The Shotgun Tenancy: The Fate of the Prime Landlord and Subtenant When a Bankrupt Tenant Rejects Its Lease in Bankruptcy

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SOPHISTICATED COMMERCIAL landlords and tenants are familiar with a tenant's right to reject its lease when it files for bankruptcy.[1] When the debtor-tenant rejects its lease, it negates its future obligations under the lease and leaves the landlord holding an unsecured claim for unpaid prepetition rent, a claim that typically yields pennies on the dollar, if anything at all.

The alternatives available to a tenant are very different when the landlord is the bankrupt debtor. When a bankrupt landlord seeks to reject a commercial lease, the tenant has the option under Section 365(h) of the Bankruptcy Code to either allow the lease to be terminated or to retain its rights to occupancy for the remainder of the term on the terms set forth in the lease.[2] While the landlord may negate its future service obligations,[3] the landlord cannot negate the tenant's right to remain in possession.[4]

1 See 11 U.S.C. §365(a).

2 11 U.S.C. § 365(h) provides: (h)(1)(A) If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and (i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection; or (ii) 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 nonbankruptcy law.

3 *See* 11 U.S.C. § 365(h)(2) and *In re Upland/Euclid, Ltd.,* 56 B.R. 250 (B.A.P. 9th Cir. 1985)

4 Where the tenant so elects, it may have a claim to offset against the rents due its damages for obligations under the lease which the

When the bankrupt tenant has sublet its premises, it is both a lessor and lessee.[5] If it does not exercise its right as a lessee to reject the Prime Lease but exercises only its right as a lessor to terminate the Sublease, it is subject to the Subtenant's right to remain in possession.

But when the bankrupt Prime Tenant rejects the Prime Lease, the Sublease is deemed to be rejected as well.[6] Under these circumstances, the question arises whether or not the Subtenant's right to remain in possession under Section 365(h) still applies.

The potential for continued occupancy by the Subtenant may come as a surprise to the Prime Landlord. This article will explore the potential application of Section 365(h) to this scenario, the widely differing conclusions reached by courts and the steps that landlords (and others in the capital stack) may take in their leasing, diligence and underwriting activities to avoid an undesirable result.

REAL PROPERTY ANALYSIS • Under typical real property law analysis, when a superior interest falls, the holder of the superior interest has the ability to extinguish the subordinate interest.[7] On this basis, where the Prime Lease terminates, the parties expect the Sublease to terminate with it.

SECTION 365(h) BANKRUPTCY • But when a bankrupt lessor elects to terminate a commercial lease, Section 365(h)(1)(A) permits the lessee to elect to "retain its rights under such lease . . . for the balance of the term of such lease . . . to the extent that such rights are enforceable under applicable nonbankruptcy law."[8]

Rights Relative to Subleases

Given the language of Section 365(h), is there anything left for the Subtenant to "retain" where the Prime Lease is terminated?

If Section 365(h) simply stated that the lessee could "retain its rights" and stopped there, one could view it as pre-empting state law and establishing a new right for subtenants to continue in occupancy without further analysis. But it does not. Rather, the ability to "retain" rights is limited "to the extent that such rights are enforceable under applicable nonbankruptcy law." In other words, state law governs whether there are rights to be retained. Both the legislative history and numerous court decisions indicate that Section 365(h) was not intended to create rights that do not otherwise exist under state law.

Before engaging in the state law analysis, however, courts first analyze whether the rejected Prime Lease is considered "breached" or "terminated" upon rejection. Where the Prime Lease is deemed "terminated", the Subtenant has nothing left to retain. Where the Prime Lease is considered "breached," both the Prime Lease and the Sublease remain in effect, unless there are other grounds to terminate them. In addressing this question, different courts have reached different conclusions:

"Breach" Decisions

The courts that find rejection of the Prime Lease to be a "breach" view the Prime Tenant's decision to reject the Prime Lease as merely an election not to assume an unfavorable obligation.[9] These courts reason that by not treating the Prime Lease as "terminated," the recovery rights of the

debtor landlord is failing to perform. See 11 U.S.C. § 365(h)(1)(B).

5 For purposes of this Article, we will call the landlord the "Prime Landlord", the tenant the "Prime Tenant", such lease the "Prime Lease", the subtenant the "Subtenant" and its sublease with the Prime Tenant the "Sublease".

6 11 U.S.C. § 365(d)(4) and *In re Stalter & Co., Ltd.,* 99 B.R. 327 (E.D. La. 1989). This is true whether or not the tenant expressly rejects the sublease.

7 *See* 74 N.Y. Jur. 2d Landlord and Tenant §317 (2016). *See also In re 48th Steakhouse Inc.,* 835 F. 2d 427 (2d Cir. 1987), *cert. denied,* 485 U.S. 1035 (1988). Of course, this is subject to exceptions such as where the parties have an agreement to the contrary, usually in the form of a non-disturbance agreement. There are also limitations on the parties' ability to voluntarily extinguish the superior interest in order to defeat the subordinate interest. *See, e.g.,* New York's voluntary surrender doctrine which prevents a landlord and prime tenant from colluding to voluntarily surrender a prime lease to effect a termination of the sublease. *Johns v. AMC Beauty Salon,* 905 N.Y.S.2d 501 (N.Y. Civ. Ct. 2010).

8 11 U.S.C. § 365(h)(1)(A)(ii).

9 *See, e.g., Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.),* 19 F. 3d 1077 (5th Cir. 1994).

Prime Landlord are preserved, albeit as limited by bankruptcy law.[10] One court reasoned that Section 365 does not expressly refer to "termination" when discussing a debtor's rejection of its lease, and points out that other provisions of the Code explicitly refer to rejection as constituting a termination when applied to these other obligations.[11] Also supporting the "breach" line of analysis is that Section 365(g) states "the rejection of . . . an unexpired lease of the debtor constitutes a *breach* of such . . . lease."[12]

Where rejection of the Prime Lease constitutes a breach (even though the lease may be terminable due to such breach[13]), the rejection of the Prime Lease by the bankrupt Prime Tenant does not immediately give the Prime Landlord the ability to terminate the subordinate interest, i.e., the Sublease. This result may simply postpone the inevitable though, as it may be just a matter of time before the Prime Landlord exercises its remedies to terminate the Prime Lease for the breach. At some point, either the bankruptcy itself or failure to pay accruing rent obligations will provide the basis for default leading to a termination.

"Termination" Decisions

Courts adopting this view interpret the rejection combined with a tenant's surrender obligation as extinguishing all rights in the subject property and affording no remedy for the Subtenant against the Prime Landlord.[14] These courts view the Prime Tenant's obligation to surrender and the Subtenant's potential right to remain in occupancy as "mutually exclusive" and find that rejection of the Prime Lease automatically effects a termination of the Sublease.[15] These courts have allowed the Prime Landlord to immediately recover possession from the Subtenant and the ability to "retain" rights under Section 365(h) of the Bankruptcy Code does not apply.[16]

BALANCING THE EQUITIES—WHICH APPROACH YIELDS A MORE EQUITABLE RESULT? • Where the Prime Tenant has sublet the premises at a profit, the issues discussed herein do not present themselves. The Prime Lease will be generating cash flow for the debtor's estate and will be viewed as an asset. The bankruptcy trustee, in fulfilling its role to maximize the value of the debtor's assets, is not likely to reject a profitable Prime Lease so we do not confront these issues. Only when the premises are sublet at a loss do these considerations come into play and this of course influences the balancing of the equities.[17]

Where the premises are sublet at a loss, permitting the Subtenant to retain its rights forces the Prime Landlord to accept a lower rent than it contracted for. Even if the Prime Landlord consented to the Sublease, its ability to withhold consent can be limited by several factors.[18] If forced to accept

10 See *In re Austin Dev. Co.,* supra, *cert. denied,* 513 U.S. 874 (1994).

11 See *Austin,* supra at 1082. However, in each of these other provisions of the Bankruptcy Code (*see, e.g.,* §§ 365 (h)(2) and (i) re: timeshare plans), it is the non-bankrupt counter-party to these contracts and not the bankrupt debtor that has the opportunity to consider these contracts "terminated." In the analysis before us, we are grappling with whether or not the bankruptcy trustee's rejection of the Prime Lease for the benefit of the debtor's estate effects a termination.

12 11 U.S.C. § 365(g) (emphasis added).

13 Note that "Ipso Facto" clauses permitting the lessor to terminate the Prime Lease based on the Prime Tenant's bankruptcy are generally unenforceable against the debtor (*see, e.g.* 11 U.S.C. §365(b)(2)), but more on this later.

14 *See, e.g., Matter of Stalter & Co., Ltd.,* supra; *380 Yorktown Food Corp. v. 380 Downing Drive, LLC,* 2012 WL 2360897 (N.Y. Sup. Ct. Mar 9, 2012).

15 *See, e.g., Keaty & Keaty v. Loyola Assocs. (Matter of Stalter & Co., Ltd.),* supra, 99 B.R. at 330.

16 A good discussion of the split of opinion on this issue is contained in *380 Yorktown Food Corp. v. 380 Downing Drive, LLC,* supra, 2012 WL 2360897, at *15, noting that even courts within the State of New York have reached different conclusions on this issue.

17 It is not unusual for subleased space to be rented at rates lower than directly leased space, in part due to the risks inherent in subletting space such as those described in this article. Similarly, when confronted with excess space, tenants are often more willing to drop the rent to mitigate their losses on unproductive space.

18 These factors may include: (a) the constraints imposed by a "reasonableness" standard contained in the Prime Lease, (b) its consent not being required at all under the terms of the Prime Lease itself, or (c) a desire to accommodate the Prime

the lower Sublease rent, the Prime Landlord likely did not have the opportunity to make a voluntary and informed decision to assume this risk and accept this result.

The Subtenant, on the other hand, did have the ability to make an informed choice. That it may not be able to remain in possession and may lose a favorable rent and its investment in the space is certainly an undesirable result for the Subtenant. But the difference is that the Subtenant's arrangement was entered into with the Prime Tenant and not the Prime Landlord. At the time of entering into the Sublease, the Subtenant had the opportunity to weigh the creditworthiness of the Prime Tenant (and resulting risk of forfeiture) against the favorable rent being obtained. Yes, circumstances may have changed in the interim, but the Subtenant had the ability to elect whether or not to condition its Sublease upon obtaining a non-disturbance agreement with the Prime Landlord.[19] If electing to proceed without such protection, a Subtenant prospectively considering entering into a Sublease transaction had the opportunity to knowingly make this choice. Between the Prime Landlord and the Subtenant, the Subtenant had a greater ability to control its own destiny and elect which risks to confront.

For the most part, the Bankruptcy Courts have not taken these equitable arguments into account in their decisions. One court simply stated that "Equity, common sense and the statute all point against [the Subtenant's] position."[20] This court also points out that the statute affords the tenant (in this case, the Subtenant) with remedies only against the debtor (i.e., the Prime Tenant) and not third parties (i.e., the Prime Landlord).[21] Another court articulating the equities more expansively came down strongly on the side of the Prime Landlord stating as follow:

> To allow a sublessor (sic), to whom the landlord has no privity of contract and whose Sublease is entirely dependent upon the continued viability of the Overlease, to be allowed, in effect, to step into the shoes of the direct tenant . . . though not under the terms of the Overlease but under the terms of a Sublease with which Defendant was not a party, flies in the face of the reasonable expectations of the parties. . . .[22]

PROPOSED SOLUTIONS • Regardless of where the courts come out, the Prime Landlord confronting this situation will still have certain remedies, although their application may be delayed. As previously mentioned, the Prime Landlord can still seek to enforce its remedies and terminate the Prime Lease, whether for the "breach" that results from the rejection of the Prime Lease or other subsequent defaults.

The Prime Landlord can put another arrow in its quiver by including an "Ipso Facto" clause in its commercial leases. This gives a party the right to terminate a contract if its counterparty is insolvent or files for bankruptcy. While these provisions are generally unenforceable against a bankrupt debtor under the Bankruptcy Code[23], they are enforceable against third parties, including subtenants.[24]

Tenant in its efforts to dispose of excess space. The Prime Landlord may also have reasonable anticipation of the continued payment of rent at the rates agreed to by the Prime Tenant only to later suffer a deterioration of the Prime Tenant's credit.

19 Prime Landlord's do not readily agree to give non-disturbance agreements. Where the Subtenant occupies merely a portion of the leased premises, recognizing the Subtenant as a direct tenant presents additional issues for the Prime Landlord. Even where the Subtenant occupies all of the leased premises for the balance of the term of the Prime Lease, the Prime Landlord may insist that the Subtenant observe the terms of the Prime Lease rather than any more favorable terms contained in the Sublease, including paying any higher rent contained in the Prime Lease, should the non-disturbance provisions come into effect.

20 See *In re Stalter,* supra, 99 B.R. at p. 330.

21 *Id.*

22 See *380 Yorktown Food Corp.,* supra, 2012 WL 2360897, at *23.

23 See 11 U.S.C. § 365 (e)(1).

24 See *Cahaba Forests, LLC v. Hay* 2012 WL 380126 (M.D. Ala. Feb. 6, 2012).

A sample "Ipso Facto" clause reads as follows:

> This Agreement shall terminate, without notice, (i) upon the institution by or against either party of insolvency, receivership or bankruptcy proceedings or any other proceedings for the settlement of either party's debts, (ii) upon either party making an assignment for the benefit of creditors, or (iii) upon either party's dissolution or ceasing to do business.

Since the Subtenant's ability to "retain its rights" under Section 365(h)(1)(A)(ii) is limited to rights that "are enforceable under applicable nonbankruptcy law", a termination of the Prime Lease under an "Ipso Facto" provision would extinguish the Prime Lease by its terms relative to the Subtenant thereby leaving no enforceable state law rights for the Subtenant to retain.[25]

Similarly, prospective purchasers of real property and investors in the capital stack, whether in the form of debt or equity, should look for an "Ipso Facto" clause when doing their diligence and add this requirement to their checklists for lease review and approval of form leases.

25 Presumably, such termination would not violate the automatic stay or any remedies relative to the Prime Tenant since by the time the Ipso Facto clause comes into play, the Prime Lease is already rejected and no longer property of the estate.