
**THE REAL PROPERTY LESSOR
AND THE BANKRUPTCY ABUSE PREVENTION
AND CONSUMER PROTECTION ACT OF 2005**

American Bankruptcy Institute
2005 Winter Leadership Conference
Indian Wells, California

December 3, 2005

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I. Unexpired Non-Residential Leases

1. The Cure Prerequisite to Assumption

a. Old Rule

In order to assume an unexpired lease, the debtor was required to do three things: (1) "cure, or provide adequate assurance that it will promptly cure" defaults, (2) compensate the non-debtor party to the contract for "actual pecuniary losses", and (3) provide adequate assurance of future performance. 11 U.S.C. § 365(b)(1).

In some cases, where the default is historical fact or requires continuous performance, it is impossible to cure, because the debtor can't turn back the clock. For example, if the lease has a provision against going dark, and the debtor ceases operations for a period of time, it would be impossible to go back in time and cure the default. Thus, the Ninth Circuit held *In re Claremont Acquisition Corp., Inc.*, 113 F.3d 1029 (9th Cir. 1997) that if there were incurable defaults, the debtor could not assume the lease.

b. New Rule

Section 365 has been revised to provide that as a prerequisite to assumption the debtor is not required to cure nonmonetary defaults that are impossible to cure, except if the default is failure to operate under a commercial lease, in which case the default is cured by performance at the time of assumption and going forward. 11 U.S.C. § 365(b)(1)(A). The landlord is also expressly entitled to "actual pecuniary losses" that result from any non-monetary breach, including a breach consisting of failure to operate.

The text of revised Section 365(b)(1)(A) is as follows:

"(A) cures, or provides adequate assurance that the trustee will promptly cure, such default, other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default

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arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph."

c. Issues under the New Rule Relating to Cure

i. Expansion of Class of Leases Capable of Assumption

Before the amendments it was impossible for debtors in some jurisdictions to assume certain unexpired leases because of the existence of nonmonetary breaches not capable of cure. These leases will now be assumable.

ii. Actual Pecuniary Losses

If the nonmonetary default consists of a "failure to operate in accordance with a nonresidential real property lease", then the default is cured by performance from the time of assumption going forward plus compensation for any "pecuniary losses resulting from such default." If state law does not provide for money damages for such a breach, is the lessor entitled to losses under the Bankruptcy Code? What is the measure of the pecuniary losses resulting from the breach of a lease provision that requires uninterrupted operations? Will a liquidated damages provision be enforceable?

2. Timing of Election to Assume or Reject Non-Residential Leases

a. Old Rule

Under Section 365(d)(4) the debtor had to assume a lease within 60 days, or the lease was automatically deemed rejected. However, the court could extend the 60-day period "for cause." The practical result was that courts frequently would give successive extensions of time, sometimes for years, rendering the deadline meaningless. The landlord was subjected to considerable uncertainty about when he could – or would have to – re-lease the premises.

b. New Rule

Under revised Section 365(d)(4) the debtor has twice as much time – 120 days – to make the elect to assume a lease, or the lease is automatically deemed rejected. The court still may extend the period "for cause," but the court may only give one 90-day extension. Any further extensions may be granted only upon the prior written consent of the landlord.

The text of Section 365(d)(4):

"(4)(A) Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of –

- (i) the date that is 120 days after the date of the order for relief; or
- (ii) the date of the entry of an order confirming a plan.

(B)(i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days on the motion of the trustee or lessor for cause.

(ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance."

c. Issues Under New Rules Relating to Timing of Assumption Election

i. Debtor May Be Forced to Make Premature Election

A debtor, in particular a debtor with many non-residential leases (such as a retail debtor), may develop a strategy of selling certain locations or closing underperforming stores. A debtor often does not know which locations it intends to sell or close until it is deep into the case – often far longer than the 120-day period, plus one 90-day extension for cause, provided in revised Section 365(d). Unless the lessor agrees in writing to a further extension, the new rule means that a debtor may have to make the election whether to assume or reject before it has enough information. An incorrect guess about whether to assume or reject can be costly for the estate. For example, it may not be prudent for a debtor to assume a lease unless it first locates a purchaser. If the debtor guesses wrong, and assumes a lease it ultimately determines it does not want, it can later reject the lease, but it may incur a substantial administrative expense. On the other hand, if the debtor rejects a lease, then discovers it could have sold the location, the debtor will have foregone the ability to reap the value of the lease for the estate.

ii. Bargaining between Debtors and Lessors

The bargaining dynamic changes. The debtor may need more time, and the lessor may extract payment in exchange for giving its written consent to an extension. The debtor's plea alone that more time is needed to formulate a plan before it will be ready to make an election regarding its leases will no longer be grounds for the court to extend the time to assume or reject for more than one 90-day extension. If the debtor needs more

than one 90-day extension, it needs the written consent of the lessor, who may extract some *quid pro quo* in exchange for giving such written consent.

iii. Designation Rights

Designation rights are the rights a third party acquires from the debtor to decide which of the debtor's leases the debtor will assume and assign or reject. The third party frequently needs as much or more time than the debtor to determine whether any particular lease should be assumed or rejected. Therefore, unless the debtor can secure a lengthy extension of time to assume or reject (and the requisite written consent of its lessors), otherwise interested parties may be unwilling to acquire designation rights, to the detriment of the estate.

3. Claims

a. Cap on Rejection Claims Unchanged

If the debtor rejects an unexpired lease, the lease is deemed breached, the breach is treated as though it occurred pre-petition, and the landlord is entitled to a claim for damages for breach as determined under state law. Assuming the landlord has no collateral, the claim is a general, unsecured claim. The issue is – how large of a claim is the landlord entitled to? The theory is that if the landlord is entitled to the full measure of damages, the claim could be huge and dwarf other general, unsecured claims. For example, if the lease is for 30-years and has been in effect for only one year, the landlord might be entitled to damages under state law (subject to rules of mitigation) for 29 years of rent reserved under the lease. Therefore, section 502(b)(6) of the Bankruptcy Code imposes a limit, or cap, on the amount of the lessor's claim. Specifically, the claim may not exceed "(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." 11 U.S.C. § 502(b)(6). The cap on rejection damages imposed under section 502(b)(6) does not change under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

b. Claims Based on Rejection Subsequent to Assumption

From time to time a debtor may assume a lease, and subsequently reject the same lease. This might occur because of changed circumstances, or because the debtor misjudged circumstances and made an improvident decision. Presumably the lease was cured at the time of the initial assumption. Upon rejection is the landlord's claim subject to the cap of section 502(b)(6), or does the initial post-petition assumption take it out of the purview of the claim cap?

- i. Old Rule – The vast majority of cases held that that when a debtor assumed a lease, then later breached the lease – whether through failure to comply with the terms of the lease or as a result of a subsequent rejection – the lessor was entitled to a damage claim that was not subject to the cap of section 502(b)(6). In addition, the full amount of damages were entitled to priority as an administrative claim. E.g., *In re Multech Corp.*, 47 B.R. 747 (Bankr. N.D. Iowa 1985). But at least one case held that a lessor's claim for breach of a lease that was assumed before it was rejected is not entitled to administrative priority. *In re Johnston*, 164 B.R. 551 (Bankr. E.D. Texas 1994).
 - ii. New Rule – The old rule could result in a windfall for the lessor. The payment of a large administrative claim to the lessor would frequently result in reduced funds available to pay general, unsecured creditors. The Bankruptcy Abuse Prevention and Consumer Protection Act added section 503(b)(7), which provides that the lessor is entitled to an administrative claim but in an amount subject to a cap. Specifically, the lessor is entitled to an administrative claim in "a sum equal to all monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, for the period of 2 years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor. . ." The balance of the lessor's damage claim is a general, unsecured claim subject to the cap of section 502(b)(6).
- c. Issue Under New Rule Relating to Lessor's Claims Under a Lease that Is Assumed then Rejected

The lessor's administrative claim may not be reduced or setoff "except for sums actually received or to be received from an entity other than the debtor. . . ." If the landlord finds a new tenant, it seems clear this language would allow the debtor to reduce the lessor's administrative claim by the amount of rent that will be paid by the new tenant. It is less clear whether the lessor has an affirmative duty to attempt to mitigate its damages by finding a new tenant. Section 503(b)(7) says the lessor's is "without reduction or setoff *for any reason whatsoever* except for sums actually received or to be received. . . ."

If the lessor has a guarantee, but has not yet received payment from the guarantor, may the debtor reduce the lessor's claim by sums "to be received" from the guarantor? How certain must the payment be before the lessor's claim will be reduced?

II. Relief from Stay

1. In Rem Relief

a. Multiple Filings; Fraudulent Transfers

In rem relief from stay orders are now expressly authorized under Section 362(d)(4) if the court finds that the bankruptcy filing was "part of a scheme to delay, hinder, and defraud creditors" that involved either (1) a transfer of an interest in the real property without the consent of the secured party or court approval, or (2) multiple bankruptcy filings affecting the real property. A relief from stay order entered under Section 362(d)(4), if recorded in accordance with state law, is binding in any other bankruptcy case filed for two years after entry of the order. A debtor in a subsequent case may obtain relief from such order "based upon changed circumstances or for good cause shown. . ."

b. Bankruptcy Filed Notwithstanding Prohibition Against Refiling

If a debtor files a bankruptcy case in violation of a court order prohibiting refiling, or in violation of Section 109(g)(prohibiting a debtor from refiling for 180 days if a case is dismissed for failure of the debtor to abide by a court order or to appear, or if the debtor voluntarily dismissed a case after being served with a request for relief from stay), an act to enforce a lien against real property of the debtor does not violate the automatic stay.

2. Residential Leases and Rental Agreements

a. Prepetition Eviction Judgment

Under section 362(d)(22), if the landlord under a residential lease or rental agreement obtained a prepetition judgment for possession against the debtor, the landlord is not prohibited by the automatic stay from continuing the eviction proceedings.

i. Delayed Effectiveness If Certification Filed with Petition

Debtors are required to disclose in the petition whether the landlord has a judgment for possession. 11 U.S.C. § 362(l)(5). If the debtor files with the petition and serves certification that the debtor would be permitted under state law to cure the monetary default notwithstanding a judgment for possession and deposits with the clerk rent that would become due in the 30 day period following filing of the petition, the exception to the automatic does not apply for 30 days. The debtor/tenant may cure the entire monetary default within the 30 days. If the debtor then certifies that the default has been cured under applicable nonbankruptcy law, the stay prohibits continuation of the eviction. The landlord may contest the debtor's certification, in which case the court must hold a hearing within 10 days.

b. Illegal Use of Drugs

Under sections 362(d)(23) and 362(m), the stay will not prohibit continuation of residential eviction proceedings based on "endangerment of the property or illegal use of controlled substances" on the property beginning 15 days after the landlord files and serves a certification that (1) an eviction action based on the foregoing has been filed, or (2) that such activity has occurred in the 30 days preceding the filing of the certification. During the 15 day period, the debtor may contest the landlord's certification, in which case the court must hold a hearing within 10 days of the objection to determine whether the circumstances the landlord certified exist or have been remedied.

If the debtor challenges the landlord's certification and claims illegal drug use has been remedied, a host of state criminal law issues may be put before the Bankruptcy Court. The court may also have to decide whether the property was "endangered", as alleged by the landlord, and whether the endangerment has been rectified. If the court determines the property is endangered or drug use on the property is ongoing, the stay will not apply. Should collateral estoppel apply to prevent the debtor from attempting to establish changed circumstances in the eviction proceeding?

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