

TREATMENT OF LEASES IN BANKRUPTCY

Kimberley H. Tyson, Esq.
Ireland, Stapleton, Pryor & Pascoe, P.C.
Direct: (303) 628-3698
E-mail: ktyson@irelandstapleton.com

A. Pre-bankruptcy Considerations.

1. Issues In Negotiating The Lease.

- a. Integrate all critical provisions into a single document. A debtor must assume or reject *all* provisions of a single lease. If separate documents are found to be separate contracts, a debtor could assume the favorable lease provisions but reject the more burdensome portions of the agreement.
- b. If the transaction could be re-characterized as a sale, instead of a lease, obtain security for damages for breach and promptly perfect the security interests. The risk here is particularly great where there is an option to purchase at the end of the lease, especially if the option is for a relatively negligible sum.
- c. In most respects, it is advantageous for the owner to have its property treated as a "shopping center" in the tenant's bankruptcy.

2. Workout Or "Pre-bankruptcy" Considerations.

- a. Consider drafting to trigger the termination of a lease as soon as possible to prevent assumption of the lease in bankruptcy. Be sure to check the terms to determine what, if any, notification is required prior to termination.
- b. Consider drafting to create automatic termination, not just automatic default. This allows for the argument that the lease terminated before bankruptcy and, therefore, cannot be assumed. This is especially important for *ipso facto* provisions based upon insolvency or the tenant's financial condition. These provisions are unenforceable after bankruptcy, but probably effective to give rise to a termination before the bankruptcy petition if all conditions of termination have occurred before the petition and no redemption or renewal provisions or protections of state law apply.

B. A Lease May Only Be Assumed With Court Approval And The Entire Agreement Must Be Assumed With All Defaults Cured.

1. In this district, court approval is *always* required to assume a lease; the debtor's conduct or oral assurances will not constitute implicit assumption, even when

there has been no default under the lease. *In re Swiss Hot Dog Co.*, 72 B.R. 569 (D. Colo. 1987). Although that is definitely the majority rule, a few other districts have ruled differently.

2. Except for certain *ipso facto* provisions, all defaults, including pre-petition defaults, must be cured for the debtor to assume the lease. 11 U.S.C. §§ 365(b)(1)(A) and (b)(2). In this important respect, parties to leases are better situated than undersecured lenders.
 - a. Alternatively, a debtor may attempt to provide "adequate assurance that the trustee will promptly cure" such default. 11 U.S.C. § 365(b)(1)(A).
 - b. The debtor can take advantage of the longer period to cure, whether it is provided under the lease or under state law, or it is the 60-day or 120-day automatic extension (of deadlines for debtors. 11 U.S.C. § 108(b). For instance, if notice of termination is required under the lease, and notice has been given, but the notice period has not expired, then a petition filed before expiration of the termination period will extend that period. *In re Gulfco Inv. Corp.*, 520 F.2d 741 (10th Cir. 1975). An option to renew or extend a lease that would have expired within the first 60 days of the bankruptcy is extended by the 60-day debtor's grace period. *In re Future Growth Enterprises, Inc.*, 61 B.R. 469 (Bankr. E.D. Pa. 1986). In addition, the Bankruptcy Code provides the court with power to extend the time for cure if equity requires, to effectuate the Bankruptcy Code's purposes. 11 U.S.C. § 105(a).
 - c. Despite the broad language of the statute requiring a debtor to "compensate [the other party to the lease] for any actual pecuniary loss to such party resulting from such default," (11 U.S.C. § 365(b)(1)(B)), post-petition attorney's fees of the landlord, in enforcing its bankruptcy rights, are not included and the court will not require the tenant/debtor-in-possession to pay the landlord's post-petition attorney's fees as a condition of assuming the lease. *In re Shangra-La, Inc.*, 213 B.R. 303 (Bankr. E.D.N.C. 1997). Pre-petition attorney's fees are recoverable as a default *if* they are specifically provided for in the lease.
3. To assume a lease in which there has been a default, a debtor must also provide "adequate assurance of future performance." Typically courts are not terribly rigorous on this requirement. A court will conduct "a pragmatic analysis taking into account the lessor's rights and expectations as they existed prior to the filing of the bankruptcy proceeding and adequately protecting such rights." *In re Grayhall Res., Inc.*, 63 B.R. 382 (Bankr. D. Colo. 1986). The landlord will not be permitted to use the "adequate assurance of future performance" requirement to improve its pre-petition position to the detriment of the debtor/tenant.

- a. A court might find it helpful if the parties, in the lease, have agreed upon what should constitute adequate assurance of future performance, such as a certain number of months' rent prepaid. The court will not be obligated to follow this, however, to the extent the parties have anticipated future exigencies, such a provision might provide useful guidance.
4. The Bankruptcy Code provides special protections to shopping centers by specifically defining the considerations for determining "adequate assurance of future performance" for a shopping center to include adequate assurance of similar financial condition of the prospective tenant, no substantial decline in percentage rent, continued compliance with provisions concerning radius, location, use or exclusivity, no breach of other leases or master agreements, and no disruption of "any tenant mix or balance in such shopping center." 11 U.S.C. § 365(b)(3).
 - a. It is helpful for a landlord to be able to claim to own a "shopping center," but the term is not defined. Cases have looked at indicia including: common ownership of contiguous property; anchor tenants; joint off-street parking; the presence of a master lease; fixed hours of operation; common areas; and joint advertising. *In re Joshua Slocum Ltd.*, 922 F.2d 1081 (3d Cir. 1990); *In re Goldblatt Bros., Inc.*, 766 F.2d 1136 (7th Cir. 1985). The parties might, therefore, want to include an express statement of the parties' understanding that the property is (or is not) a shopping center, where there might be some uncertainty. Again, this may not conclusively bind a court, but might be persuasive in a close situation.
 - b. Master Lease requirements that the space be occupied by a particular tenant may not be enforceable.
5. The decision whether to assume or reject is subject only to the "business judgment" test (*NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984)) and is, therefore, effectively wholly up to the debtor (assuming timing requirements are met). The views of a creditors' committee are, however, very likely to be carefully listened to by the court; this would be a reason why a landlord might want to agree to be a member of a creditors' committee.
 - a. Since all defaults must be cured, a landlord preferring its lease not be assumed would want to review carefully all possible defaults. A shopping center landlord has particular advantages in opposing assumption.
6. A debtor cannot partially assume a lease; the lease must be assumed in its entirety or not at all. Therefore, a debtor cannot pick the favorable provisions, and reject the unfavorable provisions.
 - a. Where, however, the court finds a single document contains undertakings beyond the central agreement, some courts have allowed the debtor to

assume the basic undertakings and reject the related agreements, such as purchase options or commission agreements. For instance, in *In re Gardinier, Inc.*, 831 F.2d 974 (11th Cir. 1987), *cert. denied* 488 U.S. 853 (1988), a debtor/seller assumed a \$5,000,000 real estate sales contract, but rejected the portion of the contract requiring payment of a 10% commission to the broker, because the court found the purchase-and-sale agreement was intended to be a separate contract from the commission agreement, *although they were contained in the same document*. The broker was left with an unsecured claim in the estate for damages for breach of the commission agreement.

- b. When drafting, include "non-severability" language, and set forth the parties' intent that each part of the agreement is dependent upon each of the other parts. Be especially careful about setting forth parts of an integrated transaction in separate documents – the part important to your client might be rejected as a separate agreement.
7. Certain "defaults" are excused. These *ipso facto* provisions include defaults for insolvency or the debtor's financial condition, filing a bankruptcy petition, or appointment of a custodian. 11 U.S.C. § 365(e). Curing these defaults is excused. 11 U.S.C. § 365(b)(2).
 - a. There are, however, reasons to include these provisions in leases. They are not illegal, nor are they viewed as an indication of oppressive intent. Further, these provisions remain effective outside of bankruptcy in pursuing obligations of non-debtor parties, such as guarantors whose liability arises upon default, even if the default is unenforceable against the primary obligor because of its bankruptcy filing.
8. If a lease or executory contract terminated prior to the bankruptcy petition, the court cannot revive it. *In re Trigg*, 630 F.2d 1370 (10th Cir. 1980).
 - a. This rule against bankruptcy revival of terminated contracts has generally been found to apply even to contracts terminated pursuant to default provisions that would be ineffective if the petition had been filed before the default provision became effective, such as *ipso facto* insolvency or financial condition requirements. If, however, the termination is not complete at the time of the bankruptcy, and the termination would be ineffective under 11 U.S.C. § 365(e), the termination will then be rendered wholly ineffective. *In re Lonepine Corp.*, 184 B.R. 370 (Bankr. D. Colo. 1995).
 - i. Defaults, particularly defaults that would be ineffective in bankruptcy under 11 U.S.C. § 365(3) should, if possible, occur either automatically, or at least automatically after notice, without a right to cure. For example, the clause enforceable in *In re*

Gordon Car & Truck Rental, provided: "In the event of the insolvency . . . of licensee . . . then this agreement shall automatically terminate, together with all rights and interests of licensee hereunder, without any notice to licensee." 59 B.R. at 957. This can sometimes be hard to negotiate. Although there are bankruptcy cases holding a bankruptcy will not stay the mere passage of time (*Moody v. Amoco Co.*, 734 F.2d 1200 (7th Cir. 1984)), a bankruptcy petition filed before expiration of an incurable notice petition gives the debtor an argument the default occurred post-petition because of an ineffective *ipso facto* clause. Allowing a cure provision will certainly allow the debtor to preserve the contract if the petition is filed before expiration of the permissible cure.

- b. By looking to state law, courts are generous to debtor/tenants in determining whether a lease terminated before the bankruptcy petition and, therefore, incapable of assumption. In Colorado, termination of a lease has been said to occur at the expiration of the time specified in a notice to quit (*Barlow v. Hoffman*, 86 P.2d 239 (Colo. 1938); *Aigner v. Cowell Sales Co.*, 660 P.2d 907 (Colo. 1983)), although specific language in the lease and the notice to quit might prevent this.
- c. Under the 2005 provisions, defaults which are impossible to cure, such as use of the property for an unauthorized purpose, will not have to be cured as long as the landlord's pecuniary losses resulting from such defaults are compensated. 11 U.S.C. § 365(b)(1)(A).

C. Rejection Of A Lease And Its Consequences.

1. Upon rejection of a lease, the debtor-in-possession or trustee must immediately surrender the property and the non-debtor party is entitled to damages.
 - a. Under the right circumstances, a debtor may seek to reject a lease retroactively to the date of the motion. *In re CCI Wireless, LLC*, 297 B.R. 133 (D. Colo. 2003).
2. A lessor's claim for damages from rejection of a lease is, however, limited under the Bankruptcy Code. This is the most significant disadvantage of structuring a transaction as a lease, as opposed to a sale with a carry-back loan. The lessor's claim for damages for rejection is limited to --
 - (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.

According to the legislative history, the claim limitation formula is applied first, before calculating the effects of a security deposit held by a landlord.

- i. In the rare instance where a landlord's security deposit exceeds its damages, the excess deposit must be turned over to the bankruptcy estate. Where the damages, as limited by the statutory formula, are more than the security deposit, the landlord's claim is split into a secured portion, to the extent of the deposit, and an unsecured claim. 11 U.S.C. § 506(a).
 - ii. It may be helpful to define all damages arising from breach of a lease as "rent," because only rent is recoverable from breach, and it would be helpful to start the formula with the largest possible number. The designation of all charges under the lease, including taxes, costs, attorney's fees and another financial covenant called a "residual guaranty," providing for a lump sum payment upon failure to exercise an option, was, however, not allowed to be included as "rent" for purposes of the statutory formula, despite what the bankruptcy court termed, "artful draftsmanship." *In re Storage Technology Corp.*, 77 B.R. 824 (Bankr. D. Colo. 1986). Also, the provision for attorney's fees might specifically include expenses incurred in bankruptcy.
 - b. A landlord will want to be sure the bankruptcy cap on damages is calculated based upon *money*, not *time*, particularly if there are provisions for rent escalation based upon inflation or the like. Calculation of the 15 percent limitation based on money has been allowed (*In re Gantos, Inc.*, 176 B.R. 793 (Bankr. W.D. Mich. 1995)), but other courts interpret the phrase "15 percent . . . of the remaining term of such lease," (11 U.S.C. § 502(b)(6)(A)), to refer only to time, thereby seeming not to take into account future rent increases. *In re Allegheny Int'l, Inc.*, 145 B.R. 823 (W.D. Pa. 1992); *In re Iron-Oak Supply Corp.*, 169 B.R. 414 (Bankr. E.D. Cal. 1994).
- 3. Administrative rent payments are not included in calculating the cap on damages, even though they reduce the actual damages incurred by the lessor. *In re First Alliance Corp.*, 140 B.R. 531 (B.A.P. 9th Cir. 1992); *In re Atlantic Container Corp.*, 133 B.R. 980 (Bankr. N.D. Ill. 1991).
 - 4. The formula limiting damages for breach of lease applies in the event of a guarantor's bankruptcy, even when the guarantor is not the tenant. If, however, the guarantor is not in bankruptcy, the guarantor does not get the benefit of the

formula limiting damages, even though the debtor/tenant gets the benefit of the limitation.

5. The 2005 amendments provide that if a debtor assumes a nonresidential real property lease and subsequently rejects it, 11 U.S.C. § 503(b)(7) grants the landlord an administrative expense claim for the amount of *all* monetary obligations it would have received in the two years following the date of actual turnover of the property minus only amounts actually received or to be received from a subsequent tenant. Additionally, the landlord is granted a pre-petition claim for *all* remaining sums due for the balance of the term of the lease.

D. Timing Of The Decision To Assume Or Reject.

1. Residential Real Estate Leases.

- a. Chapter 7. In a Chapter 7 case, all unexpired residential real estate leases are automatically rejected if not assumed within 60 days of the petition. 11 U.S.C. § 365(d)(1).
- b. Chapter 9, 11, 12 Or 13. In a Chapter 9, 11, 12 or 13 case, the trustee or debtor in possession has up to confirmation of a plan to assume or reject an unexpired lease of residential real property.

2. Nonresidential Real Estate Leases.

- a. What Is "Nonresidential"? Some courts hold *any* residential use makes the property not "nonresidential" despite some non-residential aspects. *In re Care Givers, Inc.*, 113 B.R. 263 (Bankr. N.D. Tex. 1989). Other courts reject incidental residential use where the dominant character of the property is non-residential. *In re Emory Properties, Ltd.*, 106 B.R. 318 (Bankr. N.D. Ga. 1989) (a hotel lease is nonresidential, although three employees lived on the premises); *In re Gasoil, Inc.*, 59 B.R. 804 (Bankr. N.D. Ohio 1986) (lease of oil and gas rights was nonresidential although the surface property was inhabited).
- b. Timing. A tenant's "nonresidential" real property lease is automatically rejected 120 days after the filing of the bankruptcy petition, unless the lease is assumed, or an extension of time to assume or reject is received.
 - i. Pursuant to 11 U.S.C. § 365(d)(4)(B)(i), the bankruptcy court may extend the 120-day period for 90 days only upon a showing of cause. Any additional extensions will be granted *only* upon prior written consent of the lessor.
 - ii. Further, the language indicates that the order must be entered *prior* to the expiration of the 120-day period.

3. Post-petition Performance. Until the lease is assumed or rejected, a debtor-in-possession/trustee must perform all obligations under the lease and the court may not extend the time for performance beyond the 60-day period. 11 U.S.C. § 365(d)(3). To obtain an extension of the 60-day period to assume or reject, a debtor/tenant must cure all post-petition defaults. As a consequence, debtors are frequently in haste to tender performance as they move to extend the time to assume or reject.
 - a. The rejection of the lease will not typically be effective until bankruptcy court approval of a debtor's motion to reject, so an administrative priority claim for the rent accrues until that ruling. In *In re CCI Wireless LLC*, 279 B.R. 590 (Bankr. D. Colo. 2002), *on reh'g*, 281 B.R. 319 (Bankr. D. Colo. 2002), *aff'd in part; rev'd in part* 297 B.R. 133 (D. Colo. 2003), the debtor sought to be able to reject the leases retroactively to the filing date of the case on the grounds it had either abandoned or been constructively evicted from the pertinent leaseholds. The bankruptcy court (and on appeal, the district court), however, permitted the retroactive rejection of these leases only to the filing date of the original rejection motion.
 - b. The statutory requirement to pay "all the obligations . . . after the order for relief . . . until such lease is assumed or rejected" applies to rent, common area and other charges, but does *not* include attorney's fees, even *post-petition* attorney's fees, to avoid forcing a debtor to finance its landlord's post-petition lease negotiations, a benefit not shared by any other creditors except secured creditors, as specified under 11 U.S.C. § 506(b).
 - c. Complicated questions of interpretation can arise in determining which of a debtor's obligations "aris[e] from and after the order for relief . . ." 11 U.S.C. § 365(d)(3). Most courts agree rent and other lease obligations, such as tax payments, should be prorated, regardless of when the payment was due. *In re Child World, Inc.*, 161 B.R. 571 (S.D.N.Y. 1993); *In re Washington Bancorporation*, 126 B.R. 130 (Bankr. D.D.C. 1991). Prorating would, however, be undesirable for the landlord dealing with a tenant in bankruptcy, for obligations payable in arrears, such as common area maintenance fees and property taxes. Some courts use a simplistic approach, looking only at the time when the payment was due. *In re CCI Wireless LLC*, 279 B.R. 590 (Bankr. D. Colo. 2002), *on reh'g*, 281 B.R. 319 (Bankr. D. Colo. 2002), *aff'd in part; rev'd in part* 297 B.R. 133 (D. Colo. 2003); *In re Duckwall-Alco Stores, Inc.*, 150 B.R. 965 (D. Kan. 1993).
 - i. Property taxes are a lien as of January 1 of the current year, and are not, therefore, an administrative claim for a bankruptcy filed during that year, but are, instead, secured by a perfected lien. *In re Western States Distribs., Inc.*, 179 B.R. 666 (Bankr. D. Colo.

1995). Taxes for the second year of the bankruptcy were found to be an administrative claim. Local government taxes for the second year of a bankruptcy will be secured by a perfected lien and also, perhaps, be an administrative claim as well. Most courts have not taken the all-or-nothing approach of the *In re Western States Distribs., Inc.* court. Instead, they have prorated the term of the obligation amounts which are billed after the bankruptcy petition, but which relate to time periods both before and after the petition. *In re All for a Dollar, Inc.*, 174 B.R. 358 (Bankr. D. Mass. 1994). This arises most often with tax obligations for which the landlord is entitled to be reimbursed by the debtor/tenant; courts have been reluctant to allow the fortuity of the timing of an invoice to cause all of such an obligation to be determined to be either a post-petition administrative priority, which would have to be paid in full, or a pre-petition unsecured claim, which would merely be subject to the ordinary distribution, if the lease is not assumed. A minority of courts have followed the "billing date" theory to impose the entire tax bill on a debtor/tenant when the tax came due after the bankruptcy petition, citing the language of the statute concerning obligations from and after the order for relief. *In re Appletree Markets*, 139 B.R. 417 (Bankr. S.D. Tex. 1992).

4. Non-debtor Parties. An executory contract or lease remains enforceable against the *non*-debtor party, even before a debtor has assumed or rejected it. *In re Feyline Presents, Inc.*, 81 B.R. 623 (Bankr. D. Colo. 1988).
 - a. A landlord cannot, however, be compelled to provide services or supplies to a debtor/tenant unless the landlord is compensated under the terms of the lease for any services and supplies provided under the lease, where there has been a default under the lease. 11 U.S.C. § 365(b)(4). Even in leases where there is no non-bankruptcy reason separately to specify charges for services and supplies, this would be a reason to state a charge for services and supplies as a separately specified item.

5. Surrender Of The Leased Property. Failure to act within the time period allowed for assumption results in the automatic rejection of the lease. The statute seems to contain a kind of automatic FED order stating, if the lease is not assumed or rejected within the specified period, "then such lease is deemed rejected, and the trustee shall immediately surrender such nonresidential real property to the lessor." 11 U.S.C. § 365(d)(4).
 - a. Based on this language, some courts will include, in an order rejecting a lease, language allowing the lessor to regain possession immediately. *In re Elm Inn, Inc.*, 942 F.2d 630 (9th Cir. 1991); *In re Damianopoulos*, 93 B.R. 3 (Bankr. N.D.N.Y. 1988); *In re Hurst Lincoln Mercury, Inc.*, 70 B.R. 815 (Bankr. S.D. Ohio 1987).

- b. If, however, the bankruptcy court has not included such language in its order dealing with assumption or rejection of the lease, or if the lease has been "deemed rejected" by passage of time, the prudent course would seem to be to seek relief from the automatic stay under 11 U.S.C. § 362(d)(2), to obtain the court's blessing for bringing a state court FED, or taking whatever other self-help might be appropriate. State courts handling an FED often expect to see such a "comfort order."
6. Effect Of The Statement Of Intent. New 11 U.S.C. § 362(h) provides that if an individual debtor does not (a) timely file a statement of intention as to leased property or secured personal property, (b) redeem or reaffirm debts as to personalty with 30 days after the first meeting of creditors, or (c) timely assume an unexpired lease, the automatic stay terminates as to that property. If a creditor does not agree to the proposed terms of a reaffirmation agreement, however, the stay will continued until either the issue is resolved or the creditor seeks and is granted relief from the stay.

E. Leases May Be Assigned Regardless Of Non-assignment Provisions.

1. Regardless of provisions prohibiting assignment, leases may be assigned, but the court must find there is adequate assurance of future performance by the assignee. 11 U.S.C. § 365(f). The lease must first be assumed, which means all defaults must be cured. Assignment affects a novation, releasing the debtor from any liability after the assignment. 11 U.S.C. § 365(k). The lessor may require "a deposit or other security for the performance of the debtor's obligations under the lease substantially the same as would be required by the landlord upon the initial leasing to a similar tenant." 11 U.S.C. § 365(l).
2. Only executory contracts and leases that can be assumed may be assigned. Agreements cannot be assumed where "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to a party other than the debtor in possession. . ." 11 U.S.C. § 365(c)(1).
 - a. This would typically involve positions of special trust (*In re Harms*, 10 B.R. 817 (Bankr. D. Colo. 1981)), a non-delegable personal services contract, or an executory contract that is non-assignable under state law or non-bankruptcy federal law. 11U.S.C. § 351(c)(1); *In re West Electronics, Inc.*, 852 F.2d 79 (3d Cir. 1988) (federal defense contract); *In re Alltech Plastics, Inc.*, 71 B.R. 686 (Bankr. W.D. Tenn. 1987) (patent license). Some leases fit in this category. *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983) (FAA controlled terminal leases, which could not be assigned).

- b. Merely stating in the agreement that assignment is prohibited is *not* effective.

F. Protection Of Tenants In Landlord Bankruptcies.

1. The Bankruptcy Code provides certain protections for tenants when a landlord files bankruptcy. If the debtor/landlord rejects a tenant's lease, the tenant has two choices. The tenant may either treat the rejection as a termination of the lease or, if the term of the lease has commenced, the tenant may retain its rights under the lease for the balance of the term of the lease. 11 U.S.C. § 365(h)(i)(A).
 - a. The balance of the term of the lease includes any renewal terms that are enforceable by the tenant but does not include renewal terms if the landlord has an option to terminate.
2. If the tenant chooses to remain in possession, it may offset the rent reserved under the lease against damages caused by the rejection, however, the tenant has no affirmative rights against the estate for any damages after the lease is rejected. 11 U.S.C. § 365(h)(1)(B).