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Treatment of Real Property Leases in Bankruptcy

Caveats

- Presentation is a summary only. Certain provisions and details are omitted.
- Be sure to conduct your own research or contact a bankruptcy lawyer when faced with an actual case.
- The opinions expressed in this presentation are for educational purposes only and do not necessarily reflect the opinions of Kriss & Feuerstein LLP and/or its clients.

Background

- Bankruptcy Code: 11 U.S.C. et sec.
- Chapters
 - Chapter 7
 - Liquidation
 - Chapter 7 Trustee appointed to handle bankruptcy estate
 - Chapter 9
 - Municipal Bankruptcy
 - Chapter 11
 - Reorganization
 - Usually, the debtor operates its business – the “Debtor-in-Possession” or “DIP”
 - Requires Chapter 11 Plan
 - Chapter 12
 - Family farm reorganization
 - Chapter 13
 - Solely for individuals
 - Reorganization
 - Requires Chapter 13 Plan
 - Chapter 15
 - International insolvencies
 - Applies where the “main” bankruptcy case is in a foreign jurisdiction

Automatic Stay - § 362

- Immediately upon bankruptcy filing
- Stays all acts with respect to the Debtor and the Debtor's property
- Eliminates the "race to the courthouse"
- Why would a lease party care?
 - Stay prevents termination of lease
- Stay terminates upon
 - Closing or dismissal of the case – 11 U.S.C. § 362(c)(2)(A), (B)
 - Grant or denial of the Debtor's discharge – 11 U.S.C. § 362(c)(2)(C)

Automatic Stay - § 362

- Multiple bankruptcy stay termination provisions – § 362(c)(3)
 - Individual bankruptcies only
 - Stay terminates on the 30th day after the petition date “with respect to any action taken with respect to a debt or property securing such debt or with respect to any lease” 11 U.S.C. § 362(c)(3)(A).
 - Applies where prior case was filed within 1 year of current bankruptcy case and was dismissed (unless the current case is not a chapter 7 case and prior case was dismissed under § 707(b)).
 - Stay can be extended on a motion, if current case was filed in good faith as to the creditors to be stayed. 11 U.S.C. § 362(c)(3)(C). Statute provides guidance on what constitutes “good faith.”

Automatic Stay - § 362

- Multiple bankruptcy stay termination provisions - § 362(c)(4)
 - Individual bankruptcies only
 - Stay terminates immediately if
 - 2 cases were filed within the prior year but dismissed (other than a non-chapter 7 case refiled after a dismissal under § 707(b)). 11 U.S.C. § 362(c)(4)(A)
 - Parties can ask for order
 - “to be entered promptly” confirming no stay.
 - Re-imposing stay only if the current case is in good faith as to creditors stayed. Statute provides guidance on what constitutes “good faith.”

Lifting the Automatic Stay - § 362(d)

- Creditors can move for relief from the stay:
 - For cause - § 362(d)(1)
 - “for cause, including the lack of adequate protection”
 - “cause” is not defined.
 - Lack of adequate protection
 - “adequate protection” is defined in § 361
 - Three statutory options:
 - Cash payments;
 - Additional or replacement lien; or
 - Or anything that will result in the creditor getting the “indubitable equivalent” of its interest in the property (*e.g.*, an equity cushion)
 - Bankruptcy is a bad faith filing

Lifting the Automatic Stay - § 362(d)

- Creditors can move for relief from the stay based on
 - For cause - § 362(d)(1) (continued)
 - To continue a judicial proceeding in another forum, courts in the 2d Cir. look at several factors, including:
 - (1) whether relief would result in a partial or complete resolution of the issues;
 - (2) lack of any connection with or interference with the bankruptcy case;
 - (3) whether the other proceeding involves the debtor as a fiduciary;
 - (4) whether a specialized tribunal with the necessary expertise has been established to hear the cause of action;
 - (5) whether the debtor's insurer has assumed full responsibility for defending it;
 - (6) whether the action primarily involves third parties;
 - (7) whether litigation in another forum would prejudice the interests of other creditors;
 - (8) whether the judgment claim arising from the other action is subject to equitable subordination;
 - (9) whether movant's success in the other proceeding would result in a judicial lien avoidable by the debtor;
 - (10) the interests of judicial economy and the expeditious and economical resolution of litigation;
 - (11) whether the parties are ready for trial in the other proceeding; and
 - (12) impact of the stay on the parties and the balance of harms.

In re Sonnax Indus., 907 F.2d 1280, 1286 (2d Cir. 1990).

Lifting the Automatic Stay - § 362(d)

- Actions against property - § 362(d)(2)
 - Two elements:
 - A debtor has no equity in the property
 - The property is not necessary for an effective reorganization
 - Chapter 7 liquidation – by definition, not necessary for an effective reorganization
- Typical Example: Relief to Continue Eviction Procedure
 - Many debtors facing eviction will file for bankruptcy to stop eviction.
 - The landlord will file a motion for relief from stay to continue eviction.

Lifting the Automatic Stay - § 362(d)

- Typical Example: Relief to Continue Eviction Procedure (Continued)
 - *Sonnax* factors apply, but be aware that even in the absence of a valid lease, some courts have ruled that a debtor living in an apartment/condo/house has a possessory interest until eviction is completed. *See, e.g., In re Reinhardt*, 209 B.R. 183, 187 (Bankr. S.D.N.Y. 1997).
 - Under NY Law
 - The marshal will execute the warrant of eviction, either by a full eviction or by effectuating a “legal possession.” *Facey v. Johnson*, 49 Misc. 3d 1136, 1139, 17 N.Y.S.3d 619 (Civ. Ct. Kings County 2015).
 - “Legal possession” means that the Marshal “supervises the changing of the locks and turns over legal possession of the apartment and its contents to the landlord, who assumes responsibility for the tenants property.” *Ramirez v. Goldman*, 1990 U.S. Dist. LEXIS 15772, *3 (S.D.N.Y. 1990).

Assumption/Rejection of Unexpired Leases - § 365

- For unexpired leases (and executory contracts), Trustees/Debtors may:
 - Assume the lease;
 - Assume and assign the lease; or
 - Reject the lease.
- Business judgment rule governs decision

Assumption/Rejection of Unexpired Leases - § 365

- Timing: Lease is deemed rejected unless assumed within a set time frame
 - Residential leases
 - In chapter 7, within
 - 60 days after “order for relief”
 - Or longer, if the Court finds cause on a motion filed within 60 days, 11 U.S.C. § 365(d)(1),
 - Chapters 9, 11, 12, or 13,
 - Any time prior to confirmation of a plan
 - But court can, upon a motion, order a specified period of time, 11 U.S.C. § 365(d)(2)
 - Non-residential leases where the Debtor is a lessee, within
 - 120 days
 - Can extend for an additional 90 days for cause on a motion by the Debtor. Any further extensions must be on consent of each applicable lessor. 11 U.S.C. § 365(d)(4)
 - This represents a change in the 2005 amendments to the Bankruptcy Code that has had a tremendous negative impact on retail reorganizations.
 - Non-residential leases where the Debtor is a lessor – no set time frame

Assumption/Rejection of Unexpired Leases - § 365

- Assumption

- Requirements

- Defaults

- Cure all defaults or

- “provide adequate assurance that the trustee will promptly cure” nonmonetary defaults if it is impossible to cure such nonmonetary defaults at assumption

- Compensates or provides adequate assurance that the trustee will promptly compensate, the lease party other than the debtor “for any actual pecuniary loss”

- Provides adequate assurance of future performance under the lease. 11 U.S.C. § 365(b)

- Default cure provisions do not apply to *ipso facto* defaults (*i.e.*, insolvency, financial condition, bankruptcy filing, appointment of a trustee, satisfaction of penalty rate or provision arising from a nonmonetary default)

Assumption/Rejection of Unexpired Leases - § 365

- Assumption and Assignment

- Generally, Debtor will seek to assign a lease if it can sell the lease for \$

- If Debtor is lessor, leases will be

- Over-market rates

- If Debtor is lessee, leases will be

- Under-market leases

- Requirements

- All assumption requirements;

- Assignee provides adequate assurance of future performance

- In practice, this means assignees will provide proof of adequate financing, revenue stream, experience in the industry, etc. 11 U.S.C. § 365(f)(2).

Assumption/Rejection of Unexpired Leases - § 365

- Rejection

- Upon rejection, the non-debtor party to the lease can file a proof of claim for damages. 11 U.S.C. § 502(g)(1)
 - Usually, the non-debtor lease party has a general unsecured claim.
 - But, the non-debtor party can seek administrative expense priority for any damages (e.g., missing rent payment) for the post-petition period to the extent they are “actual, necessary costs and expenses of preserving the estate” 11 U.S.C. § 503(b)(1)(A).
- Limitation on lessor damages: Claim may not exceed:
 - The rent 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 petition date]; and (ii) the date on which such lessor repossessed or the lessee surrendered, the leased property; plus”
 - “any unpaid compensation due under such contract, without acceleration, on the earlier of such dates.”

11 U.S.C. § 502(b)(7)

Assumption/Rejection of Unexpired Leases - § 365

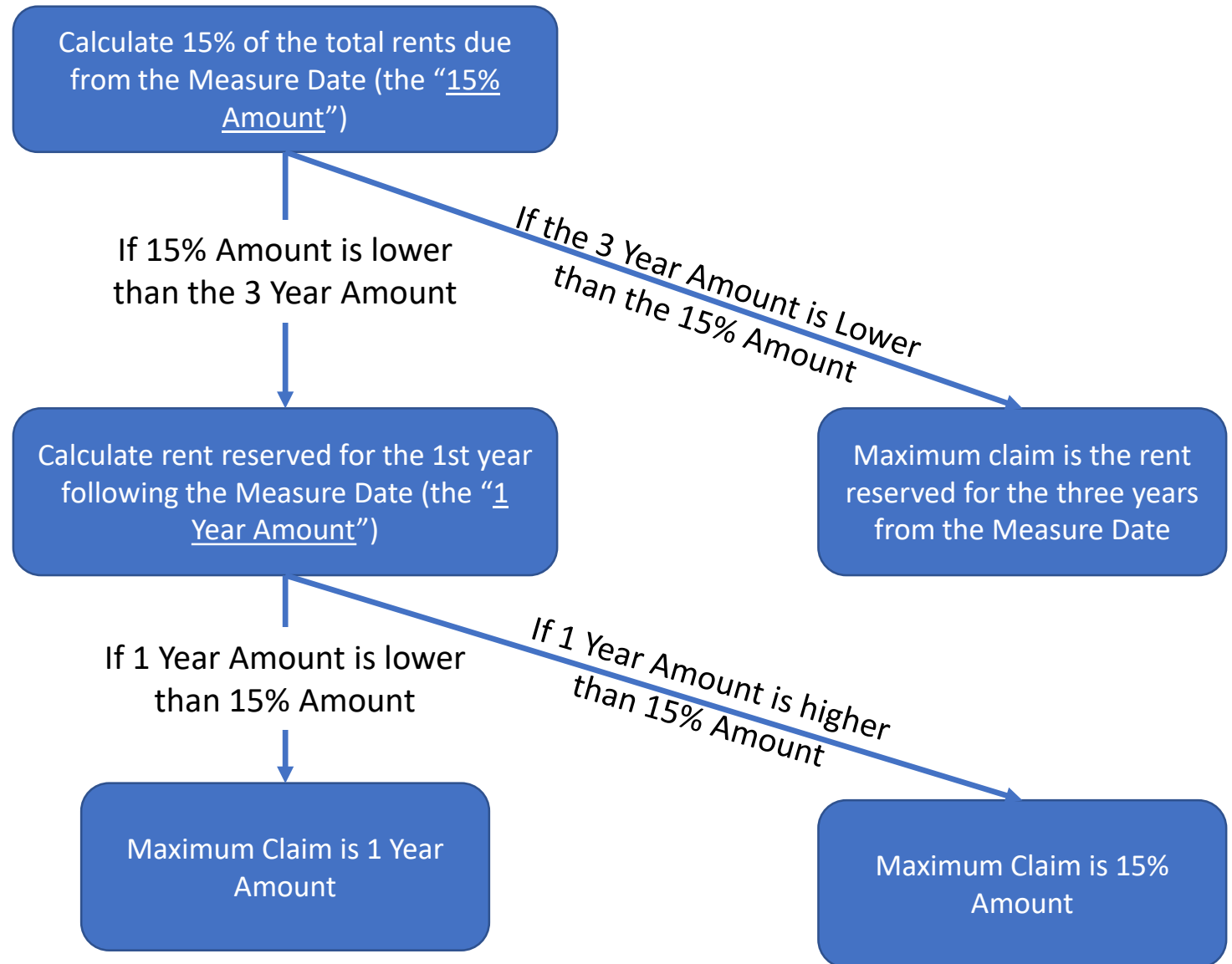
- Rejection

- Limitation on lessor damages

- “the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease . . .”
 - Majority Rule – “15 percent” = 15 percent of rent due, *see, e.g., In re Andover Togs, Inc.*, 231 B.R. 521, 545 (Bankr. S.D.N.Y. 1999); *In re Fin. News Network, Inc.*, 149 B.R. 348 (Bankr. S.D.N.Y. 1993);
 - Minority Rule – “15 percent” = 15 percent of the time (not to exceed three years), *In re Iron Oak Supply Corp.*, 169 B.R. 414, 420 (Bankr. E.D. Cal. 1994)
 - Each is analyzed in the next two slides:

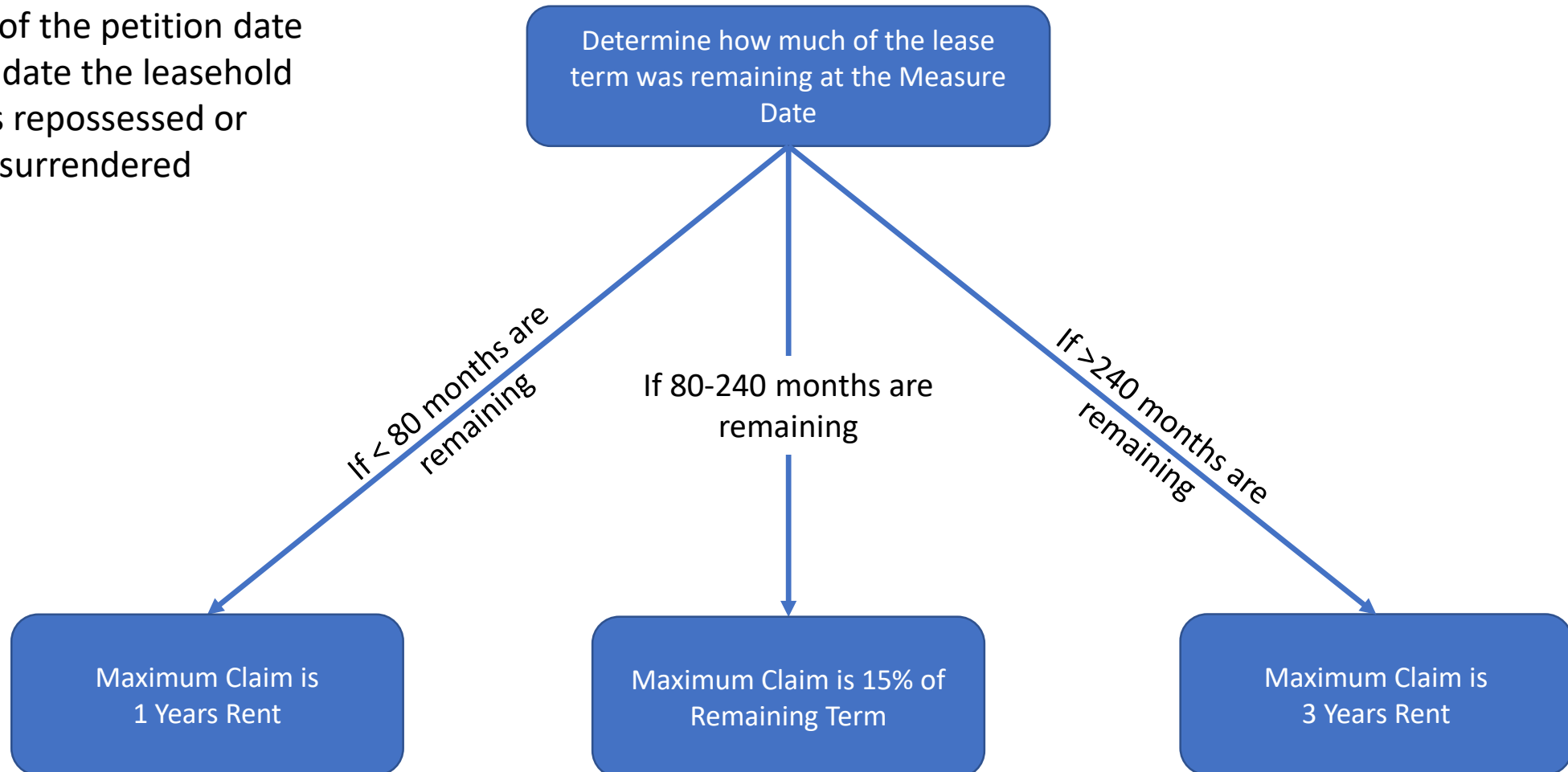
LANDLORD CLAIM FLOWCHART MAJORITY VIEW

“Measure Date” = the earlier of the petition date or the date the leasehold was repossessed or surrendered



LANDLORD CLAIM FLOWCHART MINORITY VIEW

“Measure Date” = the earlier of the petition date or the date the leasehold was repossessed or surrendered



Assumption/Rejection of Unexpired Leases - § 365

- 365(h) Protection

- Applies to lessees when lessors reject real property leases
- If a lessor rejects an unexpired real property lease
 - The lessee can treat the lease as terminated if allowed under non-bankruptcy law; or
 - If the term of the lease has begun, the lessee “may retain rights under the lease . . . 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” if enforceable under applicable non-bankruptcy law. 11 U.S.C. § 365(h)(1)(A).
- What rights are in or appurtenant? Examples:
 - Amount and timing of rent payment
 - Use, possession, quiet enjoyment
 - Subletting, assignment, or hypothecation

Assumption/Rejection of Unexpired Leases - § 365

- 365(h) Protection (continued)
 - What if its not clear whether a right is appurtenant?
 - Example:
 - You represent a lender giving a construction loan for a building where the builder is the ground lessee of the property.
 - The ground lease is 50 years with an option to purchase in year 49.
 - Case law is unclear as to whether an option to purchase is appurtenant.
 - Answer:

Assumption/Rejection of Unexpired Leases - § 365

- 365(h) Protection (continued)
 - What if its not clear whether a right is appurtenant?
 - Example:
 - ANSWER: We got the title insurer to insure that the option to purchase is appurtenant under the applicable state law.
 - If prime lessee rejects the prime lease, what happens to the sublessee?
 - Absent sublease recognition agreement with landlord, sublessee is probably SOL.
 - See Marc D. Rosenberg and Daniel N. Zinman, *Absent Sublease Recognition Agreement, the Rejection of a Prime Lease in a Bankruptcy Case Leaves a Sublessee Largely Out in the Cold*, 44 N.Y. Real Prop. L.J. 12 (Summer 2016). [Included with your materials].

Shopping Center Leases

- Special provisions protect parties to shopping center leases.
 - Note: Much of these provisions were from the 1984 amendments to the Bankruptcy Code.
 - With these provisions, Congress sought to “remedy the long-term vacancy or partial operation of space by a bankrupt tenant.” *Adelphia Bus. Solutions, Inc. v. Abnos*, 482 F.3d 602, n. 3 (2d Cir. 2007).
- What is a shopping center?
 - Not defined in Bankruptcy Code.

Shopping Center Leases

- What is a shopping center? (continued)
 - Leading case considers factors:
 - All leases held by a single landlord;
 - All tenants engaged in the commercial retail distribution of goods;
 - The presence of a common parking area;
 - The purposeful development of the premises as a shopping center;
 - The existence of a master lease;
 - The existence of fixed hours during which all stores are open;
 - The existence of joint advertising;
 - Contractual interdependence of the tenants as evidenced by restrictive use provisions in their leases;
 - The existence of percentage rent provisions in the leases;
 - Joint participation by tenants in trash removal and other maintenance;
 - Existence of a tenant mix; and
 - Contiguity of the stores.

In re Joshua Slocum Ltd., 922 F.2d 1081, 1087 (3d Cir. 1990).

WHAT ABOUT A CONDO OR MIXED USE PROPERTY WITH RETAIL IN THE BOTTOM FLOOR(S) AND APARTMENTS ABOVE?

FACTORS FAVORING

FACTORS UNCLEAR

FACTORS AGAINST

- What is a shopping center? (continued)

- Leading case considers factors:

- All leases held by a single landlord;
- All tenants engaged in the commercial retail distribution of goods;
- The presence of a common parking area;
- The purposeful development of the premises as a shopping center;
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In re Joshua Slocum Ltd., 922 F.2d 1081, 1087 (3d Cir. 1990).

Shopping Center Leases

- 365(b)(3)

- Recall – assumption/assignment of an unexpired lease requires the debtor to provide adequate assurance of future performance.
- Shopping Center lease adequate assurance when there's been a default, includes adequate assurance:
 - Of the source of the rent and other consideration due under the lease;
 - If there's an assignment, of the financial condition and operating performance of the assignee as compared with the debtor and guarantor (if any) when lease was signed;
 - That the percentage rent due will not decline substantially;
 - That assumption or assignment is subject to all provisions of the lease, including 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
 - That assumption or assignment will not disrupt any tenant mix or balance in such shopping center.

Shopping Center Leases

- 365(b)(3) (Continued)

- Shopping Center lease adequate assurance when there's no default:

- Adequate assurance of future performance by assignee.

- What about assumption or assignment is subject to all provisions of lease, including use provisions? One aggressive case:

- Facts:

- Debtor attempted to assign an unexpired lease to a discount retail clothier.

- Lease provision required that the premises be used only for an auto parts store and be operating only under the debtor's trade name.

- Held:

- Not assignable based on provision requiring the space to be used by an auto parts store.

- No ruling on the use of the debtor's trade name, as that was waived by the landlord.

Congress Fin. Corp. v. West Town Ctr. LLC (In re Trak Auto Corp.), 367 F.3d 237 (4th Cir. 2004).

The *Qualtech* problem: 363(f) sale v. 365(h) protections

- Section 363(f) allows the sale of property of the debtor free and clear of all liens claims and encumbrances if:
 - (1) Under non-bankruptcy law, the sale can be free and clear of such interest;
 - (2) consent of the interest holder;
 - (3) If the interest is a lien, the sale price is greater than all liens on the property;
 - (4) the interest is in bona fide dispute; or
 - (5) the interest holder could be compelled by a court to accept a monetary satisfaction.
- Section 363(e)
 - If a party in interest requests, the court shall prohibit or condition the sale of the property as necessary to provide adequate protection of interests in the property.

The *Qualitech* problem: 363(f) sale v. 365(h) protections

- Can a Debtor sell real property free and clear of an unexpired lease, bypassing 365(h)'s right for the lessee to stay in possession?
 - *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003)
 - Landmark decision saying that leases are “interests” in real property and Debtors can sell free and clear of such interests.
 - It appears that no party requested Section 363(e) adequate protection.
 - Some cases agree. *See, e.g., Pinnacle Rest. at Big Sky, LLC v. CH SP Acquisitions (In re Spanish Peaks Holdings II, LLC)*, 872 F.3d 892 (9th Cir. 2017).
 - There are contrary cases. *See, e.g.:*
 - *In re Patriot Place, Ltd.*, 486 B.R. 773 (Bankr. W.D. Tex. 2013) (real property cannot be sold free and clear of a lessee's interest under Section 365(h)).
 - Middle ground example:
 - *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696 (S.D.N.Y. 2014) (real property can be sold pursuant to Section 363 free and clear of a lessee's interest, but Section 363(e) adequate protection could take the form of continued possession).

The *Qualitech* problem: 363(f) sale v. 365(h) protections

- Practice Suggestions:
 - Record the Lease
 - Lease in *Qualitech* was not recorded.
 - This may protect the lessee under the first category of 363(f), allowing a sale free and clear of interests where applicable non-bankruptcy law permits the sale of the property free and clear of the interest. *In re Bedford Square Assocs., L.P.*, 247 B.R. 140 (Bankr. E.D. Pa. 2000).
 - If you record the lease, that likely avoids this provision.
 - Still might fall afoul of 363(f)(5) – allowing a sale free and clear of interest where a court can order a money satisfaction.

The *Qualitech* problem: 363(f) sale v. 365(h) protections

- Practice Suggestions: (continued)
 - Leasehold Mortgagee Should Obtain Right to Assert 363(e) Adequate Protection
 - Even if 363(f) allows the property to be sold free and clear of the lease, 363(e) provides for adequate protection, but only if a party in interest requests it.
 - If the lease is fully encumbered by a leasehold mortgage, the lessee may not have an interest in asserting adequate protection.
 - Leasehold mortgagees should obtain power of attorney to assert such rights.