



Bankruptcy, Reorganization, and Capital Recovery Alert

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Impact of New Bankruptcy Act on Real Property Leases

by David L. Pollack

Although most commentators and reporters have focused on the effect on consumers of passage of the Bankruptcy Abuse, Prevention and Consumer Protection Act of 2005 (S. 256) (the "Bankruptcy Reform Act" or "Act"), several sections of this Act will have an almost immediate and direct effect on bankruptcies involving non-residential real estate. These amendments may well change the landscape for landlords with regard to both the amount of time it takes to confirm a plan of reorganization as well as the options that a debtor will have with regard to its real property leases. The focus of this alert pertains to changes to Section 365 of the United States Bankruptcy Code (11 U.S.C. § 101, *et. seq.*, the "Code"). Three significant changes have been made to that Section: (1) the time a debtor has to assume or reject non-residential real property leases has been changed, (2) the provision concerning "anti-assignment" claims has been narrowed, and (3) certain non-monetary defaults are no longer incapable of cure.

Extensions of Time to Assume/Reject

Subsection 365(d)(4) of the Code currently provides that leases of non-residential real property under which the debtor is the lessee must be assumed or rejected within 60 days after the date of the order for relief "or within such additional time as the court, for cause, within such 60-day period, fixes." Today, virtually every request of a debtor for additional time to assume or reject a lease is granted. Indeed, it has been suggested that the term "cause" has become synonymous with "the request of a debtor." Although the legislative history of the 1984 amendments to Section 365(d) indicates that Congress had intended to shorten the time that debtors had to assume or reject leases, it is quite evident that the changes Congress made have not had the intended effect.

Accordingly, the Bankruptcy Reform Act changes subsection (d)(4) by extending the initial period of time to assume or reject leases from 60 to 120 days (or, if earlier, the date of entry of an order confirming a plan of reorganization), allows the court to extend the initial period of time for an additional 90 days "for cause" (without, once again, providing a definition of cause) and allows subsequent extensions only upon the prior written consent of the lessor. In other words, without the consent and cooperation of the landlord, the maximum time to assume or reject a non-residential real property lease is now 210 days. The current trend, whereby courts allow successive extensions of time for the debtor to assume or reject leases, effectively giving the debtor until confirmation of its plan of reorganization to assume or reject leases, is surely near an end, at least for those cases filed after the effective date of the Act.¹

Recognizing that the change to Section 365(d)(4) may force debtors to assume leases before they are absolutely sure that the leases are essential to the business of the reorganized debtor, thereby requiring a subsequent rejection, a new section was added to Section 503(b) of the Code.² Under the current law, if a lease is assumed post-petition and subsequently rejected, the landlord is entitled to an administrative claim for the entire balance of the term. That claim is not capped by the provisions of Section 502(b)(6).³ New subsection (7) of Section 503(b) now limits the administrative claim in such circumstances to the rentals due for the period of two years following the later of the rejection or actual turnover of the premises without reduction or set off for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor. Any remaining claim for sums owing and due for the balance of the term becomes an unsecured claim under Section 502(b)(6) of the Code, subject to the cap thereof. This new provision should reduce any detrimental effect of the premature assumption of leases that are later found to be a burden on the estate.



Narrowing the Effect of the Anti-Assignment Provisions

Although the changes to subsection 365(d)(4) have received the most attention, perhaps even more significant to non-residential landlords in general, and shopping center landlords in particular, is the change of one word and addition of two words to subsection (f)(1) of Section 365. Subsection (b)(3) provides that adequate assurance of future performance of a lease of real property in a shopping center⁴ includes various particular items as set forth in subparts (A) through (D) of that subsection. These include, *inter alia*, that assumption or assignment of a lease is subject to all of its provisions including, but not limited to, radius, location, use and exclusivity and that assumption or assignment of the lease will not disrupt any tenant mix or balance in such shopping center. Despite what would appear to be the specific mandate of subsection (b)(3), the courts have used subsection (f)(1), the “anti-assignment provision”, to override the provisions of subsection (b). *See e.g., In re Rickel Home Ctrs.*, 240 B.R. 826 (D.Del. 1998). In another case a district court in Massachusetts rejected the notion that Section 365(b) should take precedence over subsection (f) since the introductory language in subsection (f)(1) states “Except as provided in subsection (c) of this Section.” A notable exception to this line of cases was the fairly recent decision by the Court of Appeals in the *Trak Auto* matter [*In re Trak Auto Corporation*, 367 F.3d 237 (4th Cir. 2004)] wherein the Fourth Circuit held that bankruptcy courts should give deference to Congress’ intent in enacting the specific provisions of subsection (b) and enforce the lease’s use clause, notwithstanding subsection (f). The Bankruptcy Reform Act amends subsection (f)(1) to read “Except as provided in subsections (b) and (c) of this subsection.” Thus, Congress has made crystal clear its intent that the specific adequate assurance provisions of subsection (b) take precedence over the anti-assignment language of subsection (f)(1).

Non-Curable Non-Monetary Defaults

The final significant change to Section 365 of the Code appears in subsection (b)(1)(A) pertaining to the requirement that the debtor cure all defaults under the lease upon assumption. A body of law has developed with regard to non-curable non-monetary defaults. Some

courts have held that where a debtor has failed to perform under its lease, perhaps by ceasing operations, such a default could not be cured; and, therefore, the lease could not be assumed. The revisions to subsection (b)(1)(A) provide that breaches for failure to operate can be cured by the resumption of operation at and after the time of assumption. The landlord may also be entitled to compensation for its pecuniary loss resulting from such default.

Practical Results of Statutory Changes

What does all of this mean for commercial landlords in general, and shopping center landlords in particular? First, as noted above, the change to subsection 365(d)(4) should significantly decrease the amount of time for which there will be uncertainty for commercial landlords regarding the status of their leases in debtors’ estates. No longer will a debtor be able to extend the time to assume or reject its leases through confirmation of its plan of reorganization, a date which may be years after the filing of its voluntary petition, unless, of course, confirmation occurs within the first 210 days post-petition. Moreover, there should no longer be any question regarding a debtor’s ability to extend the time to assume or reject its leases beyond confirmation of its plan of reorganization.⁵ An important aspect of the change to Section 365(d)(4), however, is the ability of a debtor to secure additional extensions of time with the landlord’s consent. Landlords and debtor tenants will now be required to negotiate in order to accommodate the needs and desires of both parties. While a landlord may wish certainty with regard to particular leases, it may also find that that certainty is a lease rejection if it is unwilling to accommodate a debtor’s request for additional time to make a final decision. For example, if a landlord leases a borderline profitable store to a debtor tenant and the 210-day period expires in October, the debtor may be unwilling to make an assumption/rejection decision regarding that lease until after it sees the results of its sales during the holiday selling season. The landlord may, therefore, be forced to agree to an extension of time rather than lose the tenant for the balance of the year and have a dark store during that all-important season. Similarly, the tenant may find that the landlord believes that it can re-let the store easily to a preferable tenant and, therefore, is more than willing to run the risk of a dark store in order to secure the return of the premises. Under



those circumstances, the debtor will have to weigh the possible obligation of paying administrative rent on a rejected lease for a period of up to two years versus losing what may turn out to be a profitable location. Of course, this also puts the parties in the position of being able to negotiate any number of alternatives, including kick-outs for failure to meet sales thresholds, in order to accommodate the needs of both parties.

The shortening of time to assume or reject leases, especially when combined with the change to subsection (f)(1), is also likely to have an effect upon a debtor's ability to market and assign its leaseholds. Debtors will need to make determinations much earlier in the case if they want an opportunity to market their leases, lest they run up against the 210-day deadline and a landlord who refuses to grant any further extension. Additionally, it is quite likely that the development of the "designation rights industry," which has expanded greatly over the last several years, has been dealt a severe blow by these two amendments. It is not uncommon to see situations where a debtor continues to operate its stores for perhaps six months (three months of which consist of going-out-of-business sales) and then attempts to market the stores and sell designation rights, with the purchaser of the designation rights having the ability to designate the end user for a period of anywhere from six months to a year after acquisition of those rights. Obviously, a 210-day outside date for assumption or rejection, and a landlord that wants to control its own real estate, would force any debtor contemplating designation rights sales to move to a much shorter timetable. Indeed, for those cases where the debtor does not know at the outset of the case what it wants to do with its real estate, it is unlikely that it will have sufficient time to sell designation rights and, that if it does sell those rights on a shortened timetable, the value derived from such a sale is likely to decrease. Moreover, the designation rights purchaser now faces the obstacle of finding users who can fit within a lease's use clause, with much less likelihood of being able to convince a court that the use clause constitutes an anti-assignment provision under the terms of Section 365. This will likely have more of an effect on in-line stores rather than on big-box or anchor stores where the use clause may well be "any lawful use" (after some initial operating period).

Conclusion

While initially it may appear that the amendments to Section 365 favor the landlord, it should be noted that that was also the view following passage of the 1984 amendments. It did not take very long for debtors' counsel and the courts to put a different spin on the provisions of the amended Code and to shift the balance back in favor of debtors. While Congress has indicated a further intent to level the playing field, debtors' counsel will undoubtedly continue to look for ways to overcome the newest wrinkles in Section 365. It is incumbent upon both landlords' counsel and debtors' counsel to attempt to reach a middle ground such that the landlords' goal of maintaining occupancy and controlling its real estate is fairly balanced with the debtors' objective of maximizing its estate and reorganizing a viable entity.

¹ The effective date for these provisions will be 180 days after enactment.

² Section 503 pertains to allowance of administrative expenses.

³ Section 502(b)(6) places a limit on damages resulting from the termination of a lease.

⁴ Landlords of all leases are entitled to adequate assurance of future performance, but only shopping center landlords are afforded the specific protections of subsection (b)(3).

⁵ Because the 1984 amendments to the Code did not set a specific deadline for non-residential real estate leases to be assumed or rejected, some debtors have taken the position that they could assume or reject leases months, or perhaps years, after they confirmed their plans of reorganization. In the matter of *Bradlees Stores, Inc.*, a United States District Court Judge for the Southern District of New York reversed a decision of the Bankruptcy Court which allowed the debtor, *Bradlees*, the right to assume or reject leases for a long period of time post-confirmation, finding that it was certainly Congress' intent to shorten, rather than lengthen, the amount of time to assume or reject leases by enacting the 1984 amendments. Prior to the 1984 amendments, it was clear that confirmation was the outside date for assumption or rejection. When a similar issue was presented to the United States Bankruptcy Court for the Northern District of Illinois two years ago in the *Kmart* matter, that court also found that confirmation was the outside date for assumption or rejection.



If you have any questions about the information in this Alert, please contact David L. Pollack (215.864.8325 or pollack@ballardspahr.com).

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