

# Solid Rock to Shifting Sand: How the U.S. Bankruptcy Code Effectively Re-Writes Commercial Real Estate Lease Provisions

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*This article summarizes the various ways in which negotiated lease terms that were intended to benefit a landlord are modified or obliterated by the application of the provisions of the U.S. Bankruptcy Code and by the decisions of bankruptcy courts.*

*“The best-laid schemes o’ Mice an’ Men, Gang aft agley,<sup>1</sup>  
An’lea’e us nought but grief an’ pain, For promis’d joy!”*  
– Robert Burns “To a Mouse”

**L**ike the plans of the wee mousie whose winter nest was destroyed by Robert Burns’ plough, the best laid schemes of commercial real estate landlords (and of their mortgagees) often go awry in the midst of a tenant bankruptcy proceeding. This article summarizes the various ways in which negotiated lease terms that were intended to benefit the

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landlord are modified or obliterated by the application of the provisions of the U.S. Bankruptcy Code<sup>2</sup> and by the decisions of bankruptcy courts. The article also suggests certain practice tips to help ameliorate such negative consequences in limited circumstances.

Although the rights of parties under leases of real property are generally governed by state law, federal bankruptcy law preempts state law to the extent they conflict.<sup>3</sup> Therefore, each lease of real property is interpreted as if the Bankruptcy Code were expressly incorporated therein.<sup>4</sup> The main purposes of the Bankruptcy Code are to maximize and preserve the debtor's estate, to rehabilitate the debtor and to provide for equal treatment of each tier of creditors of the same class.<sup>5</sup> To those ends, the Bankruptcy Code contains various provisions that change or override certain lease provisions that would, without such change, provide financial or other benefits to the landlord (and, not so indirectly, to the landlord's mortgagee). It is often said that a bankruptcy court is a court of "equity" and therefore enjoys broad powers to effectuate a result that it considers equitable (discussed below). Those unfamiliar with such broad equitable and statutory powers may be surprised to discover that hard-won contractual protections may be lost or modified in the name of equity and of furthering the purposes of the Bankruptcy Code.

## **DEBTOR'S RIGHT TO ACCEPT OR REJECT LEASE**

Perhaps the most dramatic way that the Bankruptcy Code modifies commercial real estate leases is that it provides to a debtor/lessee the right, subject to certain restrictions, to accept or reject the lease. Section 365(a) of the Bankruptcy Code provides, in pertinent part, that "...the trustee, subject to the court's approval, may assume or reject any...unexpired lease of the debtor."<sup>6</sup> Therefore, even though the landlord and tenant had entered into a long term lease with many years then still remaining on the lease term, the tenant will be permitted in a bankruptcy proceeding to either accept the lease (with certain potential modifications (see below)) or reject the lease and be relieved of its obligations thereunder for the remaining term, subject to the landlord's claim for damages resulting from such rejection. In addition, the amount of landlord's damages claim against the

tenant is limited under Section 502(b)(6) as more fully discussed herein. Section 365(d)(4)<sup>7</sup> of the Bankruptcy Code provides that the debtor has 120 days after the order for relief to accept or reject the lease (or, if earlier, the date of entry of an order confirming a plan of reorganization). The lease will be deemed rejected if not assumed by the earlier of 120 days after the order for relief<sup>8</sup> or the date of entry of an order confirming a plan.<sup>9</sup> The 120 day time period may be extended, for cause, up to an additional 90 days.<sup>10</sup> Any extension for longer than 90 days requires the landlord's consent.<sup>11</sup> Accordingly, the maximum amount of time to assume or reject a lease without the consent of the landlord is 210 days.

Although it is up to the landlord's discretion whether to permit an extension of the acceptance/rejection period, in practice, both parties have some influence to bring to bear in the decision. For example, if the landlord refuses to extend the period, the tenant may be forced to reject the lease which may be an unwanted consequence to the landlord. Also, it may behoove both parties to see how well a given store performs during the holiday season before deciding on whether to accept or reject the lease. In such instance, an extension may enhance the decision-making process for both parties.<sup>12</sup>

The following factors are evaluated by courts in determining whether "cause" exists to justify an extension to the 120 day period:<sup>13</sup>

- Is the lease a primary asset of the debtor?;
- Has the debtor had sufficient time to determine its best course of action pertaining to such lease?;
- Is the debtor current on rent payments and other obligations under the lease?;
- Is the analysis regarding whether to accept or reject a lease or group of leases unduly complicated?; and
- Have key employees left the debtor?

If an emergency situation arises where the landlord needs the debtor to make a decision about accepting or rejecting the lease during the initial 120 day period, the landlord should file a motion under Section 365(d)(2) and/or Section 105(a) of the Bankruptcy Code and present arguments

about why the balance of equities should require a decision prior to the expiration of the 120 day period.<sup>14</sup>

### **Practice Tips**

The debtor's rights to accept or reject the lease (and to take advantage of other debtor protections provided under the Bankruptcy Code such as the automatic stay — discussed herein below) do not come into existence until the debtor has filed a bankruptcy petition.<sup>15</sup> Accordingly, if the landlord has any inkling or suspicion that the tenant may be heading toward bankruptcy, it is essential to carefully evaluate all available remedial rights and to take all appropriate actions as soon as possible and as much prior to the filing of the petition as possible. Nevertheless, a bankruptcy court will take control of prepetition lawsuits that are still in process at the time of filing and the enforcement of prepetition judgments.

In addition, state law governs the determination of whether a lease has been terminated or not prior to the filing of the petition.<sup>16</sup> State law will also control whether the termination has been waived by subsequent actions of the landlord or revived by the tenant, if such right to revive exists.<sup>17</sup> Additionally, the bankruptcy trustee may attempt to revive the lease arguing that the termination was a fraudulent conveyance.<sup>18</sup> Accordingly, all landlord actions should be consistent with such termination. For example, if practicable, the landlord should take affirmative steps to take physical possession of the leased premises. The landlord should also consider obtaining a state court judgment that the lease has been terminated.<sup>19</sup> Otherwise, the court may consider the lease to be in effect at the time of the filing of the petition and, therefore, subject to the limitations of the Bankruptcy Code. At the drafting stage, if negotiating power permits, the landlord should evaluate whether to shorten the cure periods or insert a provision that provides for automatic termination of the lease in certain instances.<sup>20</sup>

### **LIMITS ON DAMAGES RESULTING FROM REJECTION OF LEASE**

Section 502(b)(6) of the Bankruptcy Code provides a cap on the amount of damages that a landlord can claim as a result of a termination of a lease for real property. The cap is effective even if a different dam-

age formulation is specifically set forth in the lease. Also, Section 365(g) (1) of the Bankruptcy Code provides that a rejection of a lease constitutes a breach of such lease “immediately *before* the date of the filing of the petition [emphasis added].”<sup>21</sup> Consequently, a landlord’s claims for damages accruing after the rejection of the lease are accorded the status of an unsecured pre-bankruptcy claim (and therefore likely to receive a payout equal to only a fraction of the claim).

Under Section 502(b)(6), damages are limited to the lesser of (1) actual damages and (2) the sum of:

- A. an amount equal to the greater of:
  - (i) one year of rent;<sup>22</sup> or
  - (ii) rent for 15 percent of the remaining lease term (not to exceed three years);<sup>23</sup> plus
- B. any unpaid rent due under the lease on the earlier of (i) the date of filing the bankruptcy petition and (ii) the date the landlord took possession of, or the tenant surrendered, the leased premises.

Section 365(d)(3) of the Bankruptcy Code provides that “the trustee shall timely perform all the obligations of the debtor” between the date of filing the bankruptcy petition and the date the lease is assumed or rejected. Also, Section 365(b)(1) provides that the trustee may not assume a lease unless, at the time of the assumption of such lease, the trustee: (i) cures defaults or provides adequate assurance they will be properly cured; (ii) compensates or provides adequate assurance of prompt compensation to the landlord for any actual pecuniary loss; and (iii) provides adequate assurance of future performance under the lease. However, the trustee is not required to cure a non-monetary default if it is impossible for the trustee to do so, unless the non-monetary default is a failure to operate and the landlord has a claim for pecuniary losses resulting from the failure to operate.

In addition, with the court’s permission, the trustee will be relieved of certain obligations such as:

- The obligation to adhere to a prohibition on going out of business sales<sup>24</sup> (discussed below);

- The obligation to continue to operate a business (*i.e.*, the obligation to avoid “going dark”)<sup>25</sup> (however, as a result of the 2005 amendments to Section 365(f) of the Bankruptcy Code, lease requirements to continue to operate are expected to be generally enforced);
- The obligation to maintain and repair the leased property (the court may consider various factors in coming to its conclusion such as: (i) whether the item to be repaired was damaged before or after the petition date; (ii) whether the repair is necessary for public safety; (iii) the overall cost of the repair; and (iv) whether the debtor is expected to assume the lease);<sup>26</sup> and
- The obligation to lift liens (unless the lien arises postpetition).<sup>27</sup>

Leases that are assumed by the debtor and later breached are not subject to the cap under Section 502(b)(6).<sup>28</sup> Also, Section 503(b)(7) of the Bankruptcy Code now provides that if a nonresidential real property lease first is assumed then later rejected, the landlord is entitled to an administrative expense claim for all monetary obligations, excluding damages for failure to operate, for the two-year period following the date of rejection or surrender, whichever is later, without reduction or setoff except for sums actually received or to be received from an entity other than the debtor. Any additional sum due to the landlord is a claim under Section 502(b)(6). Finally, Section 365(b)(2)(D) was amended in 2005 to clarify that penalty rates as well as penalty provisions relating to non-monetary defaults need not be paid or cured.

## Practice Tips

The calculation of the damage cap is based on the amount of rent. Therefore, landlords should carefully describe in the lease all of the regular and fixed charges as “rent.” The court will make an independent determination as to which components qualify as “rent” for purposes of the calculation, but the language in the lease should be as clear and unambiguous as possible. In addition, the lease should clearly state that the tenant is responsible for the landlord’s legal fees if such fees are necessary in connection with a tenant default under the lease (the court

will usually only grant the payment of landlord's legal fees if specifically required under the lease).<sup>29</sup>

## LIMIT ON EVENTS CAUSING LEASE DEFAULT

Section 365(e)(1) of the Bankruptcy Code provides that, notwithstanding any provision in a lease to the contrary, such lease may not be terminated or modified solely because of a provision in such lease that is conditioned on the insolvency or financial condition of the tenant, the filing of a bankruptcy proceeding or the appointment of or taking possession by a trustee or custodian (such provisions, in this context, are often referred to as "ipso facto" clauses).

Section 365(e)(2) of the Bankruptcy Code provides that the prohibition against the enforcement of ipso facto clauses does not apply if applicable law (such as the federal Anti-Assignment Act)<sup>30</sup> excuses the landlord from accepting performance from a rendering performance to the bankruptcy trustee or to an assignee of the lease, whether or not such lease prohibits assignments and the landlord does not consent to the assignment. Also, the Section 365(e)(1) prohibition against ipso facto clauses does not prevent the filing of the tenant's bankruptcy petition from triggering a default against third parties such as a surety bond issuer.<sup>31</sup>

### Practice Tip

Remember that this restriction is only effective upon the filing of a bankruptcy petition. Therefore, as mentioned above, landlords and lenders should carefully determine whether they should exercise remedies under the lease prior to the filing of an impending bankruptcy petition.

## LIMITS ON ANTI-ASSIGNMENT CLAUSES (INCLUDING DE FACTO ANTI-ASSIGNMENT CLAUSES)

Section 365(f) of the Bankruptcy Code provides that, notwithstanding a provision in a lease that prohibits, restricts or conditions an assignment of the lease, the trustee may nevertheless assign such lease if:

- The trustee assumes such lease; and
- Adequate assurance of future performance by the assignee of such lease is provided.

Section 365(b)(3) provides that, in the context of a shopping center lease, adequate assurance<sup>32</sup> is defined as adequate assurance:

- Of the source of rent under the lease and that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to that of the original tenant and its guarantors, if any, as of the time that the tenant became tenant under the lease;<sup>33</sup>
- That any percentage rent will not decline substantially;
- That the assumption of the lease is subject to all provisions thereof, including (but not limited to) provisions such as radius, location, use, or exclusivity provision; and
- That assumption of the lease will not disrupt any tenant mix or balance in such shopping center.

Section 365 has been held to “express a clear Congressional policy favoring assumption and assignment.”<sup>34</sup> In addition, courts historically have looked with disfavor on restraints on the free alienation of land.<sup>35</sup> Accordingly, the courts have interpreted the prohibition on anti-assignment clauses rather broadly, and include as anti-assignment clauses, all provisions that would tend to have the de facto result of prohibiting assignments. For example, the following provisions have been invalidated as anti-assignment clauses:<sup>36</sup>

- A provision increasing the rent on assignment;<sup>37</sup>
- A provision requiring the tenant to pay the landlord 75 percent of the appreciation in value of the lease as a condition for the assignment;<sup>38</sup>
- A provision conditioning assignment of the lease on payment of 80 percent of the assignment proceeds to the landlord as additional rent;<sup>39</sup>

- A provision requiring the tenant to pay a portion of the purchase price to the landlord as a condition to the assignment;<sup>40</sup>
- A cross-default provision providing that a default in one lease was a default in the tenant's other leases;<sup>41</sup> and
- A provision granting the landlord a right of first refusal in connection with any assignment.<sup>42</sup>

In addition, restrictions on store alterations, physical subdivision of the leased premises and subleasing were held to be "nuisance provisions" that could be overlooked (i.e., not enforced) by the court.<sup>43</sup> Also, a court refused to enforce as an anti-assignment clause a landlord purchase option that was triggered when the landlord objected to the proposed assignee.<sup>44</sup>

Nevertheless, certain limitations have been upheld including use and exclusivity restrictions (e.g., assignee of lease that required use as a department store was not permitted to be an electronics retailer) and a nine month limitation on going dark was upheld but the period did not start to run until after the assignee took possession.<sup>45</sup> However, a landlord must show that "actual and substantial detriment" would be incurred if the deviation in use is permitted.<sup>46</sup> Additionally, a provision that authorized termination of the lease if the tenant's gross sales did not meet a minimum standard was upheld because of the landlord's reliance on percentage rent.<sup>47</sup> Finally, the Section 365(f) restriction on anti-assignment clauses is tempered by the 2005 amendments to the Bankruptcy Code that, among other things, now require the tenant and the assignee to continue to operate the store if required in the lease.<sup>48</sup>

Courts have also recognized that the prohibition on anti-assignment clauses permits the debtor to sell so-called "designation rights." Designation rights are the exclusive rights to determine whether a lease will be assumed or rejected by a tenant and to designate the assignee if the lease is assumed. The sale of designation rights typically occurs in bankruptcy cases involving a large number of locations, because the debtor is not usually equipped to market a large number of leases in a short period of time. Time is of the essence because the debtor continues to incur carrying costs on each property until assumed or rejected. For this reason, the debtor inevitably makes the sale of the designation rights contingent upon the buyer

assuming such carrying costs. It should be noted that the changes to Section 365(d)(4) (that now require landlord consent to an extension beyond 210 days to accept or reject a lease) and the changes to Section 365(f) (that make use clauses more likely to be enforced), have reduced the value of designation rights.

## Practice Tips

Shopping center leases are given special protections under Section 365(b)(3) of the Bankruptcy Code and courts are required to evaluate the financial condition, percentage rent impact, use clauses and tenant-mix of a proposed assignee of the lease, especially as to whether such change would cause a breach of any other lease of any property in the shopping center. Accordingly, if the tenant mix of a shopping center is something the landlord wants to preserve, the parameters of that mix should be carefully set forth in the lease and the lease should recite that such mix is part of the bargained-for exchange for the subject lease and the other leases in the shopping center (the reference to “tenant mix or balance” in Section 365(b)(3)(D) of the Bankruptcy Code directs the inquiry to contractual provisions rather than general notions of tenant mix or balance).<sup>49</sup> Likewise, if use restrictions are important, such restrictions should be specifically set forth in the lease and, if possible, in a declaration of covenants, conditions and restrictions that would run with the land, rather than simply relying on a provision in the lease that requires landlord consent to assignments or subleases by tenant.

Additionally, the lease should specifically define what constitutes adequate assurance of future performance if the lease is assigned to a third party. For example, the lease could provide that the tenant’s obligations must be affirmatively assumed by the assignee pursuant to a written instrument acceptable to the landlord (the lease should also provide that any assignee is deemed to have assumed the lease without further act). The landlord could also include a net worth or rating requirement that would have to be met by any acceptable assignee. The lease could also provide an agreement by the tenant that it would not assign the lease to any party that would result in:

- A diminution of value of the premises;
- Multiple tenants;
- Breach of exclusive use rights in favor of another tenant or lender;
- Breach of any insurance policy; or
- An adverse impact on common areas or utility systems.

If applicable, the lease should also recite a stipulation by the parties that the lease involves premises in a “shopping center” as defined in Section 365 of the Bankruptcy Code.

Finally, all bid guidelines prepared in connection with a potential assignment of the leasehold interest should be carefully reviewed by landlord prior to court approval and the landlord should object to inappropriate provisions (for example, the bid guidelines should not require the landlord to pre-qualify as a bidder and the bid and auction procedures should give the landlord sufficient time to evaluate bidders and make sure they are eligible).<sup>50</sup> Finally, no bidder in the auction should leave the auction until the auctioneer announces the conclusion of the auction and all post-auction negotiations have been completed.<sup>51</sup>

## LIMITS ON USE OF SECURITY DEPOSIT

It is a common practice for landlords of commercial properties to require tenants to establish security deposits to mitigate either concerns about tenant creditworthiness or concerns about liquidity. Although often such security deposits are equal only to a month or two of basic rent, at times they are significantly larger. Security deposits are often in the form of a cash reserve or, as even more common, in the form of a letter of credit.

Courts have consistently held, in reliance on Section 362(a)(3) of the Bankruptcy Code, that the application of a security deposit to prepetition rent obligations violates the automatic stay.<sup>52</sup> However, security deposits may be applied to postpetition damages for termination of the lease if the lease is rejected. To the extent the security deposit is applied to postpetition damages, such amounts will be required to be applied to reduce the amount of the landlord’s claim that is capped under Section 502(b)(6) (the

“Capped Claim”), even if the landlord’s actual claim exceeds the Capped Claim. Any amounts received by landlord from the cash security deposit that exceed the Capped Claim must be returned to the bankruptcy estate.<sup>53</sup> To illustrate, assume that the landlord’s actual damages due to a rejection of the lease are \$500,000, the Capped Claim is \$300,000 and the cash security deposit is \$100,000. If the landlord taps the security deposit to mitigate its losses after a rejection of the lease, the amount must be used to reduce the Capped Claim to \$200,000, rather than applied to a reduction of the actual damages to \$400,000 which would have resulted in a Capped Claim of \$300,000. If, in the foregoing example, the cash security deposit was \$400,000, the landlord would be required to apply \$300,000 to its Capped Claim and return \$100,000 to the bankruptcy estate rather than apply the \$400,000 to the landlord’s actual damages and retain a \$100,000 claim against the debtors.

Many landlords require that security deposits be in the form of letters of credit in lieu of cash because they believe that letters of credit will result in better recovery than if the security deposit is in cash. This belief stems from the independence principle that is applicable to letters of credit. The independence principle is the recognition that the obligation of the issuer of the letter of credit is independent of the account debtor’s reimbursement obligation to the beneficiary of the letter of credit. Consequently, the expectation is that, during a bankruptcy proceeding, the beneficiary could have recourse to the letter of credit without applying such payment to the Capped Claim.

However, certain cases have held that if the security deposit was in the form of a letter of credit rather than cash, the application of funds would work the same way as if it were cash, so long as the reimbursement obligation of the debtor to the issuer of the letter of credit is secured by assets of the debtor.<sup>54</sup> Commentators argue, however, that the independence principle that applies to letters of credit should be respected and that the obligation of the issuer of the letter of credit should be recognized as independent of that of the tenant.<sup>55</sup> If this line of reasoning is ever accepted by the courts (to date, it has not been accepted), payments received by the landlord from draws on the letter of credit would not be required to be applied to reduce the Capped Claim (except to the extent that the landlord’s

actual claim is reduced to an amount less than the Capped Claim). In addition, except as set forth above, letters of credit are not generally considered part of the debtor's estate, whereas cash deposits have been held to be part of the debtor's estate.<sup>56</sup> Finally, realizing on a cash security deposit postpetition requires a court order, whereas drawing on a letter of credit requires no court action.

### Practice Tips

Landlords should consider requiring that any security deposits be provided in the form of a letter of credit, but should try to ensure that the reimbursement obligations under such letter of credit are not secured by assets of the tenant.

In lieu of a letter of credit, an arguably better approach (to get around the 502(b)(6) cap) is to obtain a third-party guarantee from a credit-worthy entity. Collections on a third-party guarantee would not have to be applied to reduce the Capped Claim under Section 502(b)(6) (except to the extent such collection reduces the landlord's actual claim to an amount below the Capped Claim). However, collecting on a third-party guaranty may be more problematic than drawing on a letter of credit or accessing a security deposit because most guarantors need more prodding to elicit payment than a simple request. Additionally, if the guarantor is also in bankruptcy, the Section 502(b)(6) limitation applies against the claim against the guarantor as well. Finally, bankruptcy courts have occasionally prevented recovery against third-party guarantors holding that such recovery may prevent a successful reorganization of the principal obligor on the guaranteed obligation.<sup>57</sup>

In practice, landlords should attempt to obtain the following provisions in the lease and the letter of credit:<sup>58</sup>

- As mentioned, the reimbursement obligation under the letter of credit should not be secured by assets of the tenant;
- Any requirement or option for posting a letter of credit should be separate from any requirement for a cash security deposit;

- The lease should not describe the letter of credit as a security deposit, but should include the tenant's acknowledgment that the letter of credit is intended as a third party guaranty of the tenant's obligations under the lease;
- The lease should provide that the letter of credit may be drawn upon without any notice to the tenant;
- Draw requirements under the letter of credit should be as simple as possible (preferably, just a request stating that the amount sought does not exceed the amount owed under the lease, without any certification that notice or demand has been served on the tenant) (also, avoid requirements that are so specific that technical compliance may be impossible, such as a requirement that the draw request be signed by a particular individual);
- The letter of credit should allow for partial or multiple draws;
- The letter of credit should allow for presentation of draw requests by fax; and
- The letter of credit should include an "evergreen" provision that provides for automatic renewal unless the issuer provides 30-days, prior written notice of its intent not to renew and should provide that the beneficiary has a right to draw if it's not timely renewed.

Finally, as mentioned previously, the limits on the use of security deposits are only effective during the period after the filing of a bankruptcy petition. Therefore, decisions regarding remedial actions prior to filing of a petition are sensitive and crucial to maximizing recovery.

## **LIMITS ON PROHIBITION OF GOING OUT OF BUSINESS SALES**

In order to protect other tenants in a shopping center, many landlords will include provisions in their leases prohibiting or restricting the ability of the tenant to conduct going out of business sales. The rationale of such restrictions is to prevent a deterioration in the ambiance and culture of the shopping center and to avoid, as much as possible, the impression that the

entire shopping center is in financial difficulty.

Bankruptcy courts will permit going out of business sales, even if prohibited in the relevant lease.<sup>59</sup> The courts' rationale is that the enforcement of restrictions on such sales would contravene the fundamental bankruptcy goal of maximizing assets of the debtor's estate. Going out of business sales have been specifically held not to violate Section 365(b)(3)(C) of the Bankruptcy Code which requires that the assumption or assignment of a lease is subject to all the provisions of such lease including use provisions.<sup>60</sup> The courts seem to view the going out of business sale as intrinsic to the bankruptcy and liquidation proceedings and courts are therefore reluctant to enforce restrictions on such sales since it would conflict with the debtor's ability to receive the full benefit of the bankruptcy proceedings.

### **Practice Tip**

Landlords should attempt to negotiate guidelines for the going out of business sales and such guidelines should be set before the auction of the leasehold. For example, such guidelines may address duration of the sale, signage size, location, number, choice of words<sup>61</sup> and colors and should attempt to ensure that rules and regulations of the shopping center are adhered to as much as possible.

## **AUTOMATIC STAY**

Section 362(a) of the Bankruptcy Code provides that, subject to certain exceptions set forth in Section 362(b), the filing of the bankruptcy petition "operates as a stay" applicable to all entities against enforcement actions and exercise of remedies against the debtor. The automatic stay is one of the most powerful protections of the debtor provided by the Bankruptcy Code and, as its name implies, the automatic stay is self-executing and no court order is required. The automatic stay stops all collection efforts, all harassment and all foreclosure actions, unless such actions are authorized by the bankruptcy court. Accordingly, the landlord will be prevented from terminating the lease or exercising any other remedies or collection actions against the debtor so long as the stay is in effect. For example, even

applying funds in a security deposit to prepetition obligations, without court sanctioned relief, has been ruled a violation of the automatic stay.<sup>62</sup>

The automatic stay does not generally prohibit actions against third-party obligors such as guarantors, sureties, insurers, etc. However, see restrictions on use of letter of credit as security deposit herein above.

### **Practice Tip**

As mentioned previously, prepetition remedies should be seriously considered and timely acted upon if the landlord has forewarning of an impending bankruptcy filing by a tenant.

## **GENERAL EQUITABLE POWERS OF THE BANKRUPTCY COURT**

No discussion of bankruptcy issues would be complete without a mention of the general equitable powers of the bankruptcy court, although a full development of that concept is beyond the scope of this article.<sup>63</sup> Section 105(a) of the Bankruptcy Code provides that the “court may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].”<sup>64</sup>

### **Examples of Equitable Powers Under Section 105**

Bankruptcy court actions relying on Section 105 have been described as “brazen”<sup>65</sup> and “notorious”<sup>66</sup> although cases and commentaries have advocated limitations on such power.<sup>67</sup> In addition, the Supreme Court has stated that Section 105 conveys to bankruptcy courts the ability to “modify debtor-creditor relationships.”<sup>68</sup> For example, bankruptcy courts have relied solely on Section 105 in granting the following:

- Partial discharge of that portion of a student loan debt that is deemed to be a hardship under Section 523(a)(8) of the Bankruptcy Code although partial discharge is not specifically permitted by the Bankruptcy Code;<sup>69</sup>
- An extension of the applicability of the automatic stay;<sup>70</sup>

- Substantive consolidation of cases;<sup>71</sup> and
- Non-consensual third-party releases in mass tort and securities fraud cases.<sup>72</sup>

### **Examples of Restrictions on Equitable Powers under Section 105**

On the other hand, courts have held that Section 105 does not authorize them to act as “roving commission[s] to do equity.”<sup>73</sup> Courts have also held that “The fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be.”<sup>74</sup> Finally, the Supreme Court has held that whatever equitable powers a bankruptcy court holds may not extend beyond express provisions of the Bankruptcy Code.<sup>75</sup> For example, courts have refused to recognize the existence of the following rights as emanating solely from the power granted by Section 105:

- Payments of prepetition claims to so-called critical vendors;<sup>76</sup>
- Full payment of unsecured debt unless all unsecured creditors in the same class are paid in full;<sup>77</sup>
- Subordinate creditors;<sup>78</sup> and
- Find an exception to the absolute priority rule due to a debtor’s agreement to provide future labor, experience and expertise in running a farm.<sup>79</sup>

The broad powers granted to the court under the Bankruptcy Code do not give the court the right to completely re-write each and every term of a lease. However, a bankruptcy court’s rights to make changes to a commercial real estate lease no doubt exceed those specifically enumerated above. Suffice it to say that the perceived equitable origins of the bankruptcy process and the language of the Bankruptcy Code provide significant ability for a bankruptcy court to fashion solutions to meet problems faced by the court, subject to the restrictions identified above.

## CONCLUSION

In sum, landlords on commercial real estate leases (and lenders secured by such leases) should be aware that certain contractual protections achieved by sometimes vigorous negotiations will not hold up at the very time they are most needed (*i.e.*, after the filing of a bankruptcy petition by the tenant). Nevertheless, there are ways for landlords to soften the blow in certain instances and even, through timely prepetition action, sidestep the most damaging effects of a tenant bankruptcy.

Although care should always be taken in drafting, just as much care should be given to understanding how that careful drafting will be treated by a court in bankruptcy. Such awareness and preparation are essential when dealing with a tenant in financial difficulty.

## NOTES

<sup>1</sup> “Gang aft agley” in the Scottish dialect in which this poem was written means “often go awry” or “oft go astray.” This verse is taken from the well-known poem by Robert Burns “To a Mouse, on Turning Her Up in Her Nest, With a Plough,” written in 1785. One theory of the meaning of the poem is that the farmer symbolizes the oppressor and the mouse symbolizes the oppressed. Perhaps such sentiments have some applicability in the U.S. bankruptcy setting.

<sup>2</sup> 11 U.S.C. §101 *et seq.* (herein referred to as the “Bankruptcy Code”). The analysis in this article is limited to debtors filing under Chapter 11 of the Bankruptcy Code. Chapter 11 of the Bankruptcy Code (Reorganization) should not be confused with Title 11 of the United States Code of which Chapter 11 is a part. All section references herein are to the Bankruptcy Code.

<sup>3</sup> *Testa v. Katt*, 330 U.S. 386 (1947), cited in “To Assume or Not to Assume: Real Estate Leases in Bankruptcy” by David S. Kupetz, *Journal of Bankruptcy Law and Practice*, Vol. 8 (herein “To Assume or Not”) at p. 395.

<sup>4</sup> *U.S. ex rel. Hoffman v. City of Quincy*, 71 U.S. 535, 550 (1866), cited in *To Assume or Not*, *supra*, at p. 395.

<sup>5</sup> Perhaps a more cynical (realistic?) view is expressed in an article in the February 10, 2009 edition of the *Dow Jones Bankruptcy Review* in which a bankruptcy attorney was quoted in connection with the dissolution of Dreier

LLP as saying, “When law firms dissolve, the court wants one thing and one thing only. They want money put back in the estate to pay back creditors.”

<sup>6</sup> In this article it is assumed that the debtor is a tenant under a commercial real estate lease and that the bankruptcy trustee (or debtor in possession) is appointed to effectuate the acts of the debtor as they pertain to the bankruptcy estate. Therefore, references herein to the tenant, the debtor and the trustee all refer to the holder of the same basic interests under the lease.

<sup>7</sup> On April 20, 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “Reform Act”) was signed into law. The Reform Act was intended mainly to correct abuses in the personal bankruptcy arena and to protect non-debtors in certain financial markets, but certain provisions affect commercial leasing. For example, Section 365(d)(4) previously provided that the debtor had 60 days to accept or reject, but the 60-day period was routinely extended. In fact, it had been suggested that the term “cause” had become synonymous with “the request of the debtor.”

<sup>8</sup> Section 365(d)(4)(A)(i).

<sup>9</sup> Section 365(d)(4)(A)(ii).

<sup>10</sup> Section 365(d)(4)(B)(i).

<sup>11</sup> Section 365(d)(4)(B)(ii).

<sup>12</sup> Of course, alternative arrangements may also be made, such as an agreement that the assumption/rejection period expires if the store doesn’t meet agreed-upon sales thresholds.

<sup>13</sup> See *South Street Seaport Ltd. Partnership v. Burger Boys, Inc.*, 94 F.3d 755 (2d Cir. 1996); *In re Ames Dept. Stores, Inc.*, 121 B.R. 160 (Bankr. S.D.N.Y. 1990); *In re Wedtech Corp.*, 72 B.R. 464 (Bankr. S.D.N.Y. 1987); as cited in *Tenants Gone Wild!*, *infra*.

<sup>14</sup> Section 105(d)(2)(A) of the Bankruptcy Code provides that “The court, on its own motion or on the request of a party in interest [may]... issue an order... that... sets the date by which the trustee must assume or reject an... unexpired lease....”

<sup>15</sup> Section 365(c)(3) provides that “The trustee may not assume or assign any ... unexpired lease of the debtor... if... such lease... has been terminated under applicable nonbankruptcy law prior to the order for relief.”

<sup>16</sup> See *Robinson v. Chicago Housing Authority*, 54 F.3d 316, 318 (7th Cir. 1995), cited in *To Assume or Not*, *supra*, at p. 419.

<sup>17</sup> *In re Windmill Farms, Inc.*, 841 F.2d 1467, at 1471-72 (9th Cir. 1988), cited in *To Assume or Not*, *supra*, at p. 419.

<sup>18</sup> *Bankruptcy Strategies for Commercial Landlords, Tenants, Lenders and Real Estate Investors* by Jeffrey N. Rich, Newsstand, November 17, 2008.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> This is true even though the rejection in fact occurs *after* the filing of the petition.

<sup>22</sup> Here, rent includes base rent and charges that are regular and fixed and are payable in the same way as lease rent, including, for example, common area maintenance charges, real estate taxes, utility charges, insurance expenses and similar charges and expenses.

<sup>23</sup> One year is equal to 15 percent of 80 months. Therefore, any remaining term of less than 80 months would have a claim equal to one year of rent. At the other end of the scale, 3 years is 15 percent of 20 years. Therefore, any remaining term of 20 years or more would have a claim equal to 3 years of rent.

<sup>24</sup> *See In re Ames Dept. Stores*, 136 B.R. 357 (Bankr. S.D. N.Y. 1992).

<sup>25</sup> *In re R.H. Macy & Co., Inc.*, 170 B.R. 69, 74-75 (Bankr. S.D. N.Y. 1994), cited in *To Assume or Not*, *supra*, at p. 420.

<sup>26</sup> *See Tenants Gone Wild!*, *infra*.

<sup>27</sup> *See* Section 362(b)(3) of the Bankruptcy Code.

<sup>28</sup> *In re Klein Sleep Products, Inc.*, 78 F.3d 18, 28-29 (2d Cir. 1996), cited in *To Assume or Not*, *supra*, at p. 422.

<sup>29</sup> *In re Child World, Inc.*, 161 B.R. at 353, cited in *To Assume or Not*, *supra*, at p. 415.

<sup>30</sup> *See In re Mirant Corp.*, 440 F.3d 238, 46 Bankr. Ct. Dec. (CRR) 13, 55 Collier Bankr. Cas. 2d (MB) 1050, Bankr. L. Rep. (CCH) P 80453 (5th Cir. 2006).

<sup>31</sup> *See Liberty Mutual Ins. Co. v. Greenwich Ins. Co.*, 417 F.3d 193, 45 Bankr. Ct. Dec. (CRR) 12 (1st Cir. 2005).

<sup>32</sup> *See* Section 365(b)(3) of the Bankruptcy Code.

<sup>33</sup> The debtor has the burden of proving that the proposed assignee meets this standard (*see In re Service Merchandise Company, Inc.*, Case No. 399.02649, Opinion entered August 29, 2002 (Bankr. M.D. Tenn. 2002)).

<sup>34</sup> *In re U.L. Radio Corp.*, 19 Bankr. at 537, 545 (1982).

<sup>35</sup> *See, e.g., Rowe v. Great Atl. & Pac. Tea Co.*, 46 N.Y.2d 62, 412 N.Y.S.2d 827, 385 N.E.2d 566 (1978).

<sup>36</sup> From Practising Law Institute Real Estate Law and Practice Course

Handbook Series PLI Order Number N0-00CI October, 2003, Understanding the Sophisticated Real Estate Practice 2003, "Tenants Gone Wild!: Endless Retail Chain Bankruptcies, the Landlord Edition," by James S. Carr (herein, "Tenants Gone Wild!").

<sup>37</sup> See *In re J.F. Hink & Son*, 815 F.2d 1314 (9th Cir. 1987); *In re Boo.com North America, Inc.*, 2000 WL 1923949 (Bankr. S.D. N.Y. 2000); *In re David Orgell*, 117 B.R. 574 (Bankr. C.D. Cal. 1990).

<sup>38</sup> See *In re Standor Jewelers West, Inc.*, 129 B.R. 200 (9th Cir. BAP (1991));

<sup>39</sup> See *Robb v. Schindler*, 142 B.R. 589 (D. Mass. 1992).

<sup>40</sup> See *In re Jamesway Corp.*, 201 B.R. 73 (Bankr. S.D. N.Y. 1996); *In re National Sugar Refining Co.*, 21 B.R. 196 (Bankr. S.D. N.Y. 1982);

<sup>41</sup> See *Sanshoe Worldwide, supra*; *In re Plitt Amusement Co. of Washington, Inc.*, 233 B.R. 837 (Bankr. C.D. Cal. 1999); *In re Sambo's Restaurants, Inc.*, 24 B.R. 755 (Bankr. C.D. Cal. 1982); but see *In re Kopel*, 232 B.R. 57 (Bankr. E.D.N.Y. 1999) (holding that cross-default provision in a lease for commercial property would be enforced to preclude the debtor from assuming the lease without first curing the default under a promissory note)

<sup>42</sup> See *Ramco-Gershenson Properties, LP, supra*; *In re Mr. Grocer, Inc.*, 77 B.R. 349 (Bankr. D.N.H. 1987).

<sup>43</sup> See *In re Rickel Home Centers, Inc.*, 240 B.R. 826 (U.S. Dist. Ct. Del. 1998).

<sup>44</sup> See *In re Service Merchandise Company*, 297 B.R. 675 (2002).

<sup>45</sup> See *In re Service Merchandise Company, supra*.

<sup>46</sup> See *In re U.L. Radio Corp., supra*.

<sup>47</sup> See *In re Joshua Slocum, Ltd.*, 922 F.2d 1081 (3rd Cir. 1990).

<sup>48</sup> See Section 365(f) and Section 365(b) and the Reform Act, *supra*.

<sup>49</sup> See *In re Ames Department Stores*, 121 B.R. 160 (Bankr. S.D. N.Y. 1990).

<sup>50</sup> See *Tenants gone Wild!*, *supra*.

<sup>51</sup> *Id.*

<sup>52</sup> See *In re South Bay Medical Associates*, 184 B.R. 963 (Bankr. C.D. Cal. 1995).

<sup>53</sup> See *Oldden, infra*.

<sup>54</sup> See *In re PPI Enters. (US), Inc.*, 228 B.R. 339 (Bankr. D. Del. 1998) relying on *Oldden v. Tonto Realty Corp.*, 143 F.2d 916 (2d Cir. 1994) ("*Oldden*") and *In re Mayan Networks Corp.*, 306 B.R. 295 (B.A.P. 9th Cir. 2004).

<sup>55</sup> See, for example, "Letter of Credit as a Landlord's Protection Against a Tenant's Bankruptcy: Assurance of Payment or False Sense of Security?"

by Alan N. Resnick (American Bankruptcy Law Journal Vol. 82) (herein, "Assurance or False Sense").

<sup>56</sup> See also Section 524(e) of the Bankruptcy Code which provides that the discharge of the debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.

<sup>57</sup> See article by Christopher Combest in Business Law Today, Vol. 16, No. 2, November/December 2006 at <http://www.abanet.org/buslaw/blt/2006-11-12/combest.shtml> ("ABA Article").

<sup>58</sup> List taken largely from ABA Article, *supra*.

<sup>59</sup> See *In re Ames Department Stores, Inc.*, 136 B.R. 357 (Bankr. S.D.N.Y. 1992).

<sup>60</sup> See *In re Tobago Bay Trading Co.*, 112 B.R. 463 (Bankr. N.D. Ga. 1990).

<sup>61</sup> Terms landlords like to avoid: "Bankruptcy Ordered Sale," "Going Out of Business" and "Court Ordered Sale." Favorable landlord terms: "Store Closing Sale" and "Liquidation Sale." See "Tenants Gone Wild," *supra*.

<sup>62</sup> See *In re South Bay Medical Associates*, *supra*.

<sup>63</sup> For more complete treatment of this subject and differing views regarding whether these powers are expanding or contracting, see Resisting Expansion, *infra*, and "Whatever Happened to the Inherent Equitable Powers of the Bankruptcy Court?" by Jeffrey W. Warren, Adam Lawton Alpert and Andrew T. Jenkins. Web posted April 1, 2005, American Bankruptcy Institute (herein referred to as "Whatever Happened?").

<sup>64</sup> See also Section 1142(b) of the Code which provides that "the court may direct the debtor and any other...party to execute or deliver...any instrument required to effect a transfer of property dealt with by a confirmed plan, and to perform any other act...that is necessary for the consummation of the plan."

<sup>65</sup> See "Resisting the Expansion of Bankruptcy Court Power under Section 105 of the Bankruptcy Code: The All Writs Act and an Admonition from Chief Justice Marshall," by Daniel B. Bogart (herein referred to as "Resisting Expansion"). Arizona State Law Journal (Fall, 2003) (35 Ariz. St. L.J. 793, p. 2).

<sup>66</sup> 2 Collier on Bankruptcy ¶ 105.3. at 105-23 (Lawrence P. King, *et al.* eds. 15th ed., rev. 1999), cited in Resisting Expansion, *supra*.

<sup>67</sup> See Resisting Expansion, *supra*.

<sup>68</sup> *United States v. Energy Res. Co.*, 495 U.S. 545, 549 (1990), cited in Resisting Expansion, *supra*, p. 4.

<sup>69</sup> See *In re Saxman*, 325 F.2d 1168 (9th Cir. 2003).

<sup>70</sup> See *In re Metro Transp. Co.*, 64 B.R. 968 (Bankr. E.D. Pa. 1986).

<sup>71</sup> See *In re Augie/Restivo Baking Co.*, 860 F.2d 515 (2nd Cir. 1988).

<sup>72</sup> See *In re Drexel Burnham Lambert Group*, 960 F.2d 285 (2d. Cir. 1992) (cited in *Whatever Happened?*, *supra*).

<sup>73</sup> *United States v. Sutton*, 786 F. 2d 1305, 1308 (5th Cir. 1986) (cited in *Resisting Expansion*, *supra* at p. 26).

<sup>74</sup> *In re Chicago, Milwaukee, St. Paul & Pacific R.R.*, 791 F.2d 524, 528 (7th Cir. 1986) (cited in *In re Kmart Corporation*, 359 F.3d 866 (U.S. Ct. of Appeals, 7th Cir. 2004) (herein referred to as "*In re Kmart*").

<sup>75</sup> See *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988) ("[W]hatever equitable powers remain in the bankruptcy code must and can only be exercised within the confines of Bankruptcy Code.") at 206. Also, see *In re Powerine Oil Co.*, 59 F.3d 969, 973 (9th Cir. 1995), cited in *To Assume or Not*, *supra*, at p. 397.

<sup>76</sup> See *In re Kmart*, *supra*. *In re Kmart* is a 7th Circuit case, but other circuits have approved such critical vendor payments. Consequently, the 7th Circuit has become a venue popular with creditors for certain large bankruptcy cases.

<sup>77</sup> See *In re Oxford Management, Inc.*, 4 F.3d 1329 (5th Cir. 1993) (cited in *In re Kmart*, *supra*).

<sup>78</sup> See *U.S. v. Noland*, 517 U.S. 535 (1996) (cited in *Kmart*, *supra*).

<sup>79</sup> See *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988).