein v. RJL Leasing*, the court found that a lessor's forbearance from lease termination did not constitute new value under Section 547(c)(1) as the tenant did not economically benefit from the lessor's forbearance.[16] More particularly, the tenant made all lease payments after the alleged preferential transfer, which circumvented the application of the subsequent new value defense.[17]

Other courts are acknowledging that when a tenant receives value as a result of a forbearance that the subsequent new value defense could to a lessor's forbearance as summarized by *Sunbeam Oyster Co. Inc. v. Lincoln Liberty Ave. Inc.*[18] In *Sunbeam,* the court stated, "we agree with the bankruptcy court that forbearance by a lessor from exercising its rights under a lease does not constitute new value when the debtor is not using the property."[19]

Under Section 547(c)(4) of the Bankruptcy Code, the subsequent new value defense states that a trustee may not avoid a transfer to or for the benefit of a creditor to the extent that after such transfer, such creditor gave new value to or for the benefit of the debtor . . . on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor. The subsequent new value defense thus differs from the contemporaneous exchange for new value defense in that the new value came after the preferential payment as opposed to a substantially contemporaneous exchange.[20]

[4]—Temporary New Defense to Preference Actions

A bankruptcy trustee may avoid certain payments made during the 90 days prior to the commencement of a bankruptcy case if it enables a creditor to receive more than it would in a hypothetical Chapter 7 case. By accepting postponed or deferred payments landlords are being subjected to the risk of having deferred rent payments avoided because they were not made within the ordinary course of business. For a discussion of preferential transfers and the ordinary course defense, see Preferences and Calculating Preference Defenses. The Consolidated Appropriations Act (CAA)

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[16] Bernstein v. RJL Leasing (In re White River Corp.), 50 B.R. 403, 409 (Bankr. D. Col. 1985).

[17] *Id.* See, e.g.:

Second Circuit: Matter of Duffy, 3 B.R. 263, 266 (Bankr. S.D.N.Y. 1980) (where the court, reasoning that an obligation substituted for an existing obligation is expressly excluded from the definition of new value under Section 547(a)(2) and, therefore, the lessor's forbearance was not new value).

Sixth Circuit: Bavely v. Merchants National Bank, 36 B.R. 582, 584 (Bankr. S.D. Ohio 1983) (where a lessor's forbearance from evicting a debtor/lessee from leased premises increased the value of the estate, thereby enabling the sale of assets, the court nevertheless held that substitution of one obligation for another is not new value since no actual new value was given).

Eleventh Circuit: Chase Manhattan Bank v. Dent, 78 B.R. 351, 354–355 (Bankr. S.D. Fla. 1987) (where the court found that a lessor's forbearance following a debtor/lessee's default did not constitute new value).

Thus, courts are somewhat uniformly holding that mere forbearance does not equal the contemporaneous exchange for new value defense.

[18] Sunbeam Oyster Co. Inc. v. Lincoln Liberty Ave. Inc., 145 B.R. 823 (W.D. Pa. 1992).

[19] *Id.*, 145 B.R. at 830.

[20] See Bankruptcy Code § 547(c)(1) and (4); 11 U.S.C. § 547(c)(1) and (4).

creates a special preference defense to protect landlords who receive deferred rental payments.[21] Specifically, the CAA provides that a trustee may not avoid "a covered payment of rental arrearages," which is defined to mean payments of arrearages under an "agreement or arrangement" to postpone or defer payments due under a lease for nonresidential property if certain conditions are met:

(1) The "agreement or arrangement" must have been made or entered into on or after March 13, 2020.

(2) The payments must not exceed the amounts due under the lease.

(3) The "agreement or arrangement" may not include fees, penalties, or interest greater than the sum of fees, penalties, or interest provided for in the original lease or the amounts that the debtor would owe if the arrearages had been paid on time and in full before March 13, 2020.[22]

This temporary statutory change will sunset two years from the date of enactment.

[5]—Lease Recharacterization Risk

Should an entity file for bankruptcy relief, its capital provider has very different rights when the transaction is determined to be a mortgage loan as opposed to it being a true real property lease. Whether the transaction is a true lease or a mortgage, the capital provider will be stayed from taking enforcement actions by virtue of the automatic stay upon the commencement of a bankruptcy case. If the transaction is determined to be a mortgage, then the creditor will generally not receive any payments during the pendency of the bankruptcy case (other than possible adequate protection payments, under Section 361[23] of the Bankruptcy Code and Section 362[24] of the Bankruptcy Code, but only if specifically authorized by the bankruptcy court). Ultimately, the creditor will be entitled to receive payments with a present value (as determined by the court) equal to the value of its interest in the collateral. Thus, the amount and timing of the payments and the interest rate on the debt can be rewritten in the bankruptcy case. If the debt exceeds the value of the collateral, the creditor will receive an unsecured claim for the difference, which may result in a payment of only pennies on the dollar for that portion of the claim.[25]

If the transaction is considered a lease for nonresidential real property, however, the debtor-in-possesionpossession or trustee will be required to either assume or reject the lease. If the debtor-in-possession or trustee elects to assume the lease, it must cure defaults and provide adequate assurance of future performance of the lease terms. To retain the property, the estate will have to honor its lease obligations, including payment of rent during the administration of the bankruptcy case (subject to any exceptions to the general rule contained in Section 365[26] of the Bankruptcy Code). If the debtor-in-possession or trustee rejects a lease, the lease is treated as having been breached, and the leasehold must be turned over to the lessor, who may then file an

[21] Bankruptcy Code §547(j).
[22] Bankruptcy Code §547(j)(1)(A).
[23] Bankruptcy Code § 361; 11 U.S.C. § 361.
[24] Bankruptcy Code § 362; 11 U.S.C. § 362.
[25] Bankruptcy Code § 506(a); 11 U.S.C. § 506(a).
[26] Bankruptcy Code § 365; 11 U.S.C. § 365.

unsecured claim for damages,[27] subject to a statutory cap.[28] The estate does not have the option of delaying payments while the bankruptcy case is pending, nor can it rewrite the payment terms on the lease pursuant to a plan of reorganization, as may be done in the appropriate circumstances with a mortgage.

The rules that bankruptcy courts use for distinguishing between a true lease and mortgage transactions will affect the terms and documentation of most deals, as lawyers advise their clients on the optimal ways to protect their interests. Section 365(d)(3)[29] of the Bankruptcy Code and Section 365(d)(4)[30] of the Bankruptcy Code apply solely to "true" or "bona fide" leases. The designation of an agreement as a lease is not controlling. Instead, the court generally will look to the parties' intent in order to determine if the agreement is a lease, a financing arrangement, a joint venture agreement, a mortgage, a management agreement, or some other type of agreement. For example, in *In re LeFrak*, in a debtor-shareholder's 99-year proprietary lease for a cooperative apartment unit was deemed not to be not a true lease that needed to be assumed or rejected since the debtor's interest was more in the nature of a deed to real property.[31] This would apply in the nonresidential context as well (e.g., commercial office cooperatives). Overall, the question of whether a lease is found to be a true lease will depend on applicable state law.

[27] Bankruptcy Code §§ 365(g), 502(g); 11 U.S.C. §§ 365(g), 502(g).
[28] Bankruptcy Code § 502(b)(6); 11 U.S.C. § 502(b)(6).
[29] Bankruptcy Code § 365(d)(3); 11 U.S.C. § 365(d)(3).
[30] Bankruptcy Code § 365(d)(4); 11 U.S.C. § 365(d)(4).
[31] In re LeFrak, 223 B.R. 431 (S.D.N.Y. 1998).

§ 28.06 Sample Bankruptcy Clause

The following is a typical bankruptcy clause (with commentary) proposed by landlord during lease negotiations:

> In the event Tenant shall become a debtor under a Chapter of the Code as it may be amended or under any successor statute thereto, and the Trustee of Tenant's property or Tenant shall elect to assume this Lease for the purpose of assigning the same or otherwise, such election and assignment may only be made if all of the terms and conditions of Sections __.__ and __.__ are satisfied. If such Trustee shall fail to elect or assume this Lease within the period permitted by law after the filing of the petition, this Lease shall be deemed to have been rejected. Landlord shall thereupon be immediately entitled to possession of the Demised Premises without further obligation to Tenant or the Trustee, and this Lease shall be cancelled, but Landlord's right to be compensated for damages in such liquidation proceeding shall survive.

No election by the Trustee or Debtor-in-Possession to assume, whether under Chapter 7, 11 or 13, shall be effective unless each of the following conditions, which Landlord and Tenant acknowledge are commercially reasonable in the context of a bankruptcy case of Tenant, have been satisfied, and Landlord has so acknowledged in writing:

(i) the Trustee or the Debtor-in-Possession has cured, or has provided Landlord adequate assurance (as defined below) that:

  (k) no later than ten (10) days (counting the date of assumption as the first such day) from the date of such assumption, the Trustee will cure all monetary defaults under this Lease; and

  (l) within thirty (30) days from the date of such assumption (counting the date of assumption as the first such day), the Trustee will cure all nonmonetary defaults under this Lease; and

  (m) any obligations under the Lease that are unliquidated at the time of assumption, including without limitation repair, maintenance and replacement obligations and indemnification obligations shall survive, regardless of whether such unliquidated obligations existed, occurred, or accrued prior to the assumption of the Lease; and

(ii) the Trustee or the Debtor-in-Possession has compensated, or has provided to Landlord adequate assurance of future performance (as defined below) that within ten (10) days from the date of assumption, Landlord will be compensated for any pecuniary loss incurred by Landlord arising from the default of Tenant, the Trustee, or the Debtor-in-Possession as recited in Landlord's written statement of pecuniary loss delivered to the Trustee or Debtor-in-Possession.

(iii) The Trustee or the Debtor-in-Possession has provided Landlord with adequate assurance of the future performance of each of Tenant's, Trustee's or Debtor-in-Possession's obligations under this Lease; provided, however, that:

  (k) such adequate assurance shall include without limitation, as security for the timely payment of rent, an amount equal to three (3) months rent and other monetary charges accruing under this Lease; and

(l) minimum rent payments commencing on the first day of the next applicable monthly period and thereafter each consecutive monthly period, 1/12th of Tenant's estimated annual obligations under this Lease as additional rent of all taxes, insurance and similar charges;

For purposes of this Article, Landlord and Tenant acknowledge that, in the context of a bankruptcy case of Tenant, at a minimum "adequate assurance" shall mean:

(i) The Trustee or the Debtor-in-Possession has and will continue to have sufficient unencumbered assets after the payment of all secured obligations and administrative expenses to assure Landlord that the Trustee or Debtor-in-Possession will have sufficient funds to fulfill the obligations of Tenant under this Lease and to conduct a fully operational and actively promoted business at the Demised Premises permitted under this Lease.

(ii) If the Trustee or Debtor-in-Possession has assumed this Lease pursuant to the terms and provisions of Section __.__ or __.__ for the purposes of assigning (or elects to assign) Tenant's interest under this Lease or the estate created thereby, to any other person, such interest or estate may be so assigned only if Landlord shall acknowledge in writing that the intended assignee has provided adequate assurance as defined in this Section __.__ of future performance of all of the terms, covenants and conditions of this Lease to be performed by Tenant. If for purposes of this Section __.__ Landlord and Tenant acknowledge that, in the context of a bankruptcy proceeding of Tenant, at a minimum "adequate assurance of future performance" shall mean that each of the following conditions has been satisfied, and Landlord has so acknowledged in writing that:

(k) The assignee has submitted a current financial statement audited by an independent certified public accountant that shows a net worth, working capital and cash flow in amounts determined to be reasonably sufficient by Landlord to assure the future performance by such assignee of Tenant's obligations under this Lease; or

(l) The assignee, if requested by Landlord, shall have obtained guarantees in form and substance reasonably satisfactory to Landlord from one or more persons who satisfy Landlord's reasonable standards of creditworthiness; and

(m) The assignee has submitted in writing evidence, reasonably satisfactory to Landlord, of experience in managing properties of comparable size to the Demised Premises or will have hired a manager, reasonably satisfactory to Landlord, who has a record of successful experience in this area of work.

When, pursuant to the Code, the Trustee or Debtor-in-Possession shall be obligated to pay reasonable use and occupancy charges for the use of the Demised Premises or any portion thereof, such charges shall not be less than the Fixed Rent and additional rent, as defined in this Lease, and other monetary obligations of Tenant for the payment of operating costs, insurance and similar charges.

Commentary: The clauses set forth above provide a detailed explanation of the landlord's rights in a tenant's bankruptcy under Chapters 7, 11 or 13 but do not explain any of the tenant's rights in the event the landlord files for bankruptcy protection.

While the lease clause merely restates what the Code provides with respect to the rights in the event the Trustee fails to affirm the lease within the allowable period, the clause seeks to add to the landlord's rights for damages.

Section __.__ attempts to impose additional requirements upon the Trustee that may not be enforceable under the Code. Sections __.__ (ii) and (iii) refer to a definition of "adequate assurance" in Section ___.__ that may go beyond the limits of what is permitted under the Code. Otherwise, the provision is a very detailed and complete explanation of what rights the landlord may have in a bankruptcy without giving the same rights to a tenant when the landlord is the debtor.

At the same time, tenants, if they have defaulted, want to maintain rights and continue in possession of the premises particularly if they are merely going through a reorganization rather than a liquidation. Most tenants run into cash flow problems that precipitate their filing of a petition and many tenants believe that if they are able to occupy and continue operating out of the premises they will eventually be able to meet their cash requirements, reorganize their debt and get on to business as before. Whether the tenant will succeed in this endeavor when faced with the challenging tasks of restructuring and reorganizing its business is by no means certain and will depend on many variables specific to the particular case.

§ 28.07 Bankruptcy Definitions and Terms of Art

[1]—363 Sale

The sale of the assets under Section 363 of the U.S. Bankruptcy Code. The assets that come under this section can include anything from office furniture or intellectual property to substantially all of a debtor's assets.

[2]—Abandonment

A disclaimer of any interest by the bankruptcy trustee or debtor in burdensome or inconsequential property. Once property has been "abandoned," it is no longer property of the estate, and parties with a security interest in the property may proceed against it.

[3]—Abstention

Decision by a bankruptcy court not to hear a particular civil proceeding on the finding that it is in the interest of justice or in the interest of comity with state courts or state law. A bankruptcy court must abstain from a hearing involving a noncore proceeding based on a cause created by state law, where such cause is actually pending and can be timely adjudicated in a forum of appropriate jurisdiction. The bankruptcy court may abstain from hearing an entire bankruptcy case on the finding that the interest of both the creditors and debtor will be served by dismissal of the petition.

[4]—Administrative Expense

Costs and expenses of preserving the bankruptcy estate or expenses incurred in the course of operating a business after the petition filing date, and all professional fees and charges that are allowed by the bankruptcy court.

[5]—Adversary Proceeding

A lawsuit within a bankruptcy case.

[6]—After Notice and a Hearing

After such notice as is appropriate under the circumstances and an opportunity for a hearing. This may require a party in interest to request a hearing; otherwise, the proposed act will take place or the proposed order will be entered without further hearing or notice.

[7]—Automatic Stay

The statutory halt to actions against the debtor, or his property or to enforce claims against the debtor. The filing of a voluntary, joint or involuntary petition under any chapter of the Code automatically operates as a stay against the commencement or continuation of most judicial, administrative or other proceedings against the debtor or the debtor's estate. The purpose of the stay is to give the Chapter 11 or Chapter 13 debtor "breathing time" for rehabilitation, and to give the Chapter 7 trustee the protection necessary for administering the assets of the estate, and to relieve the Chapter 7 debtor from the pressure of creditor collection efforts. The law provides a number

of exceptions to this general rule. A party seeking relief from the automatic stay must file a motion to lift the stay.

[8]—Avoidance Power

The Code grants the trustee the power to avoid certain transactions or transfers occurring before the commencement of the case, including preferences and fraudulent conveyances. Avoiding a lien reduces or nullifies the lien; avoiding a transaction brings the assets or funds transferred back into the estate.

[9]—Bankrupt

A term formerly used under the Bankruptcy Act to describe a debtor who had been so adjudicated under the Bankruptcy Act. This term is not used under the Code.

[10]—Bankruptcy Clerk of the Court

The court officer who receives all documents that are placed in the court record in a bankruptcy case. In addition, the clerk's office schedules hearings for the bankruptcy judges, usually upon written request by an attorney.

[11]—Bankruptcy Code or Code

It means Title 11 of the U.S. Code entitled "Bankruptcy," as now and hereafter in effect, or any successor statute. The Code allows individuals, family farmers and family fisherman, municipalities, corporations, and business entities to reorganize their debts or have them discharged.

[12]—Bankruptcy Judge

The judge who presides over the administration of a bankruptcy case, and decides contested aspects of that case, which involve either the liquidation or reorganization of a debtor. A bankruptcy judge does not become actively involved in the daily administration of the bankruptcy case, as that task has been delegated to the debtor, United States Trustee, appointed trustees, examiners and creditors' committees.

[13]—Cash Collateral

This is cash and cash equivalents representing the proceeds of the sale or disposition of a debtor's property that was subject to a security interest, lien, or mortgage. Cash and cash equivalents may include negotiable instruments, documents of title, securities, and deposit accounts.

[14]—Chapter 7

The part of the Bankruptcy Code that addresses liquidation. Its provisions are available to both individual and business debtors. Its purpose is to achieve a fair distribution to creditors of whatever nonexempt property the debtor has and to give the individual debtor a fresh start through the discharge in bankruptcy.

[15]—Chapter 9

The part of the Bankruptcy Code that addresses the adjustments of debts of a municipality.

[16]—Chapter 11

The part of the Bankruptcy Code that addresses reorganization. Its provisions are available to both individual and business debtors. The purpose of Chapter 11 is to rehabilitate a business as a going concern or reorganize an individual's finances. It also may be used for an orderly liquidation. The Chapter 11 debtor is given a fresh start through the binding effect on all concerned of the order of confirmation of a reorganization plan.

[17]—Chapter 11, Subchapter V

This part of the Bankruptcy Code, that took effect on February 19, 2020 (and which has been amended since that date), allows a "small business debtor" (as defined by the Code) to obtain a discharge on the effective date of the plan, provided the plan was consensual and approved Section 1191(a), which requires compliance with all of the consensual confirmation provisions in a typical Chapter 11 case.

[18]—Chapter 12

The part of the Bankruptcy Code designed to give special relief to a family farmer with regular income.

[19]—Chapter 13

The part of the Bankruptcy Code designed as a rehabilitation vehicle for an individual with regular income whose debts do not exceed specified amounts. Chapter 13 typically is used to budget some of the debtor's future earnings under a plan through which creditors are paid in whole or in part.

[20]—Chapter 15

The part of the Bankruptcy Code that addresses cross-border insolvency proceedings.

[21]—Civil Proceeding

Any action that occurs within a bankruptcy case. Includes contested matters, adversary proceedings and plenary actions as well as disputes related to administrative matters in a bankruptcy case.

[22]—Claim

Any right to payment, as well as any right to an equitable remedy, for breach of performance if that breach also gives right to payment.

[23]—Code (the "Code")

Legislation found at 11 U.S.C. §§ 101 *et seq*. ("Title 11") containing both substantive and procedural law for bankruptcy liquidation and rehabilitation cases. The Code has been amended several times since its passage in 1978.

[24]—Confirmation

The process by which the bankruptcy judge approves a plan of reorganization of a debtor.

[25]—Contested Matter

An actual litigation that addresses a dispute in a proceeding, before a bankruptcy court, other than an adversary proceeding Rule 9014 of the Federal Rules of Bankruptcy Procedure governs contested matters.

[26]—Core Matters

Proceedings arising under Title 11 or arising in a case under Title 11 in which the bankruptcy judge may conduct the entire proceeding and may enter the final and dispositive order or judgment.

[27]—Creditor

[a]—Any entity that has a monetary claim against the debtor that arose at the time of or before the order for relief.Debtor

The person or entity that seeks voluntary relief under the Code or has been forced involuntarily into a Chapter 7 or Chapter 11 bankruptcy case by petitioning creditors.

[28]—Debtor-in-Possession or DIP

A Chapter 11 or Chapter 12 debtor who operates its own business and remains in possession of its assets and property. The bankruptcy judge may order that the debtor-in-possession be replaced by a trustee appointed by the U.S. Trustee.

[29]—Debtor-in-Possession Financing

It is a special kind of loan made to business entities or individuals that have filed for bankruptcy protection under Chapter 11. DIP financing usually happens shortly after a Chapter 11 case is filed**.**

[30]—Discharge

An order that bars the debtor's *in personam* liability on claims within its scope and acts as a permanent injunction against judicial proceedings or nonjudicial collection efforts with respect to such claims.

[31]—Dischargeability

A process or finding on whether each individual debt is eligible for discharge.

[32]—Disclosure Statement

A pleading filed with the bankruptcy court clerk and sent to creditors that contains information about the debtor and the plan of reorganization.

[33]—Estate

All of the debtor's legal and equitable interest in property as of the commencement of the case: created by the filing of a voluntary, joint or involuntary petition. An individual debtor is able to exempt certain property from the estate. Property of the estate also does not include: (1) any power that a debtor can exercise for someone else's benefit; (2) traditional spendthrift trust interests required by state law; and (3) certain retirement plans. The estate is administered by a debtor, a debtor-in-possession or a trustee.

[34]—Federal Rules of Bankruptcy Procedure

An appendix to Title 11, which sets forth the procedural law of bankruptcy. Besides the Federal Rules of Bankruptcy Procedure, each district, as well as each individual bankruptcy judge, may have its own local rules.

[35]—Fraudulent Conveyance or Fraudulent Transfer

A transfer that can be avoided by the trustee if the transfer was made with: (1) actual fraud evidenced by an intent to defraud, hinder or delay creditors; or (2) constructive fraud, evidenced by the debtor's receipt of less than reasonably equivalent value in exchange for the transfer.

[36]—General Unsecured Claim

Unsecured claim that is not entitled to priority under the Bankruptcy Code.

[37]—Involuntary Petition

A petition filed by creditors seeking to place the debtor in either Chapter 7 or Chapter 11. If the debtor contests and prevails, the court shall dismiss the involuntary petition. If the debtor does not contest, or contests and loses, the bankruptcy court shall enter an order for relief.

[38]—Objection to Claim

A method to initiate a process that will ultimately result in the allowance or disallowance of the claim at issue by the bankruptcy court.

[39]—Office of the United States Trustee or OUST

Responsible for matters of administration of a bankruptcy case. Employed by the U.S. Department of Justice, the U.S. Trustee's responsibilities include: (1) appointing from the private sector the members of a panel of trustees who administer bankruptcy cases; and (2) supervising the actions of the private trustees and the administration of all bankruptcy cases.

[40]—Official Committee of Unsecured Creditors or OUCC

A group of unsecured creditors appointed by the U.S. Trustee to represent the interests of all unsecured creditors before the court. The committee may retain counsel and other professionals at the expense of the estate in order to be heard in a wide range of matters.

[41]—Plan of Reorganization

The document the debtor submits for confirmation to restructure and, perhaps, forgive certain prepetition debt. The debtor proposes plans in Chapter 11, Chapter 12 and Chapter 13.

[42]—Preference

A transfer of the debtor's property to or for the benefit of a creditor, for or on account of an antecedent debt, made while the debtor was insolvent, within ninety days before bankruptcy (or within one year before the petition was filed in an "insider" situation), the effect of which was to give the creditor more than he would have otherwise received in a Chapter 7 distribution. The trustee's power to avoid preferences is designed to achieve the policy of fostering equality of distribution among the creditors of an insolvent debtor.

[43]—Priority Claim

Unsecured claims entitled to priority and distribution over other unsecured claims, including administrative expenses, claims arising in the ordinary course of the debtor's business after the filing of an involuntary petition and before the entry of the order for relief; certain wage, salary or commission claims; certain contributions to employee benefit plans; certain claims of farmers and fishermen; certain consumer claims; unassigned support claims; and certain unsecured tax claims.

[44]—Proof of Claim

A document that a creditor files setting forth its claim, together with all supporting evidence of such claim, including documentation reflecting perfection of a security interest, if any. There is usually a deadline by which to file a proof of claim.

[45]—Property of the Estate

Bankruptcy Code § 541 defines "property of the estate" as "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case."[1]

[46]—Redemption

When an individual debtor reclaims property intended primarily for personal, family or household use, from a lien securing a dischargeable consumer debt, if the property is exempt, or has been abandoned, by paying the lienholder the amount of the allowed

[1] Bankruptcy Code § 541; 11 U.S.C. § 541.

secured claim of the lienholder that is secured by such lien. Redemption must be a cash transaction, unless the creditor consents to payment over time.

[47]—Reference

Device by which the district courts delegate bankruptcy jurisdiction to the bankruptcy court, and bankruptcy courts act as trial courts in nearly all bankruptcy matters.

[48]—Related Matter

Proceeding related to cases under Title 11 in which, unless the parties consent otherwise, the bankruptcy judge submits proposed findings and conclusions and the district court makes the dispositive orders.

[49]—Removal

Process by which either the defendant or plaintiff may transfer a civil action in a nonbankruptcy forum involving the debtor to the district court (and by the standing order of reference to the bankruptcy court). The bankruptcy court may remand the action back to the nonbankruptcy forum.

[50]—SBRA or The Small Business Reorganization Act of 2019

In August 2019, Congress passed the SBRA, which became effective February 19, 2020.[2] The purpose of the SBRA is to make Chapter 11 reorganization faster and less expensive for small businesses. It has been characterized as a balance between Chapter 7 and Chapter 11.**Schedules**

Pleadings filed with the bankruptcy court clerk containing the assets, liabilities, and other financial information of a debtor.

[51]—Secured Claim

Creditor claims supported by collateral of equal to or greater value than the amount of the claim.

[52]—Statement of Affairs

Pleadings filed with the bankruptcy court clerk containing information about the financial transactions and affairs of a debtor.

[53]—Trustee

The court-appointed representative of the estate who administers the estate. A Chapter 7 trustee charged with liquidating the estate and paying claims and expenses. In some Chapter 11 cases, the debtor-in-possession is replaced by a Chapter 11 trustee

[2] Pub. L. No. 116-54, 133 Stat. 1079 (codified in 11 U.S.C. §§ 1181–1195 and scattered sections of 11 U.S.C. and 28 U.S.C.).

who administers the estate. In Chapter 12 or 13, ordinarily there is at least one standing trustee in each district to whom all cases under Chapter 12 or 13 are assigned. A Subchapter V trustee is appointed in all small businesses. cases under Subchapter V of Chapter 11.

[54]—Unsecured Claim

Creditor claim that is not secured by collateral. A general unsecured claim is neither secured by collateral nor a priority claim.

[55]—Voluntary Petition

A petition voluntarily submitted by a debtor seeking relief under one of the chapters of the Code. The filing of the petition operates automatically to invoke the stay.

[56]—Withdrawal of Reference

District court's power to withdraw, in whole or in part, matters that have been referred to the bankruptcy court, including both core and noncore proceedings, as well as cases.

§ 28.08 What to Do When a Petition Is Filed by a Commercial Tenant

There are numerous options and alternatives that a landlord can choose from when a bankruptcy petition is filed by a commercial tenant. According to a prominent lawyer with considerable bankruptcy experience, a landlord can:

(1) Do nothing;

(2) Negotiate with the debtor or trustee for the payments already rendered or for a modified lease;

(3) Object to a Chapter 13 plan if this is required;

(4) Attend the Section 341 first meeting of creditors;

(5) File a motion for relief from the Section 362 automatic stay, although most bankruptcy judges will reject such a motion, unless it is filed in connection with a perfected U.C.C. security interest;

(6) File a motion for an order directing payment of Section 365(d)(3) claims that are post-petition rent. This is very important since a delay in making a Section 365(d)(3) request may drastically reduce the likelihood of payment and the amount of the claim filed;

(7) File a motion for an order granting surrender of the property;

(8) Stop providing "services and supplies incidental to their lease" under Section 365(b)(4). This should only be done when the tenant is in default under the lease before assumption or rejection and when the landlord is not being compensated for the services the landlord provides under the lease.[1] This is very risky except where the services or supplies are charged separately under the lease;[2]

(9) File a motion to prohibit or condition the use, sale or lease of the property as necessary to provide adequate protection in accordance with Section 363(e);

(10) File a motion to shorten the time to assume or reject the lease in accordance with Section 365(d);

(11) File a motion to deem the lease nonassumable. This is appropriate only when the lease has allegedly been terminated or when it includes or is intimately tied to a nonassumable contract under a specific statute or public policy;[3]

(12) File a motion for a Rule 2004 examination, which is similar to a state court's debtor's examination or supplementary collection proceeding;

(13) File a motion for an expedited hearing;

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[1] See Lee "Shopping Center Leases Under the Bankruptcy Code," American Bar Association program "More Than You Ever Wanted to Know About Representing Real Estate Lessors Whose Tenants File a Bankruptcy" (Aug. 13, 1991).

[2] *Id.*

[3] *Id.*

(14) Organize a creditor's committee or special committee of landlords;

(15) File a proof of claim;

(16) Object to the proposed assumption of the lease;

(17) Object to the proposed Chapter 11 disclosure statement or plan of reorganization;

(18) File a motion to appoint a trustee under Chapter 11;

(19) File a motion to convert to another chapter or to dismiss; and

(20) Sue the guarantors, unreleased assignor and nondebtor lessees.[4]

In any case, bankruptcies can be complicated, and knowing your rights when a tenant files is crucial. Having qualified counsel on board can help a landlord navigate through these difficult issues.

Practice Pointer: A carefully negotiated prebankruptcy resolution of the rights of a landlord and its commercial tenant can help both avoid pitfalls should the tenant subsequently file for bankruptcy protection. When possible, a landlord may choose to try to negotiate a prebankruptcy resolution of various issues that may arise in a bankruptcy case filed by a financially stressed tenant. For example, a landlord may want to retain a tenant in place rather than have unoccupied space. Perhaps the lease at issue can be modified to keep the tenant in place (and paying rent). If the tenant cannot continue to operate in the leasehold because of its financial distress or the landlord wants to recapture the leasehold, perhaps the parties can agree on a peaceful and consensual termination of the lease at issue that allows the landlord regain possession on terms that are in the best interests of both the landlord and the tenant.

[4] *Id.* at pp. 13–14.

§ 28.09 Bankruptcy Code Amendments to Section 365

[1]—The Bankruptcy Reform Act of 1994

The Bankruptcy Reform Act of 1994[1] made many changes to the bankruptcy law, several of which have an important impact upon landlords and tenants. This section discusses a few provisions with particular relevance to the parties to a commercial office lease.

The 1994 Amendments make significant changes that affect the rights of tenants, leasehold mortgagees and other parties when a trustee of a debtor in bankruptcy rejects its obligations as a lessor under a real estate lease. Under the pre-amended Code Section 365(h), the lessee may "remain in possession of the leasehold" if a trustee rejects an unexpired lease of the debtor/lessor.[2] This provision has been subject to various interpretations by the courts, resulting in a very narrow reading of the provision.[3] The 1994 Amendments change Code Section 365(h) to provide that:

> "If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and . . . if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law."[4]

In addition, the 1994 legislation amended the Code to provide for an expedited hearing on an automatic stay. This legislation amends Section 362(e) of the Code to require that the final hearing on a motion for relief from the automatic stay must conclude within thirty days of the conclusion of the preliminary hearing.[5] Although the Code did provide that the court must conclude the preliminary hearing within thirty days after the filing of a motion for relief from the stay, the Code did not impose a deadline for conclusion of the final hearing. The amendment moves the whole process along and generally requires that it be concluded within that sixty day period.[6]

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[1] Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, enacted on Oct. 22, 1994.

[2] Pre-amendment 11 U.S.C. § 365(h)(1).

[3] As a result of these judicial interpretations, pre-Amendment Section 365(h) has been found to preclude a tenant's assignment of its lease, In re Carlton Restaurant, Inc., 151 B.R. 353 (Bankr. E.D. Pa. 1993); to prevent tenant's enforcement of restrictive lease covenants, Home Express, Inc. v. Arden Assocs., Ltd., 152 B.R. 971 (Bankr. E.D. Cal. 1993); and has determined that "physical possession" was required for protection under the Code, In re Harborview Development 1986 Partnership, 152 B.R. 897 (D.S.C. 1993). See 140 Cong. Rec. H10764 at 12 (1994), discussing these cases and this issue.

[4] 11 U.S.C. § 365(h)(1)(A)(ii). "Lessee" is defined to include successors, assigns and mortgagees. 11 U.S.C. § 365(h)(1)(D).

[5] 11 U.S.C. § 362(e). See 140 Cong. Rec. H10764 (1994) for a section-by-section description of the Bankruptcy Reform Act of 1994.

[6] *Id.* Section 362(e) allows some flexibility in its time frames by permitting the parties in interest to consent to an extension or by allowing the court to extend the period of time under "compelling circumstances." The latter situation would not apply to a debtor seeking

The issue of post-petition rents has been clarified by the addition of Section 552(b) of the Code. Lenders may now have a valid security interest regardless of whether or not they have perfected that interest under state laws.[7] This interest can extend to underlying property, as well as to post-petition rents.[8]

In addition, of interest to landlords and tenants who might encounter asbestos problems, a new subsection (g) has been added to Section 524 of the Code. Subsection (g) provides a trust fund and injunction procedure to deal with asbestos-related claims against a Chapter 11 debtor.[9]

[2]—The 2005 Bankruptcy Act Amendments

The Bankruptcy Code was amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Bankruptcy Act").[10] Most of the provisions of the 2005 Bankruptcy Act became effective on October 17, 2005, although a few of its provisions, including the extension of the reach back provisions of the Code Section 548(b) (relating to fraudulent transfers) from one year to two years, became effective at a later date.

Many changes were made in the Bankruptcy Code that will have an impact on bankruptcies in general, including tenant bankruptcies. Among other things, notice requirements to creditors were tightened, provisions were adopted that expose debtor's counsel to an increased risk of sanctions if debtor schedules are incorrectly completed, provisions were added with the intent to make it more difficult for debtors to file multiple bankruptcies, and the court's ability to indefinitely extend the debtor's time to file a Chapter 11 plan of reorganization was curtailed.[11]

Some highlights of the 2005 Bankruptcy Act, as they relate to leases, are as follows:

(1) Time to Assume or Reject. Congress capped the time that a tenant-debtor has to elect whether or not to assume or reject a lease. Code Section 365(d)(4) formerly gave tenants sixty days to elect, but courts generally extended the tenant's time to the end of the case, when the tenant's reorganization plan was confirmed. Code Section 365(d)(4) now gives the tenant-debtor 120 days to make its election, but provides that the court may extend the time period for ninety days for cause, and may further extend the time period *only* with the landlord's written consent. This change is expected to give landlords considerable leverage in negotiating with bankrupt tenants, because tenants will be unable to delay indefinitely assumption and rejection decisions without landlord cooperation.

(2) Cap on Landlord's Damages if an Assumed Lease is Subsequently Rejected. Prior to the enactment of the 2005 Bankruptcy Act, a landlord could file an uncapped administrative claim for all damages suffered by the landlord if

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delay, but would be applicable where there is a *bona fide* illness of a party or the court or when circumstances beyond the parties' control intervene. 140 Cong. Rec. H10764 (1994).

[7] 11 U.S.C. § 552(b)(2). See 140 Cong. Rec. H10764 at 16 (1994).

[8] *Id.*

[9] 11 U.S.C. § 554(g). See 140 Cong. Rec. H10764 at 5–7 (1994).

[10] Pub. L. No. 109-8, 119 Stat. 23, enacted on April 20, 2005.

[11] See *Id.*

the tenant-debtor entered into a lease with the landlord during the course of the bankruptcy proceeding, or if the tenant-debtor assumed an existing lease, and the tenant subsequently rejected the lease (for example, in the context of a conversion of a Chapter 11 proceeding into a Chapter 7 proceeding). The resulting claim for landlord damages tended to dwarf all other claims. Accordingly, Congress added Section 503(b)(7) to the Code.[12] Section 503(b)(7) provides that if a nonresidential lease is assumed and then rejected, the landlord will have a priority claim for all amounts due under the lease (excluding damages relating to a failure to operate or a penalty provision) for a period of two years from the later of the rejection date or the date the landlord is given possession of the premises, without reduction or setoff except for sums actually received from a third party (for example, from a bank under a letter of credit).[13] Code Section 503(b)(7) further provides that the balance of the landlord's claim for monetary damages is subject to the Section 502(b)(6) cap (which previously applied only to rejected leases that existed at the time of the bankruptcy filing).

(3) Cure of Nonmonetary Defaults. Congress attempted to resolve an issue that had arisen in the case law as to whether or not a lease could be assigned if a nonmonetary default had occurred that was not curable (such as an illegal sublease). The issue arose because one statutory condition to assumption and assignment of a bankrupt tenant's lease under the Code is that all defaults must be cured at the time of assumption or that the landlord be given adequate assurance of prompt cure. The 2005 Bankruptcy Act amended Section 365(b)(1)(A) to provide that cure is not required in the case of a nonmonetary default that is impossible to cure, unless the default relates to a requirement that the tenant continuously operate.[14]

(4) Primacy of Shopping Center Protections. Another issue that had arisen in the case law was whether Section 365(f), which invalidates lease provisions that prohibit, restrict or condition assignment of the bankrupt tenant's lease, preempts Section 365(b), which, among other things, provides that any assignment of a shopping center lease is subject to all of its provisions, including but not limited to radius, location, use and exclusivity provisions. Some courts had invalidated specific use clauses in shopping center leases on the grounds that they, as a practical matter, prohibited assignment in violation of Section 365(f);[15] other courts had upheld such restrictions, holding that Section 365(b)(3) trumps Section 365(f).[16] Congress resolved the conflict by making Section 365(f) expressly subject to Section 365(b) and (c).[17]

(5) Preferences. Congress improved the ability of creditors generally to retain payments received in the three months preceding a bankruptcy filing, by modifying Code Section 547(b) to reduce the number of hurdles the creditor must jump. Prior to the enactment of the 2005 Bankruptcy Act, Section

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[12] Bankruptcy Code § 503(b)(7); 11 U.S.C. § 503(b)(7).

[13] *Id.*

[14] Bankruptcy Code § 365(b)(i)(A); 11 U.S.C. § 365(b)(i)(A).

[15] See § 28.04[3] *supra.*

[16] *Id.*

[17] Bankruptcy Code § 365(f)(1); 11 U.S.C. § 365(f)(1).

547(b) allowed the bankruptcy trustee to recover payments made in the ninety days preceding bankruptcy if (among other things) the tenant was insolvent during that period, unless the creditor met three tests.[18] Section 547(c) now provides that payments made in the ninety-day period may not be avoided to the extent such payments are (1) made in payment of a debt incurred by the debtor in the ordinary course of business and (2) were either made in the ordinary course of business or were made according to ordinary business terms"[19] The revised language should make it easier for landlords to retain rent payments received in the ninety-day period prior to the bankruptcy filing if rent payments were made in the usual time frame.

(6) Limitation of Automatic Stay with Respect to Residential Leases. Code Section 362, which automatically stays all actions at the filing of the bankruptcy petition, was amended to add subparagraphs (b)(23) and (c)(3).[20] These subparagraphs provide residential landlords with some relief with respect to tenants engaging in illegal activities or making multiple bankruptcy filings.[21]

(7) Schemes to Hinder Creditors Through Transfer of Real Property. If the court finds that a debtor has filed a petition to delay, hinder and defraud creditors through a scheme to transfer real property without the consent of the secured creditor or court approval, the court may order that relief from the automatic stay remain binding as to real property in any case filed by the debtor within two years after the order.[22]

[3]—The Consolidated Appropriations Act of 2020[23]

The Consolidated Appropriations Act includes two key amendments affecting the rights of commercial landlords: (1) reduced preference exposure and (2) increased rent deferral under executory contracts.

[a]—Reduced Preference Exposure

Section 547 of the Bankruptcy Code provides that a bankruptcy trustee or debtor-in-possession may recover certain payments made in the ninety days prior to a bankruptcy filing.[24] Typically, a debtor's payment of previously deferred rent to a landlord within ninety days before the bankruptcy filing, while the debtor is insolvent, would potentially be subject to avoidance and recovery by the trustee as a preference. The Consolidated Appropriations Act temporarily amends this section for two years to limit a trustee's ability to "claw back" a deferred rent

[18] See Bankruptcy Code § 547(b); 11 U.S.C. § 547(b).
[19] Bankruptcy Code § 547(c); 11 U.S.C. § 547(c).
[20] Bankruptcy Code § 362(b)(23) and (c)(3); 11 U.S.C. § 362(b)(23) and (c)(3).
[21] *Id.*
[22] See Bankruptcy Code § 362(d)(4); 11 U.S.C. § 362(d)(4).
[23] The amendments to the Bankruptcy Code are set forth in Sections 320 and 1001 of the Consolidated Appropriations Act of 2021. Consolidated Appropriations Act of 2021, Pub. L. No. 116-260 §§ 320, 1001.
[24] Bankruptcy Code §547; 11 U.S.C. §547.

payment made by a debtor as a preference. As a result, this amendment gives both commercial landlords and tenants the flexibility to negotiate rent deferrals and longer repayment periods without fear of losing revenue or litigating preference clawback issues.

Under the amendment, for a landlord and debtor to qualify for protection, (1) there must be an amendment to an existing nonresidential lease for the deferral of rent, (2) the amendment must have been made on or after March 13, 2020, and (3) the amount of deferred rent must "not exceed the amount of rental and other periodic charges agreed to" under the existing lease.[25] However, this exception does not include any fees, penalties, or interest in an amount greater than those that the debtor would owe if the debtor had made every payment due under the nonresidential lease on time and in full before March 13, 2020.

[b]—Increased Rent Deferral

Section 365(d)(3) of the Bankruptcy Code provides that a commercial debtor tenant must timely perform all of its lease obligations pending the debtor's decision to assume or reject the lease.[26] This provision permits debtors to request a sixty-day rent deferral after the bankruptcy filing date before requiring them to begin paying post-petition rent (i.e., rent after the bankruptcy case commences). Typically, this extension is granted by the court for cause. However, the Consolidated Appropriations Act temporarily amends this section for two years to allow debtors who are experiencing coronavirus-related financial hardship to defer their rent to the earlier of 120 days or the debtor's assumption or rejection of the lease.[27] As a result, debtors have more flexibility in paying their rent, but this flexibility comes at the landlord's expense, as the landlord is being required to extend credit to the tenant on an involuntary basis. However, the amendment provides that any claims arising from the any such extension will be treated as an administrative expense (that receives priority payment status).

[25] See Consolidated Appropriations Act of 2021, Pub. L. No. 116-260 § 1001(g).
[26] Bankruptcy Code §365(d)(3); 11 U.S.C. §365(d)(3).
[27] *See* Consolidated Appropriations Act of 2021, Pub. L. No. 116-260 §1001(f).

§ 28.10 Summary

Bankruptcy can be an extremely complicated process, especially for someone who is unfamiliar with the practice area and its unique argot. Debtors-in- possession and bankruptcy trustees on one hand, and their contract counter parties, on the other, have been immersed in a constant "tug-of-war" seeking protection due to cash flow difficulties, insolvency and other problems. The bankruptcy statutes and rules have established a process under Article 2 of the U.S. Constitution[1] for handling insolvency cases from the filing of a voluntary or involuntary bankruptcy petition to final disposition.[2] While detailed and elaborate, the statutes and rules do not explain or clarify several key concepts even after the 1984 and 1994 amendments.

It is a truism worth repeating—the parties to a contract or lease should understand the "fine print" in their contracts and leases. Less obvious, is that they should be well versed in the applicable provisions of the Bankruptcy Code and know how their rights may be affected by the statutory scheme, Understanding the bankruptcy process and the impact bankruptcy law may have on their bargained for rights should one of the parties seek protection can only enhance economic outcomes.

Moreover, contracting parties have tools at their disposal at the time of contract formation they can use to manage bankruptcy risk. For example a contracting party can attempt to obtain certain protections that will not be controversial when a contract is being drafted, such as including a provision defining what will be required to provide the party with "adequate protection"[3] of its interests if the counterparty should file a bankruptcy case and seek to assume a contract or lease under section 365 of the Bankruptcy Code.[4]

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[1] U.S. Const., Art. 2.

[2] U.S. Const., Art. I, § 8, cl. 4. ("to establish . . . uniform laws n the subject of bankruptcies throughout the United States).

[3] Bankruptcy Code § 361; 11 U.S.C. § 361.

[4] Bankruptcy Code § 365; 11 U.S.C. § 365.