Protecting the Commercial Landlord in a Tenant Bankruptcy

by Stephen McNally

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A commercial tenant bankruptcy filing is not an uncommon event. Notwithstanding this reality, a landlord is often unprepared when the bankruptcy filing occurs. The landlord would be better prepared if the bankruptcy prospect was considered in the early stages of the landlord-tenant relationship. In the negation and enforcement stage, the landlord and its counsel should be forward thinking to the potential bankruptcy filing. Additionally, bankruptcy consideration should carry on to the default stage. Finally, when the tenant does file for bankruptcy the landlord and counsel must be familiar with the bankruptcy code[1] and pertinent case law to assure its rights are properly protected. This article will consider the various stages of the landlord-tenant relationship as they relate to the tenant bankruptcy filing.

The Lease Terms

Expiration/Termination of the Lease

When negotiating the lease, landlord's counsel should have a working understanding of the bankruptcy code, and specifically those aspects of the code that address the landlord's rights when a tenant files for bankruptcy. This understanding is important at the negotiation stage, as a subsequent court's application of the bankruptcy code to the lease terms could affect a landlord's rights. Critical lease terms in the context of a bankruptcy filing relate to when the lease is expired and when it is terminated.

New Jersey Bankruptcy Judge Judith Wizmur explained the difference between 'expired' and 'terminated' in *In re DiCamillo*:[2]

> ...the word 'expired' denotes the natural or inevitable end to a contract or lease by lapse of time, while the word 'terminated' denotes the unnatural or premature end to a contract or lease as the result of breach or forfeiture.[3]

Both expiration and termination of the lease will affect whether the automatic stay of Section 362 will apply and whether the lease can be assigned or assumed. As to the automatic stay, Section 362(a)(3) provides a stay against acts to take possession of property of the estate. Section 362(b) sets forth an exception to the general stay provisions of Section 362(a) and provides in Section 10 that the automatic 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. (Emphasis added.)

Section 362(b)(10) goes hand-in-hand with Section 541(b)(2), which provides that property of the bankruptcy estate does *not* include a nonresidential lease interest "...terminated at the expiration of the stated term of such lease..." How and when a lease expires will be governed by the terms of the lease. Clarity in identifying the end of the lease term (with a specific lease term end date) will avoid confusion as to whether the lease is an asset of the bankruptcy estate and whether the automatic stay applies.

Further confusion can arise when the lease term expiration date is made uncertain due to an option to extend and/or renew the lease. How the lease addresses the option could allow a bankruptcy court to conclude the lease has not expired. In *In re Seven Hills Inc.*,[4] Judge Michael Kaplan allowed a tenant to exercise a renewal option, notwithstanding the fact that the tenant was in default of the rent payments and the lease specifically provided that the renewal option could not be exercised if there existed a default. A landlord should clarify in the lease the circumstances in which a renewal option vests. Additionally, the landlord should make clear that if the tenant fails to notify the landlord of its intention in a timely fashion, the option is deemed not exercised and the lease will expire at the end of the term. While such a notice is no guarantee that a bankruptcy court will honor the landlord's notice of expiration, it will certainly improve the landlord's chances.

Expiration/termination can affect the tenant or trustee's ability to assume or assign the lease in accordance with Section 365 of the bankruptcy code. Section 365(a) provides that a bankruptcy trustee "...subject to the court's approval, may assume or reject... an unexpired lease of the debtor." The right to assume a lease is extended to a debtor in possession (DIP) in a Chapter 11 case (for the purpose of this article, the tenant) pursuant to Section 1107. Section 365(a) must be read in conjunction with Section 365(c)(3), which precludes a trustee or a DIP from assuming or assigning a nonresidential lease which "...has been terminated under

applicable nonbankruptcy law prior to the order for relief." So, in the context of a nonresidential lease, the lease must be both 'unexpired' and not have been terminated to permit the trustee or DIP to assume.

The majority of commercial leases will provide specific language for termination. Most will be tied to default, notice and a cure opportunity. Once all condition precedents have been satisfied, the lease would be terminated, allowing the landlord to exercise its remedies, including the right to accelerate the rent. One would expect that compliance with the lease terms pertaining to termination should deny the trustee/tenant the opportunity to assume/assign the lease. The New Jersey bankruptcy courts, however, have concluded that a default arising from nonpayment of rent will only terminate a lease upon entry of a judgment for possession, regardless of the lease terms.[5] When concluding that only a judgment for possession terminated the lease for non-payment of rent, the courts relied upon New Jersey statute N.J.S.A. 2A:18-55, which permits a tenant to cure a rent default up to the time a judgment in possession is entered.

While termination of the lease for non-payment of rent will be governed by state law, there still is value in negotiating for strong termination provisions for non-monetary defaults. When such a non-monetary default occurs, provided there is compliance with the lease terms (including notice and opportunity to cure), the lease should be subject to termination, allowing the landlord to avoid assumption or assignment.

Concerns related to termination of the lease carry over even after default. Landlord's counsel aware of the importance of a judgment for possession in a bankruptcy may seek to protect the client after a default by conditioning acceptance of late payments upon entry of a consent judgment. Such consent judgments commonly provide that upon payments being made the judgment for possession will be vacated. In *In re Seven Hills Inc.*, Judge Kaplan held that a consent judgment for possession with a cure option does not terminate the lease.[6] Accordingly, if the landlord is inclined to allow the tenant to cure with a consent judgment, caution should be taken to include air-tight language. At a minimum, the terms of the consent judgment should provide for entry of the judgment for possession and make clear judgment is not vacated until all payments have been made. While this type of consent judgment would not have saved the landlord in the *Seven Hills* case, it might have greater affect in front of other bankruptcy judges or the district court on appeal. Moreover, if the tenant threatens a bankruptcy as a tactic to convince the landlord to accept the consent judgment, the landlord may be better served to reject the payments and enter judgment.

Defining Landlord's Right to Recover Attorney's Fees

Another consideration when negotiating the lease is the landlord's ability to recover its attorney's fees as part of its collection efforts. Bankruptcy courts, like state courts, strictly construe lease terms providing for the recovery of attorney's fees. The Fourth Circuit, in *In re Shangra-La, Incorporated*,[7] considered the right of the landlord to recover attorney's fees when the trustee sought to assume the lease. The court focused on Section 365(b)(1)(B) of the bankruptcy code, which required a trustee or a DIP, before assuming a lease, to compensate the landlord "…for an actual pecuniary loss resulting from…default."

The Fourth Circuit in *Shangra-La* considered whether attorney's fees permitted under the lease constituted a "pecuniary loss" requiring compensation before a lease may be assumed. The court determined that Section 365(b)(1)(B) does not establish an independent basis for recovery of attorney's fees and such determination is dependent on state law and the lease terms.[8] With these considerations in mind, the court determined that the lease was in compliance with state law given the clear lease terms allowing for the recovery of attorney's fees for collection and enforcement of the lease.

The bankruptcy court for the District of Delaware, in *In re: Crown Books Corp.*,[9] using *Shangra-La* for guidance, considered whether a landlord could recover its attorney's fees incurred in the bankruptcy case when the lease included the following language:

> In the event either party hereto brings or commences legal proceedings to enforce any of the terms of this Lease or to assert any rights thereunder, the successful party in such action shall be entitled to receive and shall receive from the other party hereto, a reasonable sum as attorney fees and costs, such sum to be fixed by the court in such action.

The court concluded that attorney's fees could be recovered, even for the bankruptcy aspect subject to an analysis as to whether the landlord was the "successful party."[10] The lesson to be learned from the above decisions is that a landlord should confirm that the lease clearly and unambiguously provides for recovery of attorney's fees both to enforce the lease terms and to protect the landlord's rights.

Defining the Debtor's Obligations under the Lease

Before a trustee or DIP assumes a lease, he or she must comply with Section 365(d)(3), which provides:

> the trustee shall 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, notwithstanding section 503(b)(1) of this title. (Emphasis added.)

The Third Circuit, in *Centerpoint Properties v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.),*[11] considered what was intended by the term "obligations of the debtor" in a nonresidential lease. The analysis was necessary to determine whether the trustee was obligated to pay prorated taxes in accordance with the terms of the lease, notwithstanding the fact that some of those taxes were due for the period before the order for relief was entered.

In the case, the debtor filed a Chapter 11 bankruptcy on July 7, 1997, and continued to use the premises as a debtor in possession, but did not assume or reject the lease prior to the lease's expiration on Sept. 1, 1997. The landlord sent two invoices to the debtor for two installments of 1996 taxes, which were payable in 1997. A third invoice was issued pursuant to the lease for the 1997 taxes in the amount of $426,729.87. The debtor did not remit payment for either of the first two invoices but remitted a payment of $96,584.95 for the third invoice, constituting the prorated portion of taxes attributable to the date from the filing of the bankruptcy petition through Sept. 1, 1997.[12] The debtor took the position that the balance of the taxes was for the prepetition taxes and, therefore, constituted a portion of the landlords unsecured claim since they were not for the period "arising from or after the order for relief…"[13] The landlord took the position that all three tax invoices were part of the debtor's "obligations" and, accordingly, in accordance with Section 365(d)(3), the debtor must pay all taxes.[14]

The Third Circuit in determining what was intended by the term 'obligations' stated that "…[i]n the context of a lease contract, it seems to us that the most straightforward understanding of an obligation is something that one is legally required to perform under the terms of the lease and that such an obligation arises when one becomes legally obligated to perform."[15] The court accordingly held that the debtor must pay the full amount of taxes invoiced by the landlord.

The Third Circuit in the subsequent case, *In re Goody's Family Clothing Inc.*,[16] considered the landlord's right to 'stub rent.' Stub rent was defined by the court as "…the amount due a landlord for the period of occupancy and use between the petition date and the first post-petition rent payment."[17]

The debtor filed the petition in bankruptcy on June 9, 2008, at which point the debtor had not made the last rent payment, due on June 1, 2008. The debtor requested and was granted the opportunity to hold a going-out-of-business sale, which resulted in proceeds being paid into the bankruptcy estate.[18] The landlord filed an administrative claim in accordance with Section 503(b)(1) for the period between the filing of the petition (June 9) and June 30. Section 503(b)(1) permits an administrative claim for "…an actual, necessary cost and expense necessary to preserve the estate."[19] The debtor objected, asserting that the June 1, 2008, payment was due before the petition was filed and, therefore, was merely part of the landlord's unsecured claim. The landlord argued, and the court agreed, that the tenant's use of the premises for the purpose of holding the going-out-of-business sale was permitted as an administrative claim pursuant to Section 503(b)(1).[20] As an administrative expense, the claim would have priority over general unsecured claims.

Protecting the Landlord After the Bankruptcy Filing

Tenant's Obligation to Cure to Assume or Assign a Lease

If the lease has not been terminated (by reason of entry of a judgment for possession) and it has not expired, it is subject to being assumed or assigned. Section 365(b)(1) explains the circumstances under which a nonresidential lease can be assumed or assigned. Moreover, the mere fact that there exists a pre-petition default does not preclude assumption or assignment. Section 365(b)(1) only requires that the trustee or debtor in possession cures or provides assurance that the trustee will "promptly" cure such monetary default. No definition of 'promptly' is offered in the bankruptcy code. Judge Wizmur, in *In re DiCamillo*,[21] suggested that "promptly must be determined on the facts and circumstances of each case," but further noting that generally more than two years was not prompt.

Identifying and Recovering Damages

If despite the landlord's best efforts, the landlord finds itself in a tenant's bankruptcy and the trustee or DIP chooses not to assume or assign the lease, the landlord and its counsel must have an appreciation of what can be recovered as part of its damages. The determination of what can be recovered will be affected by lease terms and when the lease is rejected.

Section 365(g) provides that the rejection of the lease constitutes a breach of the lease, thereby giving the lessor a claim for prepetition damages. Upon rejection of a lease, the landlord has a claim for damages as if the breach occurred immediately before the filing of the bankruptcy. Additionally, if the lease has been terminated (thereby precluding assumption or rejection of the lease) the landlord will also have a claim for damages. A cap on the landlord's claim is established in Section 502(b)(6), which precludes recovery to the extent the 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...

While Section 502(b)(6) caps the landlord's claim, it does not address the landlord's obligation in accordance with common law to mitigate damages by re-letting the leased premises to a new tenant. The Third Circuit, in *Solow v. PPI Enterprises*,[22] concluded that the amount permitted under Section 502(b)(6) is not reduced by any recovery for re-letting the premises. That same court also concluded that the cap amount established under Section 502(b)(6) must be reduced by a security deposit retained by the landlord or any drawdown on a letter of credit.[23] Section 503(b)(7) also grants a landlord an administrative claim (and accordingly a higher priority) when a lease is assumed and then later rejected.

Determining Impairment of Claim Pursuant to Section 1129(a)(10)

Because Section 365 gives the trustee or DIP a period of time to assume or reject a lease, a landlord may not know the extent of its damages until the lease is rejected. Once a lease is rejected, the court will set a time by which the landlord is to file its proof of claim.[24] At that point, the landlord will be treated as a general unsecured creditor. If the landlord is not paid in full under a plan of reorganization, its claim will be considered impaired. A landlord/creditor can only vote on a plan if it is impaired. Additionally, a debtor in a Chapter 11 case cannot have a plan confirmed unless it is accepted by one impaired class. While it is a relatively simple matter to determine if a landlord is impaired for monetary defaults, non-monetary default creates a more complicated scenario. Section 1124(1)(D) explains under what circumstances a non-monetary default is not considered impaired:

> If such claim or such interest arises from any failure to perform a nonmonetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to section 365(b)(1)(A), compensates the holder of such claim or such interest (other than the debtor or an insider) for any actual pecuniary loss incurred by such holder as a result of such failure.

The Third Circuit, in *Solow*,[25] determined that a landlord, by reason of his claim being capped pursuant to Section 502(b)(6), is not considered impaired.

Conclusion

Unquestionably, a bankruptcy will disrupt the commercial landlord's ability to recover rent and regain possession of its property. Early consideration of the bankruptcy possibility and an understanding of relevant bankruptcy code sections could save the landlord headaches should that eventuality occur. ⚖

Endnotes

1. Title 11 U.S.C. § 101 *et. seq*.
2. *In re DiCamillo*, 206 B.R. 64 (Bankr. D.N.J. 1997) *citing*, *In re Morgan*, 181 B.R. 579, 583 (Bankr. N.D. Ala. 1994).
3. *Id.* at 68.
4. *In re Seven Hills Inc.*, 403 B.R. 327, 331 (Bankr. D.N.J. 2009).
5. *In re Great Feeling Spas, Inc.*, 275 B.R. 476 (Bankr. D.N.J. 2002); *In re Seven Hills Inc.*, 403 B.R. 327, 331 (Bankr. D.N.J. 2009).
6. *In re Seven Hills Inc.*, 403 B.R. at 331-334.
7. *In re Shangra-La, Incorporated*, 167 F.3d 843 (4th Cir. 1999).
8. *Id.* at 849.
9. *In re: Crown Books Corp.*, 269 B.R. 12 (Bankr. D. Del 2001).
10. *Id.* at 16-17.
11. *Centerpoint Properties v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)*, 268 F.3d 205 (3rd Cir. 2001).
12. *Id.* at 207.
13. *Id.*
14. *Id.* at 208.
15. *Id.* at 209.
16. *In re Goody's Family Clothing Inc.*, 610 F.3d 812 (3rd Cir. 2010), *cert. denied,* 562 U.S. 1064 (2010).
17. *Id.* at 815.
18. *Id.* at 814.
19. *Id.* at 815.
20. *Id.* at 819-820.
21. *In re DiCamillo*, at 72.
22. *Solow v. PPI Enterprises*, 324 F.3d 197 (3rd Cir. 2003).
23. *Id.*
24. Federal Rule of Bankruptcy Procedure 3002(a)(4).
25. *Solow*, at 202-207.