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Column
Last in Line

*16 LANDLORD BEWARE! BAPCPA AFFECTS NONRESIDENTIAL REAL ESTATE LEASES, TOO

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Although the new bankruptcy law (BAPCPA) was widely publicized as a complete overhaul of the consumer bankruptcy system, it also implements important changes in the treatment of unexpired leases of nonresidential real estate. Some of the changes favor the landlord and others favor the debtor, but the bottom line is clear: BAPCPA changes the landlord/tenant dynamics in several important respects.

Defaults to Be Cured Before Debtor Can Assume Unexpired Lease

Bankruptcy Code §365(b)(1) requires a debtor to cure certain defaults before it can assume any executory contract or unexpired lease, but historically, §365(b)(2) enumerated the defaults that the debtor need not cure:
(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to
(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

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

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

(D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.
In the past, §365(b)(2)(D) was problematic to apply, and it spawned litigation that resulted in a split among the circuits, as evidenced by *In re Claremont Acquisition Corp. Inc.*, 113 F.3d 1029 (9th Cir. 1997), and *In re BankVest Corp.*, 360 F.3d 291 (1st Cir. 2004), *cert. den.*, 124 S.Ct. 2874, 159 L.Ed.2d 776 (2004).

Claremont involved a car dealership franchise agreement that required the franchisee to operate continuously; the debtor had ceased operations for approximately two weeks before filing bankruptcy. When the debtor filed a motion to assume the franchise agreement, the franchisor objected, arguing that the debtor's two-week shutdown constituted a "historical" default that the debtor was *unable* to cure. In response, the debtor argued that the continuous-operation clause in the franchise agreement was a *non-monetary* obligation that 11 U.S.C. §365(b)(2)(D) did not require the debtor to cure.

The Ninth Circuit agreed with the franchisor and held that 11 U.S.C. §365(b)(2)(D) only applies to provisions that impose penalties (such as penalty rates or liquidated damages) resulting from the *failure* to perform nonmonetary obligations. *See*

Claremont, 113 F.3d at 1034. In reaching this conclusion, the Ninth Circuit Court of Appeals reasoned that the word "penalty" in 11 U.S.C. §365(b)(2)(D) modified both of the nouns that followed—in effect reading the statute to excuse satisfaction of:
(1) any penalty rate (relating to a non-monetary default), and

(2) any penalty provision (relating to a non-monetary default).
The Ninth Circuit *rejected* the debtor's argument that 11 U.S.C. §365(b)(2)(D) should be read to excuse cure of:

(1) any penalty rate or provision and

(2) any non-monetary default. [1]
Consequently, the Ninth Circuit held that if either a *penalty* rate or other *penalty* provision was tied to a non-monetary default, then the penalty portion need not be cured, but the debtor must cure all *other* non-monetary obligations—regardless of whether cure was possible. Because it was impossible for the debtor in *Claremont* to cure the historical nonmonetary defaults, the debtor's motion to assume the franchise agreement was denied.

In *In re BankVest Capital Corp.*, 360 F.3d 291 (1st Cir. 2004), the First Circuit Court of Appeals reached the opposite conclusion and observed that the *Claremont* decision was too harsh on debtors because it created a scenario in which the debtor would be unable to assume an unexpired lease or executory contract because a default might be impossible to cure, and that result would defeat the overarching purpose of the Bankruptcy Code—namely the rehabilitation of debtors. Consequently, the First Circuit ruled that debtors can assume executory contracts and unexpired leases without first curing *any* non-monetary defaults.

BAPCPA addresses this split in the circuits by incorporating some of the Ninth Circuit's reasoning in *Claremont* and some of the First Circuit's logic in *BankVest*. First, BAPCPA amends 11 U.S.C. §365(d)(2)(D) to include the word "penalty" in two places within the first line, as follows (emphasis added):
(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to—
(D) the satisfaction of any *penalty* rate or *penalty* ***53** provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under the executory contract or unexpired lease.
This amendment to 11 U.S.C. §365 (b)(2)(D) codifies the Ninth Circuit's ruling in *Claremont*, which inferred that the word "penalty" applies to both "rate" and "provision" in the first line of the statute.

Next, Congress apparently recognized that even the amended version of 11 U.S.C. §365(b)(2)(D) would produce the same harsh result as *Claremont* unless some ameliorating language was inserted in 11 U.S.C. §365(b)(1). Consequently, BAPCPA amends 11 U.S.C. §365(b) (1)(A) to read as follows:
(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—
(A) cures, or provides adequate assurance that the trustee will promptly cure, such default *other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform non-monetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing non-monetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph...* (emphasis added).

This complex amendment to 11 U.S.C. §365(b)(1)(A) is problematic. First, it excuses the debtor from impossible-to-cure obligations, but *only with respect to unexpired leases of real property*. Thus, ironically, this amendment will *still* result in a *Claremont*-type ruling that prevents a debtor from assuming *executory contracts* if there have been any impossible-to-cure non-monetary defaults. The amendment to 11 U.S.C. §365(b)(1)(A) contains a further qualification, namely that a default based on "failure to operate" in accordance with a nonresidential real property lease *must* be cured prospectively. Query, in the ***54** absence of a crystal ball, how can the bankruptcy court determine, *at the time of the lease-assumption hearing*, whether a debtor will satisfy the *future* operational performance requirements? What proofs must a debtor present in order to satisfy this statutory criteria for assumption of a nonresidential real property lease?

New Deadline for Assumption or Rejection of Nonresidential Real Estate Leases

The Reform Act amended 11 U.S.C. §365(d)(4) to read as follows:
(4)(A) Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of—
(i) the date that is 120 days after the date of the order for relief, or

(ii) the date of the entry of an order confirming a plan.

(B)(i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days on the motion of the trustee or lessor for cause.

(ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.
The changes to 11 U.S.C. §365(d)(4) are rather straightforward. First, BAPCPA gives the debtor a longer time to decide whether to assume or reject unexpired leases of nonresidential real estate to the *earlier* of (i) 120 days after the date of the order for relief or (ii) the date of entry of an order confirming a reorganization plan. The amendment also permits the bankruptcy court to grant a motion of the debtor, or the lessor, to extend the 120-day deadline for "cause," but unlike the prior law (which was silent on the number of extensions or their duration), BAPCPA's amendment to §365(d)(4) enables the court to extend the deadline for only 90 days. If the debtor desires further extensions of this deadline, the court can grant such an extension only if the lessor consents in writing in advance.

At first blush, the new 120-day deadline in §365(d)(4) appears to benefit debtors, but in reality, it is a victory for landlords who were often frustrated by long or serial extensions of the debtor's deadline to assume or reject the lease of nonresidential real estate. Indeed, this amendment is particularly troublesome for debtors with numerous retail leases because they often need longer than 120 days—indeed, sometimes longer than 210 days (*i.e.*, the 120-day initial time plus the 90-day extension that the bankruptcy court can grant over the landlord's objection) to obtain sufficient data (such as "same store sales" statistics) in order to determine which leases should be assumed, and which should be rejected. The impact of this amendment to 11 U.S.C. §365(d)(4) may force debtors to prematurely reject valuable leases or to prematurely assume leases that later prove to be burdensome to the debtor and the bankruptcy estate. Also, by requiring the lessor to consent to any subsequent extension (*i.e.*, beyond the one-time 90-day extension that the amended 11 U.S.C. §365(d)(4) permits), BAPCPA effectively gives the landlord of a nonresidential real estate lease "veto power" that enables the landlord to force the debtor to make a decision on its lease through the landlord's refusal to consent to further extensions.

Cap on Administrative Claim for Assumed Lease of Nonresidential Real Estate that Is Later Rejected

Congress apparently recognized that BAPCPA's amendment of 11 U.S.C. §364(d)(4) might adversely impact trade creditors (and perhaps even other landlords whose leases are not assumed) if the amendment to §365(d)(4) causes debtors to improvidently assume nonresidential real estate leases that later prove burdensome to the bankruptcy estate. In order to fix this problem, BAPCPA amends 11 U.S.C. §503(b)(7) to limit the amount of a lessor's administrative expense claim when a nonresidential real estate lease is assumed and later rejected. BAPCPA's new 11 U.S.C. §503(b)(7) states:

(b) after notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under §502(f) of this title, including

(7) with respect to a nonresidential real property lease previously assumed under §365 and subsequently rejected, a settlement equal to all monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, *for the period of two years following the later of the rejection date or the date of actual turnover of the premises*, without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor, and the claim for remaining sums due for the balance of the term of the lease shall be a claim under §502(b)(6) (emphasis added).

Under the new 11 U.S.C. §503(b)(7), if a nonresidential real estate lease is assumed and later rejected, the lessor's administrative expense claim is capped at an amount up to monetary obligations due under the lease (except for penalty provisions and provisions relating to a failure to operate) for two years after the later of the rejection date, or the date the premises are turned over to the lessor. The portion of the landlord's claim that is not afforded administrative priority under §503(b)(7) would be subject to the cap imposed by 11 U.S.C. §502(b)(6) and relegated to unsecured status.

The Reform Act's new §503(b)(7) is a blow to lessors. Before BAPCPA, some lessors argued that once a lease was assumed it could not later be rejected, or that any post-assumption rejection gave the landlord an administrative claim for ***55** all sums due for the balance of the lease. BAPCPA's amendment to §503(b)(7) eviscerates those landlord-oriented arguments because it expressly addresses the circumstance where a previously-assumed lease of nonresidential real estate is rejected, and it caps the landlord's administrative claim.

Clarification of Protection for Shopping Center Lessors

Historically, 11 U.S.C. §365(b)(3) protected shopping center lessors, the other tenants in a shopping center and the "tenant mix" of the shopping center by creating more stringent standards for a debtor-tenant to assume a shopping center lease. There has always been tension between §365(b)(3), which restricts assumption and assignment of shopping center leases, and §365(f)(1), which renders the debtor's unexpired leases freely assignable. This tension spawned litigation on the issue of whether a use restriction in a shopping center lease will be enforced against a debtor who proposes to assume and assign that lease, or whether the free assignability language of 11 U.S.C. §365(f)(1) effectively trumps a restrictive-use provision in a shopping center lease.

BAPCPA does *not* amend §365(b)(3), but it amends §365(f)(1) to make it expressly subject to 11 U.S.C. §365(b). In doing so, Congress clarifies that the special protection that §365(b)(3) affords shopping center lessors (and other shopping center tenants) will be enforced. By making §365(f)(1) expressly subject to §365(b)(3), Congress codifies the landmark decision in *In re Trak Auto*, 367 F.3d 237 (4th Cir. 2004), in which the Fourth Circuit held that 11 U.S.C. §365(b)(3) controls over 11 U.S.C. §365(f)(1). This amendment is very good news for shopping center lessors and the other tenants in the shopping center who wish to enforce the restrictive use provisions in their shopping center leases.

Conclusion

Although the lion's share of BAPCPA targets the consumer bankruptcy system, it also contains important amendments to the Code's provisions relating to nonresidential real estate leases. Judicial interpretation (and creative counsel) will undoubtedly provide valuable insight on these important amendments, and on the impact of BAPCPA on nonresidential real estate leases.

Footnotes

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1 The Ninth Circuit rejected the debtor's proposed interpretation of the statute, holding that it would render 11 U.S.C. §365(b)(2)(A), (B) and (C) superfluous because they would be subsumed in §365(b)(2)(D).

25-OCT AMBKRIJ 16

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