

## **LEASES - REMEDIES AND REQUIREMENTS IN BANKRUPTCY**

### **Introduction**

The Bankruptcy provisions concerning leases are, for the most part, contained in Section 365 of the Code, which section of the Bankruptcy Code sets forth provisions concerning Executory Contracts and Unexpired Leases. This is a complex section of the Bankruptcy Code. The interplay with Section 362 and the automatic stay should also be considered when dealing with leases in a Bankruptcy case. Also, whether or not a claim may be obtained under Section 502(b)(6) of the Bankruptcy Code following rejection of a lease or contract may vary depending upon the type of lease and what occurred during the course of a case.

With many new large retailers filing Chapter 11, leases are being canceled as part of the Bankruptcy proceeding. Often a large retail chain or restaurant chain will file Chapter 11 specifically for the purpose of rejecting and terminating leases. When retailing was prospering, favorable leases were often sold as a lease in bankruptcy may be transferred and assigned notwithstanding a provision in a lease which states otherwise.

In addition, if the debtor, who has filed bankruptcy, is actually the landlord, the treatment of a lease even though rejected may cause some difficulties for that debtor. This is because of the interplay between Section 365(h) of the Bankruptcy Code versus Section 363 of the Bankruptcy Code relating to sales.

### **Pre-Petition Actions in Landlord/Tenant Cases:**

- If the lease contains provisions which permit termination of the lease pre-Petition, upon a default, you should also consider sending a letter of termination to the tenant, even if the landlord does not wish to evict the tenant. This has an effect if and when the tenant files bankruptcy. In particular, Section 365(c)(3) provides that if there is a non-residential lease, and the lease has been terminated under non-bankruptcy law, there cannot be an assumption or assignment of any lease.

## **Leases may be assumed or rejected by the Trustee:**

- It should be noted that in a Chapter 13 or Chapter 11 case, the Trustee is really the debtor. There are also varying time frames for the treatment of leases and when they may be assumed or rejected, as is set forth below.

## **Lease Assumption:**

- An assumption of lease means that the lease will continue. The debtor, particularly business debtors, may wish to assume leases and keep leases in place. There are requirements for such assumption, however leases may be assumed and assigned.
- A lease can only be assumed if there is a cure of all defaults. In particular, this means, with a monetary default, a cure payment at the time of assumption must be made to bring the lease current. It should be noted, however, that it is very common to enter into negotiations with the landlord as to payments over time of the cure amount or some compromise of the cure amounts.
- If there is a non-monetary default and the default is not capable of being cured at the time of assumption or assignment of the lease, such cure need not occur at the time of assumption. These defaults may be some repair item, or some other such item.
- The debtor also has to provide adequate assurance of future performance under the contract. This would mean showing the feasibility of the assumption and that the debtor can continue to make payments.
- If the lease is a store in a shopping center, the assumption and assignment cannot change the tenant mix in a shopping center. The assignee must also show that percentage rent, if owed under the lease, would not substantially decline.

## **Leases That Cannot be Assumed or Assigned:**

- These include personal service contracts such as franchise agreements, athletic or artistic contracts. This issue particularly arises under franchise agreements where the franchisor can insist that any party who is to be an assignee. Often franchisors are the lessee and the debtor is a subleasee which raises additional issues. A lessee must meet the normal requirements for franchisees.
- As stated above, if a lease has been terminated, it is not capable of being assumed.

## **Time for Assumption:**

- Under Chapter 7, as set forth in Section 365(b)(1), an executory contract or lease of residential real property or personal property of the debtor must be assumed within sixty (60) days after the Order for relief. Consider though what Trustee would assume a residential lease. In actuality, such assumption almost never happens. Landlords almost never attempt to then argue that the lease is rejected.
- There is also a provision under Section 365(p)(2)(A) where the debtor can send a creditor or landlord a letter that the debtor desires to assume the lease. The creditor may then notify the debtor whether it wishes to have the lease assumed and if it then consents. Within thirty (30) days thereafter, the debtor can then state that the debtor wishes to assume the lease and therefore the debtor assumes it and not the bankruptcy estate. Generally, we can think of almost no situations where this procedure occurs.
- In Chapters 11, 12 or 13, residential real property and personal property contracts and leases may be assumed at any time up until the time of the confirmation of a Plan. Usually, in a Chapter 11 case, the lease assumptions occur as part of the Chapter 11 Plan.
- With respect to non-residential real property, such lease will be deemed rejected unless it is assumed within 120 days after the date of the Petition. A one-time extension is permitted for up to ninety (90) days. If an extension is needed, as a matter of practice, the request for the extension

must be approved by an Order prior to the expiration of the 120 days. This means that one should request the extension approximately thirty (30) days prior to the expiration of the 120 day period of time.

- With respect to unexpired leases of non-residential real property, until the lease is assumed or rejected, the Trustee (debtor-in-possession) must perform all of the various requirements under the lease (except for *ipso facto* clauses which is explained below).

### **Assignment:**

- Leases may also be assigned under Section 365. Typically, a lease will be assumed and then assigned. Valuable leases are often sold and subject to auctions. This particularly occurs with respect to shopping center leases or box store leases that have good locations or below market rent rates. Once the assignment occurs, the Trustee or the debtor is released from any further liability under the lease. The assignee must also provide adequate assurances of future performance.

### ***Ipso Facto* Clauses:**

- Clauses in leases and contracts which state that they are terminated in the event a default occurs upon a bankruptcy are void as set forth in Section 365(e)(1). Nonetheless, almost every lease or contract has such provision. You should be prepared to explain this to your client if you are negotiating a lease or contract.

### **Rejection Damages:**

- Normally upon a rejection under Section 365(g), one receives an unsecured claim as of the Petition date, unless the case has previously been converted and rejection then occurs. If the case has been converted, then one looks to the conversion date to determine the date and amount of the claim.
- Rejections raise issues as to an administrative claim potentially under Section 503(b)(7). Such Section provides that if there is a non-residential lease which has previously been assumed under Section 365, then the claim is allowed for all monetary obligations for a period of two years following

the later of the rejection date or the actual turnover of the property. This is a reason why debtors often do not wish to assume non-residential leases in Chapter 11 cases, as it may burden the estate with such larger sums that might otherwise be paid. Administrative claims need to be paid in full, arguably, at confirmation. In contract, in Chapter 11 cases unsecured claims are often paid very little.

- Section 502(b)(6) limits the amount of a rejection claim from a termination of a lease of real property. The limitation is rent owed for the greater of one year, or fifteen percent (15%), not to exceed three (3) years of the remaining term of the lease, plus any rents owed pre-Petition or up to the date of the premises being surrendered or repossessed.

### **Effect of Debtor Being the Lessor:**

- If the debtor is the lessor, if the lease is rejected, you cannot dispossess someone who is a tenant, but rather, the tenant may, at its option, remain in the premises. The non-debtor party also can treat the rejection as a breach and can, at its option, leave the premises.

### **Automatic Stay:**

- Of course, even if a lease is rejected, the landlord may not necessarily gain possession. The Code specifically says that if personal property is rejected, the stay is lifted. However, it states nothing about what happens after real estate lease rejections. Most likely, even following rejection, a lift stay motion should be filed. Normal state procedures should also be utilized to gain possession. This process can give rise to a matter of negotiation with the landlord as to the rejection terms.

### **Miscellaneous Provisions:**

- New deposits can be required if the lease is assigned following an assumption.
- What about hotel rents.
  - Is the hotel stay an actual lease of real estate or is it a license?
  - What if the hotel stay is for a long term period of time?

- Are the hotel charges “rents”?

Hotel rents also raise cash collateral issues (which are dealt with separately).