Originally published in volume 44, number 3 of the Summer 2016 edition of the N.Y. Real Property Law Journal, a publication of the Real Property Law Section of the New York State Bar Association.

Absent Sublease Recognition Agreement, the Rejection of a Prime Lease in a Bankruptcy Case Leaves a Sublessee Largely Out in the Cold

By Marc D. Rosenberg and Daniel N. Zinman

As a recent decision by Bankruptcy Judge Robert Drain of the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") in the *A&P* bankruptcy case highlights,[1] sublessees are largely powerless to remain in possession of the subleased premises when the sublessor rejects its primary lease in the sublessor's bankruptcy case, at least in the absence of a sublease recognition agreement between the sublessee and the primary lessor.

Background

When A&P, a longtime supermarket operator, commenced its second bankruptcy case in approximately five years, it did so with the goal of winding down its business and liquidating its assets. It simply could not profitably operate as a supermarket chain any longer. Among its most valuable assets were hundreds of real property leases for properties on which A&P operated its supermarkets. A&P's primary secured lenders agreed to fund A&P's orderly liquidation, provided that it was conducted in accordance with strict sale related milestones reflected in the parties' financing agreements. Promptly after filing for bankruptcy, the Bankruptcy Court granted A&P permission to conduct a sale process for its real estate leases designed to monetize the value of such assets.[2]

One of the leases subject to the sale process (the "Supermarket Lease") covered a property located in New York City that had an initial term expiring in 2024, with renewal options totaling nearly another 24 years.[3] A&P had previously subleased about 9% of the property to a third party (the "Supermarket Sublease") for five years, plus renewals for an additional 8.5 years. After conducting a thorough sale process, A&P decided to reject the Supermarket Lease pursuant to an agreement with the primary lessor (the "Landlord").[4]

Typically, if the rent provided for under a lease is above market, no one would bid on the lease and the lessee would reject the lease, leaving the lessor with an unsecured claim for breach of the lease.[5] If the rent due under the lease is below market, however, the lessee could assume and assign the lease to a third party for value. Here, the Landlord was sufficiently concerned with the possibility that a third party might pay value to acquire the Supermarket Lease that the Landlord agreed to pay A&P to reject the Supermarket Lease in consideration for two payments: $10.5 million after entry of a final order approving the lease rejection and an additional $10.5 million (minus any litigation costs incurred in connection with any eviction action) after the sublessee under the Supermarket Sublease (the "Sublessee") had surrendered or been dispossessed of the property.[6]

A&P filed a motion seeking the Bankruptcy Court's approval of its decision to reject the Supermarket Lease. To approve a debtor's decision to reject an unexpired lease, bankruptcy courts typically apply a "business judgment" test—similar to a state law "business judgment" standard of review of corporate decision making—but one in which the court is quite deferential to the views of the major stakeholders in the bankruptcy case.[7] Here, only the Sublessee objected to the motion. Given the support of the other stakeholders in the case and the fact that the Landlord's bid represented the only bid A&P received for the Supermarket Lease, the Bankruptcy Court readily agreed that A&P exercised good business judgment in rejecting the Supermarket Lease in exchange for the payments from the Landlord. The more difficult questions facing the court concerned the Sublessee's post-rejection possessory rights. The Sublessee made a series of arguments in support of its contention that it had the right to continue to possess the subleased premises, notwithstanding A&P's rejection of the prime lease.

The Voluntary Surrender Doctrine

First, the Sublessee relied upon New York's voluntary surrender doctrine, which is a fact-based common law exception to the general rule that a sublease does not survive the termination of the prime lease. The voluntary surrender doctrine applies to protect the sublease where the landlord and the tenant agree to the voluntary surrender of the prime lease[8] and is intended to prevent the landlord and prime lessee from colluding to deprive the subtenant of its rights under the sublease. The doctrine does not protect the sublease, however, from the termination of the prime lease because of the prime lessee's breach.[9]

One example of the application of the voluntary surrender doctrine is the seminal case of *Eten v. Lyster*,[10] in which a landlord paid a tenant to surrender his lease and vacate the premises and then sued the sublessee for possession. The New York Court of Appeals ruled that although the "expiration of the term of the [prime]

lease in any of the ways provided for" in the prime lease (*e.g.*, expiration of the term or a breach of lease by the lessee) would have ended the sublease, the prime lease came to an end because of the surrender of the lease by the prime lessee.[11] Accordingly, the subtenant was entitled to continued possession and the prime lessor became the immediate landlord of the subtenant under the same terms and conditions as the sublease.[12]

In the A&P case, the Sublessee argued that the agreement between the Landlord and A&P to reject the Supermarket Lease in exchange for a monetary consideration from the Landlord was effectively the same as the voluntary surrender in *Eten v. Lyster* and its progeny. Despite the fact that both A&P and the Sublessee requested that the Bankruptcy Court issue a binding ruling on the application of the voluntary surrender doctrine, the Bankruptcy Court ruled that it was precluded from doing so under the decision of the United States Court of Appeals for the Second Circuit in *Orion Pictures*.[13] In *Orion*, the Second Circuit held that a motion to reject a lease under section 365 of the Bankruptcy Code is a summary proceeding, under which there is no prolonged discovery or lengthy trial with respect to disputed factual issues. Given those limitations, the Bankruptcy Court refused to issue a binding ruling on whether the voluntary surrender doctrine applies in the context of a section 365 lease rejection motion, leaving the issue to be resolved in state court between the primary Landlord and the Sublessee.

The Bankruptcy Court did express a non-binding view of the merits, however. Given that one-half of the consideration payable by the Landlord to A&P was contingent upon removal of the Sublessee from the premises, the Bankruptcy Court considered the likelihood of the Landlord's success on the issue in order to rule on whether A&P was exercising good business judgment in agreeing to the Landlord's terms.[14]

The Bankruptcy Court ruled that A&P did exercise good judgment in this regard, concluding that it believed that a state court would likely rule that the voluntary surrender doctrine is not triggered by a lease rejection pursuant to section 365 of the Bankruptcy Code. The Bankruptcy Court believed that the rejection was not "voluntary" given that A&P was pursuing an expedited liquidation strategy and that A&P, after a thorough marketing process, agreed to accept valuable consideration from the Landlord to reject a lease. Also, a rejection of the contract under section 365 amounts to a breach of the lease, not a termination.[15] If other courts follow the Bankruptcy Court's views on the application of the voluntary surrender doctrine, absent actual collusion between the prime lessor and prime lessee, a sublessee would not be able to use the voluntary surrender doctrine to protect its sublease in the event of a rejection of the primary lease by the primary lessee.

The Application of Section 365(h)(1)(A)(ii) to the Sublessee

In the alternative, the Sublessee argued that section 365(h) of the Bankruptcy Code protected its possessory rights. Section 365(h) contains statutory protections for lessees where lessors reject their leases in bankruptcy. Under section 365(h)(1)(A)(ii), if a debtor rejects an unexpired lease of real property in which the debtor is the lessor, then:

> if the term of such 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 bankruptcy law.[16]

Thus, if a debtor-lessor rejects a lease, the lessee may elect to remain in possession of the subleased premises for the balance of the term plus any renewals, with rent due at the contractual rate.

The Sublessee argued that A&P's rejection of the primary lease amounted to the rejection of the Supermarket Sublease, granting the Sublessee the right to remain for the balance of the Supermarket Sublease plus any renewals under section 365(h)(1)(A)(ii). The Bankruptcy Court disagreed. When A&P rejected the primary lease, it was obligated to surrender the premises to the Landlord pursuant to section 365(d)(4). Interpreting section 365(h)(1)(A)(ii) such that the Sublessee was entitled to remain in possession of the subleased premises for the balance of the Sublease's term (plus renewals) would cause a conflict with the requirement of the primary lessee—A&P—to surrender the entire premises immediately. The Sublessee could hardly stay in the subleased premises after A&P had surrendered the premises to the Landlord.[17]

The Bankruptcy Court made one additional point in this regard. Recall that section 365(h)(1)(A)(ii) states that the lessee may retain its rights "under such lease." Thus, the Subtenant is limited to retaining its rights under its Sublease. Subject to a favorable state court ruling on the voluntary surrender doctrine, the Bankruptcy Court ruled that the Sublessee no longer had any rights once A&P surrendered the premises to the Landlord. Although, as noted above, a rejection of the lease pursuant to section 365 is a breach of the lease, not a termination, the Bankruptcy Court nevertheless held that the requirement

that A&P surrender the premises "is tantamount to termination as far as the subtenant's rights" under the Sublessee.[18] Once A&P rejected the Supermarket Lease and surrendered the premises, the Subtenant no longer had any meaningful right to possession from A&P. According to the Court, "a proper reading of section 365(h)(1)(A)(ii)'s reference to the [Sublessee's] rights 'under such [sub] lease' and section 365(d)(4)'s surrender requirement show that section 365(h) does not give the subtenant a meaningful election to remain in its former subtenancy when the debtor has rejected the overlease first or simultaneously with the sublease."[19] The Sublessee retained the right to seek relief against the Landlord in state court, but given the Bankruptcy Court's views concerning application of the voluntary surrender doctrine to the facts presented, the Sublessee's prospects do not seem overly bright.

Sublessee's Rights Under Section 363(e)

The Sublessee also attempted to invoke the Bankruptcy Code's protections for holders of property interests when a debtor sells property, arguing that A&P's rejection of the Supermarket Lease should be properly characterized as a sale. Under section 363 of the Bankruptcy Code, a debtor in possession, such as A&P, can seek to sell its property free and clear of all interests. That right, however, is subject to a number of restrictions, including section 363(e), which requires that the court "prohibit or condition such use, sale or lease as is necessary to provide adequate protection" of a third party's interest in the property being sold, used, or leased.

As the Bankruptcy Court pointed out, however, nowhere did A&P describe its lease rejection motion as a "sale," nor did A&P seek relief under section 363 of the Bankruptcy Code. Thus, the Bankruptcy Court could have ruled that there was no sale and ended its discussion of this issue. The Bankruptcy Court chose, however, to address this issue to the extent that the A&P could be said to have "sold" the Supermarket Lease to the Landlord.

In so doing, the Bankruptcy Court distinguished the case before it—in which the debtor was proposing to reject a lease—from a situation where the primary lessor of real property is the debtor and is seeking to sell the underlying real property free and clear of the lessee's interest in the real property. In the latter case, there is a split of authority as to whether a debtor can sell real property free and clear of a lease without affording the lessee the protections of section 365(h);[20] however, that was not the situation here. To the extent that anything was being "sold," according to the Court, it was the Supermarket Lease, not the underlying real property. In contrast, the Bankruptcy Court held that the Sublessee's property interest was in the Sublease and the real estate subleased pursuant to it. A&P was not "selling" that property, nor was it using or leasing it. Instead, A&P was rejecting the lease. Accordingly, the Bankruptcy Court held that the sublessee had no interest in property entitled to adequate protection.

Conclusion

As the foregoing discussion makes clear, a sublessee is unlikely to be able to remain in possession of the subleased premises if the sublessor rejects the primary lease in its bankruptcy case. To the extent possible, a sublessee, in negotiating a sublease, should require a sublease recognition agreement with the primary landlord whereby the primary landlord agrees to recognize the sublease if the primary lease is rejected or otherwise breached by the tenant/sublandlord under circumstances not caused by the subtenant.[21]

Endnotes

1. *In re The Great Atl. & Pac. Tea Co., Inc.*, 544 B.R. 43 (Bankr. S.D.N.Y. 2016).
2. *See id.* at 47-48. In a chapter 11 bankruptcy case, a debtor may, subject to the bankruptcy court's approval, reject, assume, or assume and assign an unexpired lease. The purpose of giving a debtor such rights is to permit the debtor "to use valuable property of the estate and to 'renounce title to and abandon burdensome property.'" *In re Orion Pictures Corp.*, 4 F.3d 1095, 1098 (2d Cir. 1993). Ultimately, the decision whether to reject, assume, or assume and assign an unexpired lease is a matter of the debtor's business judgment, subject to court approval.
3. *Id.* at 45.
4. *Id.* at 48.
5. *See* 11 U.S.C. § 502(b)(6) (2012). Usually, lessor receives a poor recovery on such a claim, as the claim often will receive payment from the debtor's bankruptcy estate of only cents on a dollar of claim. In addition, the amount of the claim itself is capped by section 502(b)(6) of the Bankruptcy Code, which disallows claims arising from the rejection of real property leases 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.
6. *The Great Atl.*, 544 B.R. at 48.
7. *See id.* at 48-49. Usually, a debtor's major stakeholders are the debtor's creditors. Here, A&P's agreement with the Landlord had the support of both the debtor's secured creditors and its official committee of unsecured creditors (which represents the interests of all unsecured creditors).
8. Goldcrest Transp., Ltd. v. Across Am. Leasing Corp., 298 A.D.2d 494, 495, 748 N.Y.S.2d 411, 413 (2nd Dep't 2002).
9. *The Great Atl.*, 544 B.R. at 51.
10. 60 N.Y. 252 (1875).
11. *Id.* at 258-59.

12. *Id.* at 259.
13. *In re Orion Pictures Corp.*, 4 F.3d 1095 (2d Cir. 1993).
14. Another recent decision in the United States Bankruptcy Court for the Southern District of New York took a similar approach, citing to Judge Drain's decision in A&P. In *In re Sabine Oil & Gas Corp.*, No. 15-11835, 2016 WL 890299, *4 (Bankr. S.D.N.Y. Mar. 8, 2016), Judge Chapman, in allowing the debtor to reject certain pipeline and gas gathering agreements, refused to issue a binding ruling on the non-debtor parties' argument that the contractual covenants ran with the land (and thus would survive the debtor's rejection of the contract), but did examine the issue in the context of determining whether the debtor was exercising good business judgment in determining to reject the agreements.
15. *See In re Lavigne*, 114 F.3d 379, 386-87 (2d Cir. 1997).
16. 11 U.S.C. § 365(h)(1)(A)(ii) (emphasis added).
17. *The Great Atl.*, 544 B.R. at 52-53.
18. *Id.* at 53.
19. *Id.*
20. *Compare In re Patriot Place, Ltd.*, 486 B.R. 773 (Bankr. W.D. Tex.) (holding that real property cannot be sold pursuant to section 363 free and clear of a lessee's interest under section 365(h) *with Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (B.A.P. 7th Cir. 2003) (holding that a debtor can sell real property free and clear of leases, without necessarily giving the lessees the protections they have under section 365). *See also Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696 (Bankr. S.D.N.Y. 2014) (holding that a debtor can sell real property free and clear of leases, but the lessee's interest in the property must receive adequate protection under section 363(e)). A discussion of this issue is beyond the scope of this article.
21. Although the sublease between A&P and the Subtenant granted the Subtenant a right to terminate if it failed to receive a recognition agreement from the primary landlord within 60 days of the sublease's effective date, no such agreement was entered into between the parties and the condition was deemed waived.

Marc D. Rosenberg is a partner of and Daniel N. Zinman is an attorney associated with Golenbock Eiseman Assor Bell & Peskoe LLP. Mr. Zinman is also a co-chair of the Committee on Real Estate Workouts and Bankruptcy of the Real Property Law Section of the New York State Bar Association.

The Real Property Law Section is now accepting applications for its two law student scholarships in the amount of $5,000 each. The scholarships will be awarded in 2017.

REAL PROPERTY LAW SECTION LORRAINE POWER THARP SCHOLARSHIP

Through a gift from the Real Property Law Section, The New York Bar Foundation established the Real Property Law Section Lorraine Power Tharp Scholarship in 2008. The $5,000 scholarship is awarded to a second- or third-year law school student who best exemplifies the core values important to Lorraine: academic excellence, a demonstrated interest in public service, high integrity and, if possible, an interest in real property law.

The Scholarship was created to honor the memory of Lorraine Power Tharp, who served as President of the NYSBA and Chair of the Real Property Law Section.

Efforts will be made to honor Lorraine's commitment to gender equity and diversity in the profession. To ensure geographic diversity, the Foundation will strive to select students attending New York State law schools in different counties each year, so that over time students from all areas of the state will be able to benefit from the scholarship. A preference will be given to students who demonstrate financial need.

The Real Property Law Section Lorraine Power Tharp Scholarship application form has details on eligibility, requirements and the deadline.

Application Deadline: November 30, 2016.

PAST RECIPIENTS OF THE REAL PROPERTY LAW SECTION LORRAINE POWER THARP SCHOLARSHIP

2008 – Rufus Williams
2009 – n/a
2010 – Christopher R. Copeland
2011 – Milana Khlebina
2012 – Alissa Fortuna
2013 – Leanne Monique Welds
2014 – no scholarship awarded
2015 – no scholarship awarded
2016 – David Ullman—Columbia Law School

REAL PROPERTY LAW SECTION MELVYN MITZNER SCHOLARSHIP

Through a gift from the Real Property Law Section and Rosalyn Mitzner, The New York Bar Foundation established the Real Property Law Section Melvyn Mitzner Scholarship in 2013. The $5,000 scholarship is awarded to a full- or part-time student enrolled in a New York State law school.

The scholarship was created to honor the memory of Melvyn Mitzner, a legend in the New York real estate legal community. Mitzner is a former chair of the Real Property Law Section, and was an active and valued member of the Section for many years.

Efforts will be made to honor Mitzner's commitment to professional achievement and to diversity in the profession. To ensure geographic diversity, the Foundation will strive to select students attending New York State law schools in different counties each year, so that over time students from all areas of the State will be able to benefit from the scholarship. A preference will be given to students who demonstrate financial need.

The Real Property Law Section Melvyn Mitzner Scholarship application form has details on eligibility, requirements and the deadline.

Application Deadline: November 30, 2016.

PAST RECIPIENTS OF THE REAL PROPERTY LAW SECTION MELVYN MITZNER SCHOLARSHIP

2013 - Edward Hyde Clarke
2014 - no scholarship awarded
2015 - no scholarship awarded
2016 - Nicholas Zapp—Albany Law School

For more information and applications forms, go to www.nysba.org/realpropertyscholarships