

**COMMERCIAL LEASES IN BANKRUPTCY: ISSUES AND STRATEGIES**

George M. Cheever  
Kirkpatrick & Lockhart LLP

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## **COMMERCIAL LEASES IN BANKRUPTCY: ISSUES AND STRATEGIES**

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### **A. Is It Really a Lease?**

Sections 365 and 502 of the Bankruptcy Code together set out a comprehensive and relatively coherent set of rules for dealing with the rights and responsibilities of landlords and tenants in bankruptcy. Whether an agreement described by the parties as a “lease” is a “true lease,” rather than a financing agreement in the nature of a mortgage, will determine whether the agreement is governed by these rules, or by the very different rules that govern consensual liens on real estate. The resulting differences in the treatment of a non-debtor “lessor’s” claims in bankruptcy were recently summarized by Bankruptcy Judge Wedoff in *United Air Lines, Inc. v. HSC Bank USA (In re UAL Corp.)*, 307 B.R. 618, 627-28 (Bankr. N.D. Ill. 2004) as follows:

There are a variety of financial arrangements in which one party occupies real property while making payments to another party which has an interest in the property. The two most common are mortgages and leases, and in many respects they are similar. In both, the party occupying the property, the mortgagor or lessee, has an obligation to make periodic payments to the other party, the mortgagee or lessor. And in both, the consequence of a default in the required payments is a loss of occupancy rights, either through foreclosure or eviction. But in other respects, and particularly under the Bankruptcy Code, the two situations are quite different.

If a Chapter 11 debtor occupies non-residential real property as owner under a mortgage, the debtor may retain the property by paying the mortgagee no more than the current value of the property, with any additional amounts owing on the mortgage treated as an unsecured claim, pursuant to §§ 506(a) and 1129(b)(2)(A) of the Code. *In re Smith*, 287 B.R. 882, 884 (Bankr. W.D. Tex. 2002). On the other hand, if the debtor does not retain the property, the mortgagee is entitled under § 506(a) of the Code to an unsecured claim for the full difference between the amounts due on the mortgage at the time of the filing and the property value.

However, if the debtor holds the property as tenant under a lease, the situation is governed by § 365 of the Code, under which the debtor may retain its occupancy and other rights only by “assuming” the lease. Lease assumption requires that the debtor cure any defaults that occurred before the bankruptcy, maintain payment obligations during the bankruptcy, and give assurance that there will be no defaults in future

payment obligations. *In re Resource Technology Corp.*, 254 B.R. 215, 221 (Bankr. N.D. Ill. 2000). On the other hand, if the debtor surrenders the property and rejects the lease, the landlord is entitled to an unsecured claim as limited by § 502(b)(6) of the Code, which may be less than the balance due under the lease.

In this way, the Bankruptcy Code gives greater protection to the occupancy rights of the owner of leased property than to the occupancy rights of a lender on mortgaged property, but it gives less protection to the owner's total claim. The owner of leased property is denied repossession only if the debtor makes full payment under the lease, but the owner may receive a claim for less than the full amount due under the lease if the debtor surrenders the property; the lender on mortgaged property will be denied repossession if the debtor merely pays the lender's claim up to the value of the property, but the lender receives an unsecured claim in the full amount of any deficiency.

The legislative history of section 502(b)(6) (which imposes a statutory cap on a lessor's allowed claim for "damages resulting from the termination of a lease of real property") describes the test for determining whether a lease is a "true lease" as follows:

[I]n a true lease of real property, the lessor retains all risk and benefits as to the value of the real estate at the termination of the lease ...

Whether a "lease" is [a] true or bona fide lease or, in the alternative, a financing "lease" or a lease intended as security, depends upon the circumstances of each case. The distinction between a true lease and a financing transaction is based upon the economic substance of the transaction and not, for example, upon the locus of title, the form of the transaction, or the fact that the transaction is denominated as a "lease". The fact that the lessee, upon compliance with the terms of the lease, becomes or has the option to become the owner of the leased property for no additional consideration or for nominal consideration indicates that the transaction is a financing lease or lease intended as security. In such cases, the lessor has no substantial interest in the leased property at the expiration of the lease term. In addition, the fact that the lessee assumes and discharges substantially all the risks and obligations ordinarily attributed to the outright ownership of the property is more indicative of a financing transaction than of a true lease. The rental payments in such cases are in substance payments of principal and interest either on a loan secured by the leased real property or on the purchase of the leased real property.

S.Rep. No. 989, 95<sup>th</sup> Cong., 2d Sess. 64 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5850.

Some courts have listed the factors they look to to distinguish "true leases" from financing agreements as follows:

(i) whether the “rental” payments were calculated to compensate the lessor for the use of the land, or rather were structured for some other purpose, such as to ensure a particular return on an investment;

(ii) whether the [lessor’s] purchase price was related to the fair market value of the land, or whether it was calculated as the amount necessary to finance the transaction;

(iii) whether the property was purchased by the lessor specifically for the lessee’s use;

(iv) whether the transaction was structured as a lease to secure certain tax advantages;

(v) whether the lessee assumed many of the obligations normally associated with outright ownership, including the responsibility for paying property taxes and insurance.

*In re UAL Corporation, supra*, 307 B.R. at 631. In that case, Judge Wedoff determined that three so-called “leases” of aircraft facilities that were part of sale and leaseback transactions were not true leases, but that a more conventionally structured lease of a fourth facility was a true lease subject to section 365.

## **B. Bankruptcy Limitations on Lessors’ Remedies**

### **1. The Automatic Stay**

Whether or not a lease is a “true lease,” the lessor’s exercise of his contractual and statutory remedies against a defaulting lessee will be stymied, at least temporarily, by the “automatic stay” triggered by the filing of a bankruptcy petition by or against the lessee.

In general, the filing of a bankruptcy petition “operates as a stay, applicable to all entities,” of virtually all collection activities on the part of creditors, including the filing or continuation of lawsuits, the enforcement of judgments against the debtor or against property of the estate, acts to “obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;” and acts to create, perfect, or enforce liens against property of the estate. 11 U.S.C. § 362(a).

Thus the stay applies to all a landlord’s default remedies under an unexpired real property lease, including actions to terminate the lease and eviction proceedings against defaulting tenants who are in bankruptcy.

The stay does not apply to “any act by a lessor to the debtor under a lease of nonresidential real property that has terminated by the expiration of the stated term of the lease before the commencement of or during a case under this title to obtain possession of such property.” 11 U.S.C. § 362(b)(10). This provision meshes with 11 U.S.C. § 541(b), which provides:

Property of the estate does not include—

... (2) 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 stated term of such lease during the case; ...

Note that the 362(b)(10) exception only applies to leases “terminated by the expiration of the stated term of the lease ...”. It does not apply to leases terminated before the end of their stated term by reason of the debtor’s default. Even if a landlord has obtained a judgment for possession of the leased premises based on the debtor/lessee’s defaults, the landlord will need relief from the automatic stay to complete the eviction process and recover possession. And if the lessee’s bankruptcy trustee<sup>1</sup> can provide “adequate protection” of the landlord’s interest by performing all the lessee’s post-petition obligations under the lease, relief from the stay may not be forthcoming. See *In re P.J. Clarke’s Restaurant Corp.*, 265 B.R. 392 (Bankr. S.D.N.Y. 2001) and discussion in paragraph 3 below.

Even actions having only an indirect impact on estate property may violate the automatic stay. See *Rockefeller Group, Inc. v. I.S.H. Liquidating Corp. (In re 48<sup>th</sup> Street Steakhouse, Inc.)*, 835 F.2d 427 (2d Cir. 1987), cert. denied, 485 U.S. 1035 (1988) (landlord’s termination notice sent to non-debtor tenant/sublessor violated automatic stay since termination of lease would destroy debtor-sublessee’s leasehold interest).

## **2. How Do You Get Relief From the Automatic Stay?**

A bankruptcy court can grant relief from the automatic stay on an appropriate showing. Specifically, section 362(d) provides in relevant part:

On request of the party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay --

(1) for cause, including the lack of adequate protection of an interest in property of such a party in interest;

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<sup>1</sup> It is the debtor’s “trustee” who has the rights and responsibilities created by section 365. However, in many bankruptcy contexts, the debtor exercises the powers conferred on a bankruptcy trustee by the Bankruptcy Code. See, e.g., 11 U.S.C. § 1107 (which provides that a Chapter 11 “debtor in possession” has most of the “rights, title and powers,” and “shall perform [most of] the functions and duties ... of a trustee ...”). As used in these materials, the word “trustee” encompasses a debtor exercising the rights and powers of a bankruptcy trustee, including a debtor in possession in a Chapter 11 case.

(2) with respect to a stay of an act against property under subsection (a) of the section, if --

(A) the debtor does not have an equity in such property;  
and

(B) such property is not necessary to an effective reorganization; ...

### **3. Are Landlords Entitled to Adequate Protection?**

Most motions for relief from the stay are brought by secured creditors who believe that their security interests are not receiving “adequate protection.” In some early decisions, bankruptcy courts concluded that the Bankruptcy Code guaranteed “adequate protection” only to secured creditors and not to landlords, who had to look to their remedies under section 365. *See, e.g., In re Sweetwater*, 40 B.R. 733 (Bankr. D. Utah 1984), *aff’d*, 57 B.R. 743 (D. Utah 1985). More recent decisions have shied away from this approach, which does not fit very comfortably with the broad language employed in section 362(d).

The fact remains that the protections afforded to landlords by section 365 are so extensive that it is only in unusual circumstances that a landlord should need to resort to a motion for relief from stay. As discussed more fully in subsection C.5 below, section 365(d)(3) charges trustees with an affirmative duty to “timely perform all the obligations of the debtor ... arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected ...”. The trustee’s compliance with this statutory duty will normally provide the landlord with all the “adequate protection” the law requires. *See, e.g., P.J. Clarke’s Restaurant Corp.*, 265 B.R. 392, 403-08 (Bankr. S.D.N.Y. 2001) (landlord entitled to adequate protection, but “such protection is provided where the debtor makes ongoing current payments under the lease pursuant to § 365(d)(3) .... adequate protection payments at an amount higher than the rent reserved in the lease, or an amount based on the possibility that the landlord might be able to relet the property for a higher amount pending assumption or rejection of the lease” not required).

As the court explicitly noted in that case, a motion for relief from stay would be an appropriate response to the debtor’s failure to make post-petition payments in accordance with section 365(d)(3). However, any such failure would also probably prompt the court to deny any further extension of the time within which the trustee could assume or reject the lease, forcing the trustee to a quick decision on the issue of assumption or rejection. In that event, if the trustee did not assume the lease, the lease would be “deemed rejected” by operation of law, and the trustee will be obliged to surrender the premises to the landlord. *See* 11 U.S.C. § 365(d)(4), discussed in subsection C.3 below.

Nonetheless, there may be occasions when it is appropriate for the landlord to seek, and the court to grant, relief from the stay. For example, if it is clear that the lease cannot be assumed, relief from stay should be granted. *In re Beckett*, 2001 W.L. 767601 (E.D. Pa. 2001).

#### 4. “Ipso Facto” Provisions Are Not Enforceable in Bankruptcy

Even if the automatic stay is lifted, an unexpired lease may not be terminated or modified “at any time after the commencement of the case solely because of a provision in such ... lease that is conditioned on –

- (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 [the Bankruptcy Code]; or
- (C) The appointment of or taking possession by a trustee in a case under [the Bankruptcy Code] or a custodian before such commencement.” 11 U.S.C. § 365(e).

Exception: An ipso facto clause will be enforceable if “(i) applicable law excuses a party, other than the debtor, to such ... lease from accepting performance from or rendering performance to the trustee or to an assignee of such ... lease, whether or not such ... lease prohibits or restricts assignments of rights or delegation of duties; and (ii) such party does not consent to such assumption or assignment ....” 11 U.S.C. § 365(e)(2)(A).

Unlike most other defaults, ipso facto defaults need not be cured as a precondition to assumption of a lease. 11 U.S.C. § 365(b)(2).

#### 5. Landlord’s Liens in Bankruptcy

A landlord’s common law lien of distress for unpaid rent is codified in the Pennsylvania Landlord and Tenant Act of 1951. *See* 68 P.S. § 250.302. The lien does not attach until the landlord has seized the personal property on the premises. Seizure is usually accomplished symbolically, by written notice. However, it can be accomplished in other ways as well, such as by sheriff’s levy. Subject to a long and detailed list of exemptions, any personal property located on the premises is subject to the landlord’s distress.

Once it has attached, the landlord’s lien will prime even a prior perfected security interest. *In re Einhorn Bros., Inc.*, 272 F.2d 434, 440-41 (3d Cir. 1959). For this reason, prudent secured lenders usually insist on receiving a waiver of the landlord’s lien rights.

There are possible constitutional infirmities in the procedure for enforcing a landlord’s lien. *See* the discussion in *In re Egg Crate, Inc.*, 105 B.R. 283, 285-6 (Bankr.W.D. Pa. 1989) (holding the procedures to be constitutional).

The practical value of a landlord’s lien rights is limited by section 545 of the Bankruptcy Code, which provides that a bankruptcy trustee “may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien ... is for rent; or ... is a lien of distress for rent.”

Note that the operative word here is “may.” Avoidance of the lien is not automatic; the trustee must take affirmative action to avoid the lien. If the trustee chooses not to exercise his

avoidance power, the lien may be enforceable in bankruptcy. *See e.g., In re Recycling Research, Inc.*, 49 B.R. 327 (Bankr. 1985).

## **6. Consequences of Avoidance: Is the Lien Preserved for the Benefit of the Estate under Section 551?**

The fact that, under Pennsylvania law, a landlord's lien will prime a prior perfected security interest raises the possibility that a bankruptcy trustee might (i) avoid a landlord's lien pursuant to section 545, and then (ii) preserve the avoided lien for the benefit of the estate pursuant to section 551, thereby allowing the value of the personal property to pass to unsecured creditors, notwithstanding a secured creditor's perfected UCC security interest in the property. Section 551 may permit this because the landlord's assertion of its lien is an involuntary "transfer" of the debtor's property, and under section 551, "[a]ny transfer avoided under section ... 545 ... is preserved for the benefit of the estate ...". As noted in the legislative history to section 551: "The Section as a whole prevents junior lienors from improving their position at the expense of the estate when a senior lien is avoided." House Report No. 95-595, 95<sup>th</sup> Cong., 1<sup>st</sup> Sess. 376 (1977); Senate Report No. 95-989, 95<sup>th</sup> Cong., 2d Sess. 91 (1978).

## **C. The Trustee's Rights and Responsibilities under Section 365**

### **1. Assumption vs. Rejection**

The central focus of section 365 is the trustee's decision to assume or reject the debtor's executory contracts and unexpired leases. In the commercial leasing context, because leases often are long-term obligations and can constitute a substantial percentage of a tenant's operating costs, the decision to assume or reject a lease can have momentous consequences for a bankruptcy estate.

Assumption will secure all the benefits of the lease for the bankruptcy estate, including the right to remain in possession for the remainder of the lease term. However, in return, the trustee must assume all the burdens of the lease, including the cure of all existing payment defaults, and performance of all the debtor's ongoing obligations under the lease for the remainder of the term.

Rejection, on the other hand, will free the bankruptcy estate from the burden of ongoing performance under the lease. If the debtor is the tenant, rejection can convert a huge future rent obligation into a general unsecured pre-petition claim that may be capped at a fraction of the aggregate amount of future rent due under the lease pursuant to section 502(b)(6). And, of course, the trustee must surrender all the benefits of the lease, including the right to possession.

The specific requirement for lease assumption and the ramifications of the decision to assume are addressed in greater detail in section D. below. Lease rejection is dealt with more fully in section E. This section C. deals with the timing and procedure for assumption or rejection, and the trustee's rights and responsibilities in the interim.

## 2. The Requirement of Court Approval

Subsection (a) of section 365 provides that, in general, "... the trustee, subject to the court's approval, may assume or reject any ... unexpired lease of the debtor," provided that certain requirements are satisfied.

Note that, in either case, "court approval" is required; a simple communication of the trustee's intention to assume or reject the lease will not suffice. Courts almost never buy the argument that a trustee, by its actions, can effectively assume or reject a lease without court approval after motion and hearing. *See In re Kelly Lyn Franchise Co., Inc.*, 26 B.R. 441 (Bankr. M.D. Tenn. 1983), report and recommendation approved, 33 B.R. 112 (M.D. Tenn. 1983). On the other hand, if the debtor is the lessee, the trustee's inaction prior to the applicable statutory deadline for assumption or rejection of the lease will result in the lease being "deemed rejected." *See* 11 U.S.C. § 365(d)(4) and discussion in subsection C.3 below.

Unless the decision to assume or reject the lease is being made pursuant to a Chapter 11 reorganization plan, court approval for the rejection or assumption (and any related assignment of the lease) must generally be sought by motion, on notice "to the other party to the...lease, to other parties in interest as the court may direct, and...to the United States Trustee." Bankruptcy Rule 6006. At the hearing on the motion, the court will determine whether the trustee's request meets the "business judgment test" discussed below, and, if the lease is to be assumed (or assumed and assigned), whether the specific statutory requirements for such action have been satisfied. For example, the court may have to resolve disputes over the amounts necessary to cure defaults under the lease, or the assignee's ability to perform its future obligations under the lease. If there is no objection to the trustee's request, the hearing may be dispensed with.

## 3. The Business Judgment Test

A trustee's motion for approval of the assumption or rejection of an unexpired lease should be evaluated under the "business judgment" test. As one bankruptcy judge recently put it:

"The Court's role in the assumption/rejection process is one of an "overseer of the wisdom with which the bankruptcy estate's property is being managed by the trustee or debtor-in-possession." "[A] bankruptcy court reviewing a trustee's or debtor-in-possession's decision to assume or reject an executory contract should examine [the] contract and the surrounding circumstances and apply its best 'business judgment' to determine if it would be beneficial or burdensome to the estate to assume it." The business judgment rule requires the Court to determine whether a reasonable business person would make a similar decision under similar circumstances.

*In re Vencor, Inc.*, 2003 Bankr. LEXIS 659 (Bankr. D. Del. 2003) (citations omitted). Other courts emphasize the deference that should be given to the trustee's business judgment:

Generally, absent a showing of bad faith, or an abuse of business discretion, the debtor's business judgment will not be altered.

“Transposed to the bankruptcy context, the rule as applied to a bankrupt’s decision to reject an executory contract because of perceived business advantage requires that the decision be accepted by courts unless it is shown that the bankrupt’s decision was one taken in bad faith or in gross abuse of the bankruptcy retained business discretion.”

*In re G Survivor Corp.*, 171 B.R. 755, 757-8 (Bankr. S.D.N.Y. 1994) (citations omitted).

Factors that courts have considered in applying the business judgment test to a motion for approval of a trustee’s decision to assume or reject an executory contract or unexpired lease include (i) whether the contract or lease burdens the estate financially; (ii) whether rejection would result in a large claim against the estate; (iii) whether the trustee has shown real economic benefit resulting from the rejection; and (iv) whether upon balancing the equities, rejection will do more harm to the other party to the contract or lease than to the estate if the contract or lease is not rejected. The fundamental, overriding question is whether the proposed assumption or rejection will benefit the estate. *Id.* at 758.

#### **4. When Must the Trustee Make Up His Mind to Assume or Reject a Lease?**

In any case in which the debtor is a lessee under a lease of nonresidential real property, a bankruptcy trustee has 60 days from the date of the petition to assume or reject the lease. At the end of that period, if the lease has not been assumed, it will be deemed rejected and the trustee must immediately surrender the property to the lessor. The 60-day period can be extended by the court on motion made prior to the expiration of the 60-day period (or any extension thereof). 11 U.S.C. § 365(d)(4); *see In re Channel Home Centers, Inc.*, 989 F.2d 682 (3d Cir.), *cert. denied*, 114 S. Ct. 184 (1993).

Although the literal language of the statute might suggest that the court must act on the extension request before the current period expires, it is now generally established that the trustee need only have filed the extension request before the end of the current period. *See In re Southwest Aircraft Services, Inc.*, 831 F.2d 848 (9<sup>th</sup> Cir. 1987), *cert. denied*, 487 U.S. 1206 (1988). In the Western District of Pennsylvania, this practice is codified in a local rule of the bankruptcy court. *See* LR 9013-6.

Multiple successive extensions are commonplace, especially in large Chapter 11 cases. Especially from the debtor/tenant’s perspective, the economic consequences of assumption can be momentous, and so there is a natural tendency to postpone the decision as long as possible.

If the assets of a business are to be sold pursuant to 11 U.S.C. § 363, the buyer may wish to take an assignment of some or all of the debtor/seller’s leases. The trustee may seek to have a lease assumption motion heard simultaneously with the sale motion. Frequently, the buyer will want the right to designate at closing (or even post-closing) which leases it wants. *See In re G Survivor Corp.*, 171 B.R. 755 (Bankr. S. D. N.Y. 1994) and discussion in subsection C.4 below.

If a debtor is seeking to reorganize under Chapter 11, the decision to assume or reject its leases may be made pursuant to its reorganization plan. *See* 11 U.S.C. § 1123(b)(2) (a plan may, “subject to section 365..., provide for the assumption, rejection, or assignment of any ...

unexpired lease of the debtor not previously rejected under such section; ...”. Needless to say, the assumption or rejection will not be effective unless the other party to the lease has received timely notice of the plan. *In re Jennings*, 204 B.R.41, 44 (Bankr. W. D. Mo. 1997).

In cases under chapters 9, 10, 11, or 13, in contrast to unexpired leases of nonresidential real property, leases of residential real property and executory contracts generally may be assumed or rejected “at any time before confirmation of a plan but the court, on request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.” This right to request a shortening of the time for the assumption/rejection decision is not expressly extended to non-debtor parties to unexpired nonresidential real property leases, but the bankruptcy court’s general equity powers almost certainly include the power to grant such a request in an appropriate case. The request should be made by motion pursuant to Bankruptcy Rules 6006(b) and 9014.

## **5. What Happens in the Meantime? The Trustee’s Obligations Under Section 365(d)(3)**

In the meantime, the trustee “shall timely perform all the obligations of the debtor [except those arising under ipso facto clauses or obligations for penalty rates] arising from and after the order for relief ... until such lease is assumed or rejected.” The time for performance may be extended for cause, but not beyond 60 days after the order for relief. A lessor’s acceptance or performance does not constitute a waiver or relinquishment of any right under the lease or under the Bankruptcy Code. 11 U.S.C. § 365(d)(3).

Subsection (d)(3) gives landlords an important leg up on other post-petition creditors. Prior to its enactment as part of the 1984 “shopping center” amendments to the Bankruptcy Code, landlords, like other post-petition creditors, might:

- (i) be required to engage in expensive and time-consuming motions practice under 11 U.S.C. § 503(b) (which deals generally with the allowance of administrative expenses) in order to enforce the payment of post-petition rent;
- (ii) recover only the reasonable value of the trustee’s actual use and occupancy of the premises (which might be considerably less than the rent reserved in the lease, especially if the trustee were using only a portion of the premises, and/or market rental rates had declined since the inception of the lease); and
- (iii) in the court’s discretion, be denied payment of its allowed administrative expense claim until the end of the case.

Imposing these burdens on landlords was thought to be unfair, since landlords, unlike post-petition trade suppliers, are involuntary creditors, in the sense that they cannot unilaterally suspend services provided under the lease and take back the premises. *See In re Montgomery Ward Holding Corp.*, 268 F.3d 205, 210 (3d Cir. 2001). Subsection (d)(3) relieves landlords from these burdens. It applies “notwithstanding section 503(b)(1) of [the Bankruptcy Code].”

In addition, if the debtor is in default, “the trustee may not require a lessor to provide services or supplies incidental to such lease before assumption of such lease unless the lessor is compensated under the terms of such lease for any services and supplies provided under such lease before assumption of such lease.” 11 U.S.C. § 365(b)(4).

## **6. When Does an Obligation “Arise” for Purposes of Subsection (d)(3)?**

- The “billing date” or “performance date” approach. *See In re Montgomery Ward Holding Corp.*, 268 F.3d 205 (3d Cir. 2001) (“an obligation arises when one becomes legally obligated to perform,” so therefore, real estate tax reimbursement obligations coming due post-petition must be paid in full, even though some of the taxes were assessed for pre-petition periods).

- The “proration” approach. *See In re Handy Andy Home Improvement Centers, Inc.* 144 F.3d 1125 (7<sup>th</sup> Cir. 1998) (real estate taxes for a period that spanned the petition date and billed post-petition must be prorated as of petition date).

- When does a claim for percentage rent arise under subsection (d)(3)? The sales “breakpoint” approach.

The “breakpoint” approach appears to be the approach taken by bankruptcy courts in the majority of reported decisions on the question of how subsection (d)(3) is to be applied to percentage rent. *See, e.g., In re Petrie Retail, Inc.*, 233 B.R. 256 (S.D.N.Y. 1999). Other approaches include the “billing date” approach (under which the court would look to the date on which the percentage rent actually became due and payable, irrespective of when it accrued, so that if the due date occurs after the petition date, all the percentage rent is a subsection (d)(3) expense even if the lease year ended prior to the petition date), the “sales volume approach,” (under which the amount of percentage rent payable as a priority claim under subsection (d)(3) is determined by multiplying the total percentage rent accrued during the lease year in question by a fraction of which the numerator is the volume of sales accruing after the petition date and the denominator is the debtor’s total sales for the lease year), and the “calendar approach,” (under which the portion of percentage rent for the lease year in question that is payable as a priority expense item under subsection (d)(3) is determined by multiplying the total percentage rent for the lease year in question by a fraction of which the numerator is the total number of days subsequent to the petition date during the lease year, and the denominator is the total number of days in the lease year).

Under the “breakpoint” approach, the court first determines the “breakpoint,” which is the date during the lease year when the debtor’s sales reached the minimum amount necessary to trigger the accrual of percentage rent. If the “breakpoint” date occurs on or after the petition date, all the percentage rent for the lease year is payable as a priority item under subsection (d)(3). If the “breakpoint” date is prior to the petition date, only sales occurring after the petition date will be taken into account in determining the percentage rent payable under subsection (d)(3). Percentage rent attributable to sales occurring after the breakpoint date but before the petition date will not be treated as a priority payment obligation under subsection (d)(3). Rather, it will be treated as a pre-petition lease obligation which the debtor must pay in full only if the

lease is assumed. If the lease is rejected, the pre-petition percentage rent becomes a general unsecured claim, just like other accrued and unpaid pre-petition rent.

- Indemnity and Defense Obligations.

In *In re FFP Operating Partners, L.P.*, Case No. 03-90171-BJH-11 (Bankr. N.D. Tex) (Not yet reported), applying the “billing date” rule and Texas indemnity law, the Bankruptcy Court ruled that the lessee’s contractual obligation to indemnify against “liability” under an expired lease did not “arise” for purposes of subsection (d)(3) until the lessor/indemnitee’s liability was determined in the underlying lawsuit (a slip and fall claim). Similarly, an indemnity obligation for attorney’s fees incurred by the indemnitee did not arise “until all of the liabilities of the indemnitee become fines and determined by the judgment.” *Id.* at 6; citation to applicable state court decision omitted.

In the same case, the court ruled that subsection (d)(3) did not require the debtor in possession to continue to defend the indemnitee during the case, because the defense obligation arose out of a pre-petition lease and was triggered by pre-petition events. Query whether this would not be true of any ongoing obligation of the lessee, including the obligation to pay rent. *Cf. In re Montgomery Ward Holding Corp.*, *supra*, 268 F.3d at 209 (“Unmatured rights to payment under a lease exist from the date the lease is executed, and no right to payment would ever arise under an unexpired lease after the order for relief” if obligations under a lease “arose” when the lease was executed).

## **7. What If the Trustee Fails to Perform His Obligations under Section 365(d)(3)?**

The typical response to a trustee’s failure to perform his obligations under subsection (d)(3) is a motion to compel performance. Other possible responses include a motion for relief from stay, a motion to shorten the time within which the trustee may assume or reject the lease, and an objection to any attempt by the trustee to extend the time to assume or reject. State court remedies will not be available to the landlord unless the stay is lifted, even if the trustee has failed to perform his section (d)(3) obligations. *In re LPM Corp.*, 300 F.3d 1134 (9<sup>th</sup> Cir. 2002).

If the trustee fails to perform and the estate is liquidated, the question arises whether subsection (d)(3) in effect creates an administrative superpriority claim in favor of the landlord. The majority view is that it does not. The landlord will have a first priority administrative expense claim for the full amount of the trustee’s unperformed obligations under subsection (d)(3), but that claim will have no priority over other administrative expense claims allowable under section 503(b), and subsection (d)(3) claims accruing in a Chapter 11 case will, like other unpaid Chapter 11 administrative expenses, be junior in priority to administrative expense claims arising in a subsequent Chapter 7 case. If the lease has been rejected and the estate appears to be administratively insolvent, the court may exercise its discretion to defer payment until the end of the case, notwithstanding subsection (d)(3)’s “timely payment” requirement. *Id.*; *see also In re National Refractories & Minerals Corp.*; 297 B.R. 614 (Bankr. N.D. Cal. 2003).

## **D. Lease Assumption**

### **1. What Does Assumption Mean?**

The trustee gets all the benefits of the lease, but must assume all the burdens of the lease as well; i.e., assumption binds the trustee to perform all the debtor's obligations under the lease. *See in re Nitec Paper Corp.*, 43 B.R. 492, 498 (S.D.N.Y. 1984).

Once a lease is assumed, future obligations under the lease are administrative expense obligations, even if the lease is later rejected. Moreover, the statutory "cap" imposed by 11 U.S.C §502(b)(6) on "the claim of a lessor for damages resulting from the termination of a lease of real property" does not apply to a landlord's claim under lease that is assumed and later rejected. *In re Klein Sleep Products, Inc.*, 78 F.3d 18 (2d Cir. 1996).

### **2. Conditions to Assumption**

A lease cannot be assumed unless it retains some legal vitality: "a bankruptcy filing cannot revive a lease ... which has been already terminated." *In re Telephonics, Inc.*, 85 B.R. 312, 315 (Bankr. E.D. Pa. 1988); *see* 11 U.S.C. § 365(c) ("The trustee may not assume or assign an ... unexpired lease of the debtor, whether or not such ... lease prohibits or restricts assignment of right or delegation of duties, if - ... (3) such lease is of nonresidential real property and has been terminated under applicable non-bankruptcy law prior to the order for relief; ...").

Whether a lease has been effectively terminated pre-petition is, of course, a question of state law, which may vary from jurisdiction to jurisdiction. In Pennsylvania, the critical event is the final completion of the eviction process:

... under applicable Pennsylvania law, a lease is not "terminated" when the tenant fails to pay rent due until the tenant is physically evicted, rather than upon the entry of a judgment for possession. This is because, under Pennsylvania common law and court rule, a tenant retains a right to cure any rental delinquency and preserve the tenancy until the moment of actual valid and complete eviction of a tenant .... [E]ven if a debtor is physically evicted pre-petition, the debtor may be restored to possession if the state court proceedings were defective.

*Id.*, 85 B.R. at 16 [citations committed]; *See generally In re P.J. Clarke's Restaurant Corp.*, 265 B.R. 392 (Bankr. S.D.N.Y. 2001) (New York law).

If the debtor is in default under a lease but the lease has not been terminated, then, subject to certain exceptions (discussed below), in order to assume the lease, the trustee must:

- (i) cure all defaults, or at least provide "adequate assurance" that he will "promptly cure" all such defaults;

- (ii) compensate, or provide adequate assurance of such compensation to, “a party other than the debtor to such ... lease, for any actual pecuniary loss to such party resulting from such default;” and
- (iii) provide “adequate assurance of future performance” of the debtor’s obligations under the lease. 11 U.S.C. § 365(b)(1).

### **3. Defaults That Need Not Be Cured as a Condition to Assumption**

- “Ipso facto” clauses. 11 U.S.C. § 365(b)(2),(A), (B) and (C).
- Defaults relating to “the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under the ... unexpired lease.” 11 U.S.C. § 365(b)(2)(D). This has been interpreted as meaning the trustee is relieved from any obligation to pay monetary penalties, but is not excused from curing non-monetary defaults, even if they are inherently incurable. *In re Claremont Acquisition Corp.*, 113 F.3d 1029 (9<sup>th</sup> Cir. 1997); *see In re Beckett*, 2001 WL 767601 (E.D. Pa. 2001) (historical default under lease provision requiring tenant to maintain apartment in “clean, orderly and safe condition” could not be cured, and therefore the lease could not be assumed); *but see In re Bankvest Capital Corp.*, 360 F.3d 291 (1<sup>st</sup> Cir. 2004) (non-monetary defaults need not be cured before assumption of equipment lease; *Claremont* rejected).

### **4. Adequate Assurance of Future Performance under Shopping Center Leases**

Section 365 does not contain any general definition of “adequate assurance of future performance.” However, the term is given some specific statutory content in the shopping center context pursuant to 11 U.S.C. § 365(b)(3) as follows:

Adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance –

(A) of the source of rent and other consideration due under such lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease;

(B) that any percentage rent due under such lease will not decline substantially;

(C) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and

(D) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.

## 5. Lease Assignments

The trustee may assign the debtor's rights under an unexpired lease only if the trustee assumes the lease and provides "adequate assurance of future performance by the assignee ... whether or not there has been a default in such ... lease." 11 U.S.C. § 365(f)(2). In the case of a shopping center lease, such "adequate assurance" includes adherence to the specific requirements of 11 U.S.C. § 365(b)(3), discussed in subsection D.4 above.

Unless applicable law prohibits such an assignment without the non-debtor party's consent irrespective of what the lease itself says, any provision in the lease "prohibits, restricts, or conditions the assignment of a lease is unenforceable against a trustee." Likewise, any provision in the lease or in applicable law that "terminates or modifies, or permits a party other than the debtor to terminate or modify such . . . lease or a right or obligation under such . . . lease on account of an assignment of such lease" is unenforceable against a trustee. 11 U.S.C. § 365(f)(3). These provisions will generally render unenforceable lease provisions that require the lessee to share the proceeds of a lease assignment with the lessor. *See, e.g., South Coast Plaza v. Staudor Jewelers West, Inc.* (In Re *Staudor Jewelers West, Inc.*), 129 B.R. 200 (B.A.P. 9<sup>th</sup> Cir. 1991) (provision in commercial lease requiring tenant to pay landlord 75% of appreciated value of the lease as a condition of assignment unenforceable); *Robb v. Schindler*, 142 B.R. 589 (D. Mass. 1992) (lease provision requiring turnover of 80% of proceeds of lease assignment not enforceable). Outside of the shopping center context (where an assignee's adherence to use restrictions is part of the "adequate assurance of future performance" required by section 365(b)(3)), use restrictions may be held unenforceable against a trustee if their primary purpose appears to be to restrict the assignability of the lease, or to deny the trustee some or all of the economic benefits of the assignment. *See, e.g., In re U.L. Radio Corp.*, 19 B.R. 537 (Bankr. S.D. N.Y. 1982) (lease term that required use of premises as TV store not enforceable).

Although section 365 does not expressly require court approval for the trustee's assignment of a lease, Bankruptcy Rule 6006 is predicated on the assumption that approval is required. Given the many potential issues regarding adequate assurance of the assignee's future performance and the enforceability of lease provisions that may be construed as diagnosed restrictions on assignability, this seems only common sense. Authorization to assume and assign a lease is usually sought in a single motion, and may be determined by a single order.

An order authorizing the trustee to assign an unexpired lease "is stayed until the expiration of 10 days after the entry of the order, unless the court orders otherwise." Bankruptcy Rule 6006(d).

Assignment of a lease relieves the trustee and the estate from any liability for any breach of the lease occurring after such assignment. 11 U.S.C. § 365(k).

## **6. Designation Rights**

In large retailer cases, trustees sometimes dispose of large portfolios of potentially valuable but unwanted store leases by selling “designation rights” to real estate brokers, who thereby acquire the right to designate which leases will be assumed and assigned to new lessees located through the brokers’ marketing efforts, and which leases (i.e., the ones that turn out to be unmarketable) will be rejected. Alternatively, the buyer of the designation rights may itself be a potential assignee of the leases, who simply needs additional time to analyze the lease portfolio and select the leases it wants. In either case, the buyer pays a premium to the trustee, and also undertakes to pay the carrying costs for the leases during the marketing/review period. *See In re Ames Department Stores, Inc.*, 287 B.R. 112 (Bankr. S.D. N.Y. 2002) (holding that designation rights are property that can be sold in a case under the Bankruptcy Code, and that the sale of such rights does not involve an impermissible delegation of the trustee’s fiduciary rights and responsibilities.)

### **E. Lease Rejection**

#### **1. What Is the Effective Date of a Lease Rejection?**

The trustee in a case involving a debtor/lessee may seek to have the lease rejected retroactively, effective as of the filing of the rejection motion (or, alternatively, the day on which possession of the premises was surrendered to the landlord) in order to minimize the estate’s liability for post-petition rent and other charges under the lease.

A bankruptcy court may “when principles of equity so dictate ... approve a rejection of a nonresidential lease pursuant to section 365(a) retroactive to the motion filing date. ... The power to grant relief retroactively is derived from the bankruptcy court’s equitable powers to ensure a fair outcome.”

*In re TW, Inc.*, 2004 WL 115521 (D. Del. 2004) (citing and quoting from *In re Thinking Machines, Inc.*, 67 F.3d 1021, 1028 (1<sup>st</sup> Cir. 1995). In the *TW, Inc.* case, the district court affirmed the bankruptcy court’s denial of retroactive effect where “possession of the Premises was not properly surrendered and that fault in this regard, indisputably rested with the debtor.” *Id.* at 2.

#### **2. Consequences of Rejection of the Lease if the Lessee is the Debtor**

Rejection of a lease is deemed a breach of the lease immediately prior to the commencement of the case. 11 U.S.C. § 365(g). Any resulting “claim arising from the rejection” of the lease will be allowed or disallowed “the same as if such claim had arisen before the filing of the [debtor’s bankruptcy] petition.” 11 U.S.C. § 502(g).

Rejection does not necessarily mean that the lease is terminated. *In re Teleglobe Communication Corp.*, 304 B.R. 389 (D. Del. 2004) (“rejection” of a lease does not constitute “termination” of the lease; since “termination” did not occur prior to “rejection,” the

debtor/lessee's contractual repair and removal obligations arising on termination were not within the scope of 11 U.S.C. § 365(d)(3)).

If the debtor is the tenant, the landlord will have a claim for damages that (at least if the trustee presses an objection to the landlord's claim) will be limited by 11 U.S.C. § 502(b)(6), which mandates disallowance of a claim to the extent that:

(6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds –

(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of –

(i) the date of the filing of the petition; and

(ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates;

“[Section 502(b)(6)] was designed to compensate a landlord for his loss while not permitting a claim so large (based on a long term lease) as to prevent other unsecured creditors from recovering a dividend from the estate.” S. Rep. 95-989, 95<sup>th</sup> Cong., 2<sup>nd</sup> Sess. 63, reprinted in 1978 U.S.C.C.A.N. 5787, 5849, and quoted in *In re Farley, Inc.*, 146 B.R. 739, 745 (Bankr. N.D. Ill. 1992). It reflects the fact that landlords, unlike trade suppliers and other general unsecured creditors, get their property back and have the chance to mitigate their damages by reletting.

The “cap” imposed on a landlord's damage claim by section 502(b)(6)(A) is a purely notional amount, calculated by applying the statutory formula to the terms of the lease, without taking into account actual post-petition events. Post-petition rent and other amounts paid by the trustee pursuant to section 365(d)(3), and rent received from the reletting of the premises after their surrender to the landlord, do not reduce the “cap.” They do, of course, reduce the landlord's actual damages – possibly even to a level below the “cap,” which simply marks the outer limit of the landlord's potential allowed claim. If the premises are relet immediately at an equal or greater rental, the landlord may have no allowable claim for rejection damages at all. *See In re Goldblatt Bros., Inc.*, 66 B.R. 337, 347 (Bankr. N.D. Ill. 1986).

Somewhat anomalously, security deposits are subject to a different rule. They are credited against the landlord's allowed claim (i.e., the claim determined by applying the “cap”), rather than to the landlord's actual damages. S. Rep. No. 95-989, 95<sup>th</sup> Cong., 2<sup>nd</sup> Sess. 63 (1978); *In re Atlantic Container Corp.*, 133 B.R. 980, 989 (Bankr. N.D. Ill. 1991). *See also In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197, 208-210 (3d Cir. 2003) (proceeds of letter of credit intended to serve as security deposit applied against landlord's allowed claim as determined pursuant to section 502(b)(6)).

Lurking in the text of subsection (b)(6) are a number of questions, some of them unresolved:

- What was Congress thinking when it used the word “termination” in subsection (b)(6)? Since we now know that lease “rejection” is not the same as lease “termination,” is a claim for “damages resulting from the termination” of a lease of real property different from a “claim arising from the rejection” of the lease? *Cf.* 11 U.S.C. § 502(g). In other words, can the landlord avoid the “cap” by declining to terminate the lease after its rejection? Despite the logical appeal of this argument, the answer is probably “no”: “... if the vast majority of reported opinions are correct, rejection is equated to termination” for purposes of section 502(b)(6). *In re Mr. Gatti’s Inc.*, 162 B.R. 1004, 1013 (Bankr. W. D. Tex. 1994); *but see In re Atlantic Container Corp.*, 133 B.R. 980 (Bankr. N.D. Ill. 1991), which seems to suggest that, at least under the terms of the lease there at issue, terminating the lease was an option that the landlord might or might not exercise post-rejection:

Upon the Trustee’s rejection of the Leases in this case, *the Landlords chose to treat the Leases as terminated* and asserted claims for damages against the bankruptcy estate. The Landlords therefore no longer have the option of curing the breach of the covenants to repair and maintain by making the needed repairs and charging the costs to the Debtor or Trustee as additional rent.

*Id.*, 133 B.R. at 986 [emphasis supplied].

- What do “damages resulting from the termination” of a lease of real property encompass? Are they limited to “only those damages which the lessor would have avoided but for the lease termination?” *See In re Atlantic Container Corp.*, 133 B.R. 980, 987 (Bankr. N. D. Ill. 1991) (“damages caused to the Premises by the debtor’s failure to fulfill its repair and maintenance obligations are unrelated to the termination of the lease” and hence are not subject to the “cap”); *In re Best Products Co., Inc.*, 229 B.R. 673 (Bankr. E.D. Va. 1989). Or are they strictly limited to future rent? *See In re International Coins and Currency, Inc.*, 18 B.R. 335, 338 (Bankr. D. Vt. 1982). Or do they encompass all the lessor’s damages without distinction or limitation? *See In re McSheridan*, 184 B.R. 91, 102 (9<sup>th</sup> Cir. BAP 1995) (“... rejection of the lease results in the breach of each and every provision of the lease, including covenants, and § 502(b)(6) is intended to limit the lessor’s resulting from that rejection .... The distinction between past obligations and damages “caused” by the termination is incorrect because all damages due to nonperformance are encompassed by the statute.”).

- What does the “rent reserved by such lease” encompass? Does it include every charge under the lease? Is it anything the parties designate as rent? *See In re McSheridan*, 184 B.R. 91, 99-100 (9<sup>th</sup> Cir. BAP 1995):

We hold that the following three-part test must be met for a charge to constitute “rent reserved” under § 502(b)(6)(A):

1) The charge must: (a) be designated as “rent” or “additional rent” in the lease; or (b) be provided as the tenant/lessee’s obligation in the lease;

2) The charge must be related to the value of the property or the lease therein; and

3) the charge must be properly classifiable as rent because it is a fixed, regular or periodic charge.

- Does “the rent reserved by such lease ... for ... 15 percent ... of the remaining term of the lease” mean (1) 15% of the aggregate rent payable over the remaining lease term, or (2) the rent payable over the first 15% of the remaining term? The question matters if the rent increases (or decreases) over the remaining term. While (2) might seem to be the plain meaning of the statute, a surprising number of courts find the text ambiguous, and opt for (1) on grounds of fundamental fairness. See *In re Gantos, Inc.*, 176 B.R. 793 (Bankr. W.D. Mich. 1995) (describing (1) as the majority view); but see *In re Iron-Oak Supply Corp.*, 169 B.R. 414 (Bankr. E.D. Cal. 1994) (adopting (2) as the “plain meaning of the statute”).

- Does the “cap” apply to claims against guarantors? Yes (if the guarantor is in bankruptcy). *In re Lindsey*, 129 F.3d 117 (4<sup>th</sup> Cir. 1997).

- Does the “cap” apply if the claim is reduced to judgment and/or secured by a lien? Yes. *In re Lindsey*, 129 F.3d 117 (4<sup>th</sup> Cir. 1997).

- Does the “cap” apply if the debtor is solvent? Yes. *In re Federated Department Stores, Inc.*, 131 B.R. 808 (S.D. Ohio 1991); *In re Integrated Telecom Express*, 2004 WL 1136547 (D. Del., May 19, 2004) (Chapter 11 petition filed by solvent debtor for purpose of taking advantage of section 502(b)(6) not filed in bad faith); but see *In re Danrik*, 92 B.R. 964 (Bankr. N.D. Ga.) (“cap” did not apply in case of solvent guarantor).

- If the landlord’s allowed claim determined in accordance with section 502(b)(6) is paid in full, is the claim “impaired” for plan confirmation purposes? No. *In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197, 203-204 (3d Cir. 2003).

### **3. Filing a Proof of Claim for Lease Rejection Damages**

Since “a claim arising from the rejection . . . of an . . . unexpired lease of the debtor” will be allowed or disallowed “the same as if such claim had arisen before the date of the petition,” 11 U.S.C. § 502(g), a lessor whose lease has been rejected will normally need to file a proof of claim in order to share in any distributions from the debtor’s estate. However, by the time the trustee makes the decision to reject the lease, the general deadline for filing proofs of claim (colloquially referred to as the “bar date”) may have long passed. To remedy this problem, Bankruptcy Rule 3002(c)(4) gives bankruptcy courts the discretion to set a separate bar date for lease rejection claims. Customarily, the bar date for a lease rejection claim will be the later of (i) the general bar date and (ii) the thirtieth day after (a) entry of the order approving the rejection of

the lease, or (b) the date as of which the lease is deemed rejected by operation of law because of the trustee's failure to assume the lease.

#### **4. Consequences of Rejection of the Lease if the Lessor is the Debtor**

If the debtor is the landlord, the lessee may treat the lease as terminated, "if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable to non-bankruptcy law, or any agreement made by the lessee ...". 11 U.S.C. § 365(h)(1)(A)(i). Alternatively, if the term of the 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 non-bankruptcy law." 11 U.S.C. § 365(h)(1)(A)(ii). If the lessee elects to retain such rights, he may offset any damages for breach against his rental obligations, but he will have no enforceable claim for damages against the trustee for any amount over and above such setoff.

If the lease is a shopping center lease, rejection by the landlord "does not affect the enforceability under applicable non-bankruptcy law of any provision in the lease pertaining to radius, location, use, exclusivity, or tenant mix or balance," if the lessee remains in possession. 11 U.S.C. § 365(h)(1)(C).

#### **5. What Happens to the Rights of Sublessees and Leasehold Mortgagees If a Lease is Rejected?**

Prior to the 1994 amendments to the Bankruptcy Code, which substantially rewrote subsection (h) and added paragraph (h)(i)(D), the prevailing view was that rejection of a lease under which the debtor was the lessee necessarily resulted in the rejection of any sublease. *In re Chatlos Systems, Inc.*, 147 B.R. 96 (D. De. 1992), *aff'd sub. nom. In re TIE Communications, Inc.*, 998 F.2d 1005 (3d Cir. 1993). ("deemed rejection" of prime lease under §365(d)(4); debtor lessee effectively "surrendered" the premises and the prime lease was terminated when landlord received notice of court order confirming "deemed rejection;" debtor not required to evict subtenant, which became landlord's tenant at sufferance).

Any ensuing disputes between the landlord and the subtenant regarding the subtenant's possessory rights or its obligation to pay rent to the landlord were generally held not involve the bankruptcy estate, and were left for resolution in state court. *Id.* At 100-101 (landlord's claim for rent should be pursued in a state court; question whether landlord could sue subtenant for possession in bankruptcy court "must await resolution until another day"); *In re Dial-a-Tire, Inc.*, 78 B.R. 13, 16 (Bankr. W.D.N.Y. 1987) (Subtenant's statutory rights under §365(h) noted, but "the dual rejection which occurred here will leave [the landlord and the subtenant] to vie for possession of the Premises according to New York Law").

As for leasehold mortgages, there was a split of authority as to whether they were wiped out by the debtor/lessee's rejection of the lease. *Compare In re Giles Associates Ltd.*, 92 B.R. 695 (Bankr. W.D.Tex. 1988) ("deemed rejection" of lease as to which debtor was the lessee,

coupled with lessee's statutory duty to surrender the premises, resulted in termination of the lease by operation of Federal law and extinguishment of security interests in the leasehold) *with In re Austin Development Company*, 19 F.3d 1077 (5<sup>th</sup> cir. 1994), *cert. denied sub. nom. Sowashee Venture v. EB, Inc.*, 513 U.S. 874 (1994) ("Deemed rejection" of lease as to which tenant was lessee did not result in "termination" of lease or of third-party beneficiary rights of leasehold mortgage; extent of those rights should be determined in state court).

As noted above, subsection (h) now preserves not only the lessee's possessory rights, but "all rights under such lease...that are in or appurtenant to the real property...". Moreover, subsection (h)(1)(D) provides that "[I]n this paragraph [*sic*, presumably a reference to subsection (h)], "lessee" includes any successor, assign or mortgagee permitted under the terms of such lease." Presumably, this means that a sublessee or leasehold mortgagee can retain and exercise all such rights even if the lessee elects to treat the lease as terminated.

## **6. Can the Debtor/Lessor's Real Estate be Sold Free and Clear of the Lessee's Interest?**

Section 363 of the Bankruptcy Code authorizes a bankruptcy trustee to sell property of the estate. Sales "other than in the ordinary course of business" require prior notice and a hearing. 11 U.S.C. § 363(b). If the debtor's business is operated during the case, the trustee can sell property of the estate "in the ordinary course of business, without notice or a hearing, ...". 11 U.S.C. § 363(c)(1). Subsection (f) of section 363 provides:

(f) the trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if –

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Does a trustee's power to sell estate property "free and clear of any interest in such property of an entity other than the estate" include the power to sell real estate free and clear of leasehold interests?

- Yes, says the United States Court of Appeals for the Seventh Circuit in *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7<sup>th</sup> Cir. 2003), at least if one or more of the conditions specified in subsection (f) are satisfied. The court concluded that section 365(h) does not trump section 363(f): "... the statutory provisions themselves do not suggest

that one supersedes or limits the other,” and the absence in either section of any “cross-reference indicating that the broad right to sell estate property free of ‘any interest’ is subordinate to the protections that section 365(h) accords to lessees” suggests that Congress did not intend section 365(h) to limit section 363(f). The court went on to conclude that section 365(h) applies only when a lease is rejected, and that a sale unaccompanied a formal rejection of a lease is merely a “repudiation” of the lease, and does not trigger consideration of section 365(h). Finally, the court noted that the lessee could protect its interest by requesting adequate protection pursuant to 11 U.S.C. § 363(e), which provides that, “on request of an entity that has an interest in property ... proposed to be ... sold ... by the trustee, the court, with or without a hearing, shall prohibit or condition such ... sale ... as is necessary to provide adequate protection of such interest.” *Id.* at 547.

- No, say two lower court decisions: *In re Taylor*, 198 B.R. 142 (Bankr. D.S.C. 1996); *In re Churchill Properties III, L.P.*, 197 B.R. 283 (Bankr. N.D. Ill. 1996). (Each holding that section 365(h) prevails over section 363(f)).

- No, says a commentator: Michael St. Patrick Baxter, *Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in Precision Industries v. Qualitech Steel*, 59 Bos. Law. 475 (February 2004) (section 363(l) clearly subordinates all sales under sections 363(b) and (c) to the provisions of section 365, including subsection (h)); the *Precision Industries* court “ignored the reality that a sale effecting the repudiation of a lease is tantamount to rejection”; and the court’s holding effectively nullifies section 365(h)).

At the very least, it seems advisable for a trustee to give the lessee notice of the trustee’s intention to sell free and clear of the lessee’s interests. Otherwise, lessees may be unfairly lulled into complacency, particularly if (as if often the case) parties in interest are told that a final decision on assumption or rejection of leases will be deferred until a time after the sale hearing.