ABI Webinar:

Recent Trends in Lease Rejection Issues

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Overview of Commercial Real Estate Lease Rejection Issues

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- Most chapter 11 debtors have one or more unexpired leases of nonresidential real property. Some have hundreds or thousands.
  - For example, Toys "R" Us disclosed in its recent bankruptcy filing that it operates 879 domestic and 812 international stores, the vast majority of which are leased.
- For retail chapter 11 debtors, sections 365 and 502(b)(6) are among the most critical provisions of the Bankruptcy Code. The language of these provisions and their real world application in chapter 11 reorganization proceedings often have an outside influence on the direction a case will take–they may dictate whether the debtor will achieve a stand-alone reorganization, maintain going concern value in a section 363 asset sale, or be forced to discontinue operations and liquidate.

Overview of Commercial Real Estate Lease Rejection Issues

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- This webinar focuses on discrete facets of the treatment of commercial real estate leases in bankruptcy proceedings that arise in connection with or as a consequence of the rejection of commercial real estate leases under the Bankruptcy Code:
  1. When must the decision to assume or reject a lease be made? [11 U.S.C. § 365(d)(1), (2) & (3)]
  2. How do bankruptcy courts evaluate a debtor's request to reject a lease? [11 U.S.C. § 365(a)]
  3. When is the rejection of a lease effective and what influences that determination?
  4. What are the rights and objections of debtors and their landlords pending a decision on assumption or rejection of a lease? [11 U.S.C. § 365(d)(3)]
  5. How are claims arising from the termination of a lease treated in bankruptcy and, to the extent they are capped, how should the section 502(b)(6) cap be applied? [11 U.S.C. § 365(g) & 502(b)(6)]
  6. When the debtor is the landlord, what rights does its tenant have when a lease is rejected? [11 U.S.C. § § 365(h) & 363(f)]
  7. What does this all mean in terms of a chapter 11 debtor's ability to arrange a pre-petition plan, negotiate rent concessions with landlords, close underperforming stores, rationalize the store base, manage its liquidity, and emerge successfully from bankruptcy?

Time to Reject in Chapter 7 Cases: Section 365(d)(1)

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- In chapter 7 cases, a trustee must decide to assume or reject an unexpired lease of residential real property or personal property within 60 days after the order for relief.
- Court may grant additional time for cause if request is made within the 60-day period.
- If trustee fails to act within the 60-day period, the lease is deemed rejected.
  - *See Matter of Benson*, 76 B.R. 381, 382 (Bankr. D. Del. 1987) (noting that a contract or unexpired lease under section 365(d)(1) is "rejected by operation of law and cannot be revived for either the benefit of the estate or a debtor in bankruptcy").
  - The court has no power to extend the 60-day period if the trustee fails to act.

Time to Reject: Conversion Under Section 365(d)(1)

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- When a case is converted from another chapter to chapter 7, the 60-day period will start running from the conversion date if the time to assume or reject has not previously expired.
  - *See In re Tompkins*, 95 B.R. 722, 723-24 (9th Cir. B.A.P. 1989) (finding that conversion of a chapter 11 case to a chapter 7 constituted an order for relief and thus triggered the start of the 60-day period).
- If the time has expired, conversion does not start a new time period within which a trustee may assume or reject a contract or lease.
  - *See In re Bane*, 228 B.R. 835, 841 (Bankr. W.D. Va. 1998) (determining that the lease was rejected because the 60-day period expired in the chapter 7 proceeding before the case converted into a chapter 13 case). *But see In re Caster*, 2010 WL 4272583, at *2 (Bankr. N.D. Ohio Oct. 25, 2010) (indicating that some cases hold that the time to assume or reject an executory contract recommences in a converted case).

Time to Reject for Residential Real Property Leases in Chapter 9, 11, 12 & 13 Cases: Section 365(d)(2)

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- The rejection deadline for a lease of residential real property is the date of the plan confirmation.
- The court may, on request of the other party to the lease, order the trustee to decide whether to assume or reject unexpired leases earlier than the plan confirmation.
  - The court will consider whether the debtor or trustee has had a reasonable time to decide to assume or reject, taking into account such factors as whether the debtor or trustee is timely performing obligations under the lease and the landlord's need for an earlier decision date to mitigate its damages.

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Section 365(d)(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.

- Does an order granting assumption need to be entered before the applicable deadline, or is the filing of a motion to assume sufficient?
- What constitutes "cause" to extend the 120-day period?
- Does assignment need to occur within the deadline, when the lease is assumed?

Consent to Extending the 210 Day Deadline to Assume or Reject Commercial Leases – Recent Cases

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- Hanckcock Fabrics – Approximately 80% of landlords agreed to extend assumption deadlines in exchange for debtors' payment of three months' rent on an administrative basis regardless of whether lease was rejected during extended period
- Linens'n Things – Approximately 90% of landlords agreed to extend assumption deadline in exchange for debtors' release of preference actions against such landlords
- Movie Gallery – Court approved "opt in" lease extension protocol by which debtors mailed $100 checks to landlords along with letter requesting consent to extension. Endorsing and cashing checks constituted a grant of the requested extension
- Is affirmative consent necessary?

Standard for Lease Rejections

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- The Bankruptcy Code provides no guidance as to the standard a court should apply in evaluating a trustee's decision to reject a lease.
- Vast majority of courts apply the business judgment rule
  - *In re Orion Pictures Corp.*, 4 F.3d 1095, 1099 (2d Cir. 1993)
  - *Sharon Steel Corp. v. Nat'l Fuel Gas Distrib. Corp.*, 872 F.2d 36, 39-40 (3d Cir. 1989)
  - *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1047 (4th Cir. 1985)
  - *In re Old Carco LLC*, 406 B.R. 180, 193 (Bankr. S.D.N.Y. 2009)
  - *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 511-12 (Bankr. D. Del. 2003)

Majority Standard for Lease Rejections: Business Judgment

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- Court must affirm a debtor's decision to reject a lease unless the decision is the product of "bad faith, or whim or caprice."
  - *In re Wheeling- Pittsburgh Steel Corp.*, 72 B.R. 845, 849-50 (Bankr. W.D. Pa. 1987); *see also In re Trans World Airlines, Inc.*, 261 B.R. 103, 121 (Bankr. D. Del. 2001); *In re G Survivor Corp.*, 171 B.R. 755, 757 (Bankr. S.D.N.Y. 1994) ("Generally, absent a showing of bad faith, or an abuse of business discretion, the debtor's business judgment will not be altered.").
- The Second and Third Circuits note that the crux of this standard is whether rejection would benefit the estate.
  - *Sharon Steel*, 872 F.2d at 39-40; *Matter of Minges*, 602 F.3d 38, 43 (2d Cir. 1979).
  - Debtor does not need to show that the lease is burdensome to the estate. *See In re Stable Mews Assocs., Inc.*, 41 B.R. 594, 596 (Bankr. S.D.N.Y. 1984).
- Adverse effects on non-debtor parties are not relevant unless the effect is so disproportionate to the estate's benefits that it shows the trustee or debtor in possession did not exercise sound business judgment.
  - *See In re Old Carco LLC*, 406 B.R. at 192; *see also In re Wheeling- Pittsburgh Steel Corp.*, 72 B.R. at 848 (noting that under the business judgment standard, "the effect of rejection on other entities is not a material fact to be weighed").

Minority Standard for Lease Rejections: Disproportionate Damage Test

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- This standard weighs the trustee's or debtor in possession's business judgment against the interests and potential damages of non-debtor parties to the lease or contract.
- Limited case law:
  - *In re Petur U.S.A. Instrument Co., Inc.*, 35 B.R. 561, 564 (Bankr. W.D. Wash. 1983) (holding that although the debtor satisfied the business judgment rule, the debtor may not reject the contract because rejection would disproportionately damage the non-debtor's business).
  - *In re Davidson Hydrant Techs., Inc.*, 2012 WL 987620 (Bankr. N.D. Ga. 2012) (considering the fact that an intellectual property licensee may be able to retain its rights under the license agreement in determining whether the debtor in possession's rejection of an executory contract satisfied the business judgment standard).

Cum Onere vs. Severability

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- A single contract or lease may not be rejected in part without the consent of the non-debtor counterparty to such contract or lease.
  - *See, e.g.*, *In re Fleming Co.*, 499 F.3d 300, 308 (3d Cir. 2007); *In re Buffet Holdings, Inc.*, 387 B.R. 115, 119 (Bankr. D. Del. 2008).
- A court may review a single contract or lease to determine whether, in reality, it consists of multiple agreements that are severable.
  - Whether an agreement is severable is an issue of state law. *See, e.g.*, *Buffet Holdings*, 387 B.R. at 120.

Cum Onere vs. Severability: Application in Lease Rejections Context

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- Bankruptcy treatment of sale-leaseback transactions involving multiple properties when a debtor seeks to assume or reject the resulting master lease as to only certain of the properties
  - *See, e.g.*, *Buffet Holdings*, 387 B.R. at 128 (holding that master lease resulting from sale-leaseback transaction was intended by parties to be an integrated agreement that could not be assumed or rejected, in part).
- Bankruptcy treatment of lease amendments that may expand the scope of an existing real estate lease to encompass ancillary properties
  - *See, e.g.*, *In re Contract Research Solutions, Inc.*, Case No. 12-11004 (KJC), 2013 WL 1910286 (Bankr. D. Del. May 1, 2013) (holding that lease amendment which expanded scope of lease to include unattached, adjacent premises located in the same office complex was part of a single, indivisible agreement and could not be severed for purposes of debtor's request to reject the amendment).
- Bankruptcy treatment of purchase options, rights of first refusal, and similar provisions within a lease agreement
  - *See, e.g.*, *In re CB Holding Corp.*, 448 B.R. 684 (Bankr. D. Del. 2011) (holding that provision of restaurant lease that granted lessor right of first refusal to acquire debtor's liquor license upon termination of lease was non-severable from other provisions of lease being rejected and, even assuming that ROFR was severable, the ROFR was executory in nature and could be rejected by the debtor).

Retroactive Effectiveness of Lease Rejection in Chapter 11 Cases

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- Section 365(d)(3), subject to limited exceptions, requires a trustee or debtor in possession to timely perform all of the obligations of a debtor under a lease "arising from and after the order for relief … until such lease is assumed or rejected, notwithstanding section 503(b)(1) …."
  - Accordingly, a landlord is generally entitled to demand payment of rent when due under the lease.
- Significance of the Effective Date of Rejection
  - Impact on the debtor's ability to manage its post-petition liquidity in jurisdictions that interpret "arising" in section 365(d)(3) to mean "occurring" or "becoming due" under a lease
  - Effect on retail debtors that have already vacated underperforming stores prior to the petition date
  - Impact on a debtor seeking to sell its business and assets through bankruptcy or to liquidate its inventory through store closing sales

Availability of Retroactive Lease Rejections

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- Most courts hold that the bankruptcy court has the equitable power to make a lease rejection retroactively effective.
  - *See, e.g.*, *In re At Home Corp.*, 392 F.3d 1064, 1070-71 (9th Cir. 2004); *Thinking Machines Corp. v. Mellon Financing Servs. Corp. #1 (In re Thinking Machines Corp.)*, 67 F.3d 1021, 1028 (1st Cir. 1995); *In re TW, Inc.*, C.A. No. 03-533 (SLR), 2004 WL 115521, *2 (D. Del. Jan. 14, 2004).
- A minority of courts hold that lease rejections cannot be effective until the order is entered.
  - *See, e.g.*, *Paul Harris Stores, Inc. v. Mabel L. Salter Realty Trust (In re Paul Harris Stores, Inc.)*, 148 B.R. 307, 309 (S.D. Ind. 1992); *In re Federated Dep't Stores, Inc.*, 131 B.R. 808, 815-16 (S.D. Ohio 1991).

Factors Influencing Courts to Make Lease Rejections Retroactively Effective

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- Delaware courts use the *NAMCO* factors as guidelines:
  - The leased premises were previously surrendered to landlord
  - The surrender was accompanied by debtor's unequivocal statement to the landlord that the debtor is abandoning any interest in the lease
  - The motion to reject the lease was filed without undue delay
  - The motion contains a representation that the creditors' committee, if one exists, does not oppose the motion
  - The debtor must indicate in the motion that debtor waives any right to change its mind about rejection of the subject leases after filing of the motion
- Whether debtor tendered possession back to the landlord
  - *See In re Chi-Chi's, Inc.*, 305 B.R. 396, 396-99 (Bankr. D. Del. 2004) (declining to order rejection effective *nunc pro tunc* to the petition date because the debtor failed to tender possession back to landlord since sublessees remained on the premises post-petition). *But see, e.g., In re New Meatco Provisions, LLC*, BAP NO. CC-13-1319, 2014 WL 2446314 (9th Cir. B.A.P. May 20, 2014) (finding debtor's failure to evict its subtenant from premises did not preclude retroactive rejection).

How Far Retroactive Can a Lease Rejection Effective Date Be?

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- Most courts that permit retroactive rejection will allow the rejection to be effective as far back as the date of service of the motion in appropriate circumstances.
- Rejection of a lease retroactive to an earlier date, such as the petition date, may be appropriate where the debtor has surrendered possession of the premises to the landlord and unequivocally communicated its intent to reject the lease.
  - *See, e.g.*, *In re New Meatco Provisions, LLC*, Case No. 13-22155 (PC), 2013 WL 3760129 (Bankr. C.D. Cal. July 16, 2013).

Post-Petition, Pre-Rejection Claims: Debtor's Payment Obligations under Section 365(d)(3) & Stub Rent

Section 365(d)(3) of the Bankruptcy Code

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- Section 365(d)(3) of the Bankruptcy Code provides that a bankruptcy trustee or chapter 11 debtor-in-possession "shall timely perform all the obligations of the debtor . . . arising from and after the order for relief under any expired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1)."
- The debtor is entitled to temporary deferral of its obligations under a lease during the first 60 days of the case, but the court may not defer those obligations past the 60th day.

Section 365(d)(3) of the Bankruptcy Code

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- Prior to enactment of section 365(d)(3), landlords were routinely compelled to seek payment of rent and other amounts due under a lease by petitioning the bankruptcy court for an order designating these amounts as administrative expenses under section 503.
- Section 503(b)(1) of the Bankruptcy Code provides that allowed administrative expenses include "the actual, necessary costs and expenses of preserving the estate."

When are Section 365(d)(3) claims paid?

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- Split of authority regarding whether a debtor is obligated to pay all amounts arising from its post-petition lease obligations under section 365(d)(3) where there may be insufficient funds to satisfy other administrative expense claims.
  - Should such claims effectively receive a "super-priority" such that they are fully paid even if doing so will prevent other administrative expense claims from being paid?
- The cases can generally be divided into three groups:
  - Plurality/Majority: obligations under section 365(d)(3) effectively do not give rise to a "super-priority" administrative claim and should not be paid until it is determined that there are sufficient funds in the bankruptcy estate to fully pay all administrative claims.
  - Substantial minority: obligations arising under section 365(d)(3) give rise to a "super-priority" administrative claim that must be timely paid regardless of the bankruptcy estate's ability to pay other administrative claims.
  - Substantial minority: takes an approach midway between those two lines of cases, holding that the bankruptcy estate should pay all obligations under section 365(d)(3), subject to later partial disgorgement if it turns out that there are insufficient funds in the bankruptcy estate to pay all administrative claims in full (so that all allowed administrative claims end up receiving the same pro rata distribution).

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Stub Rent

- Under section 365(d)(3), the debtor in possession "shall timely perform all the obligations of the debtor . . . *arising* from and after the order for relief under any unexpired lease of nonresidential property."
- If a retail debtor is obligated to pay rent in advance on the first of each month and files for bankruptcy on the 10th of the month without paying rent, does the landlord have a section 365(d)(3) claim for the remaining portion of the month or is the whole monthly amount a prepetition unsecured claim?
- Circuit Split: Proration vs. Billing Date

Stub Rent – the "Proration" Approach

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- Under the "proration" approach, the obligation to pay rent and other charges is considered to "arise" on each day the tenant occupies the leased premises.
- The Seventh, Ninth, and Tenth Circuits have adopted the proration approach.
  - *See In re Handy Andy Home Improvement Centers*, 144 F.3d 1125 (7th Cir. 1998) (*but see HA-LO Indus., Inc. v. CenterPoint Properties Tr.*, 342 F.3d 794, 798 (7th Cir. 2003) (following "billing date" approach for post-petition pre-rejection amounts)); *In re Treesource Indus., Inc.*, 363 F.3d 994, 998 (9th Cir. 2004); *In re Furr's Supermarkets, Inc.*, 283 B.R. 60, 65-66 (10th Cir. 2002).

Stub Rent – the "Billing Date" Approach

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- The "billing date" approach posits that obligations "arise" on the day that they become due and payable under a lease.
- Under the "billing date" approach, debtors are obligated to pay rent, real property taxes and other charges that become due under a lease during the post-petition, pre-rejection period, even when such payments may relate back to the prepetition period.
- The Third, Sixth, and Eighth Circuits have adopted the "billing date" approach.
  - *See*, *In re Centerpoint Properties v. Montgomery Ward Holding Corp.*, 268 F.3d 205 (3d Cir. 2001); *Koenig Sporting Goods, Inc. v. Morse Road Co.*, 203 F.3d 986, 989 (6th Cir. 2000); *Burival v. Creditor Committee (In re Burival)*, 406 B.R. 548 (B.A.P. 8th Cir. 2009), *aff'd*, 613 F.3d 810 (8th Cir. 2010).

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Stub Rent – Decisions of Note

- *In re Stone Barn Manhattan LLC*, 398 B.R. 359 (Bankr. S.D.N.Y. 2008): Judge Gropper firmly endorsed the proration approach in a detailed Memorandum of Decision that canvassed most of the case law on the issue.
  - Focused on congressional intent to avoid forcing landlords to become involuntary post-petition unsecured lenders by requiring payment for the post-petition use and occupancy, and the fact that proration is easy to apply and consistent with the overall goals of the Bankruptcy Code.
  - Noted that the billing date approach leads to absurd results, such as converting pre-petition tax obligations into administrative claims because they are due under the lease post-petition.
  - Hoping for a decision from the Second Circuit on the issue, Judge Gropper stayed the enforceability of his order *sua sponte* and invited an appeal directly to the Second Circuit.
  - The Second Circuit has yet to rule on this issue.

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Stub Rent – Decisions of Note

- *In re Circuit City Stores, Inc.*, 447 B.R. 475 (Bankr. E.D. Va. 2009):
  - Judge Huennekens held that despite the debtors' agreement with the landlords that the proration approach would apply and that stub rent is entitled to administrative priority under section 503(b)(1) because it did not become due post-petition, the company was not required to pay the stub rent immediately, or even within 60 days after the petition date.
  - Found that 'timely performance' meant, in connection with a lease where the stub rent is due before the petition date, that immediate payment is not required.
  - Held that immediate payment of the stub rent, or even payment within the first 60 days of the case, would improperly elevate stub rent claims to "super priority" status, contrary to prior decisions of the Court and determined the Court has discretion to order that stub rent be paid with other allowed administrative claims under section 507(a) of the Bankruptcy Code on the effective date of any plan of reorganization.
- For debtors, the Circuit City decision represents the best of both approaches; avoid paying any charges that accrue pre-petition, while providing a significant liquidity boost by delaying the obligation to pay stub rent.
  - Toys "R" Us filed in the same court, but a different judge was appointed

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Stub Rent – Decisions of Note

- *In re Goody's Family Clothing Inc.*, 610 F.3d 812 (3d Cir. 2010):
  - Goody's did not pay rent for the stub month but made payments thereafter. Goody's continued to occupy the properties owned by the landlords post-petition, and sales occurred on the premises.
  - The landlord filed a motion for administrative expense claims, seeking immediate payment of stub rent. The debtor argued that, based on Third Circuit precedent, stub rent was a prepetition expense and that section 365 is the exclusive source of obligations and remedies under unexpired leases, making any reference to section 503(b)(1) inapplicable.
  - Based on the statute's plain language, the Third Circuit concluded that section 365(d)(3) does not foreclose a landlord from relying on section 503(b)(1) to recover stub rent; rather, section 365(d)(3) offers a less burdensome mechanism for a landlord to recover rent payments due and owing after a debtor files for bankruptcy.

Claims Arising from Rejection: Calculation & Capping of Damages

Overview of Section 502(b)(6)

- Section 502(b)(6) of the Bankruptcy Code caps a landlord's rejection damages claim at the rent reserved for the greater of one year or 15% "of the remaining term of the lease"
  - This has been the subject of debate between whether there should be a "rent vs. time" approach in valuing the damages of a landlord's claim on rejected leases
  - Case law supports both methodologies, but more recently, the "time" method has tended to be adopted
- Claim for damages under Section 502(b)(6) are compared under two amounts
  - "Rent reserved"
  - "Total rent"
- Section 502(b)(6) provides that, upon the filing of a timely objection, a claim filed in a bankruptcy case shall be disallowed to the extent that: it is for damage resulting from the termination of a lease of real property, in as much as it exceeds:
  - 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:
    - The date of filing of the petition; and
    - The date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
      - Any unpaid rent due under such lease, without acceleration, on the earlier of such dates
- Definitions of "repossession" and "surrender" are not defined in the Bankruptcy Code

Filene's Basement Case Study

- Filene's Basement, LLC filed a petition for Chapter 11 relief on November 2, 2011 in the United States Bankruptcy Court for the District of Delaware
  - Connecticut / DeSales, as landlord, entered into a retail lease with Raleigh Stores Corporation
  - This lease had an original term of 20 years, with four options to renew for additional terms of 10 years each
  - The lease also provided that upon termination, the tenant had an obligation to surrender the property "broom clean"
    - "Broom clean" is generally understood to mean that the seller will remove all personal property, debris and trash prior to the closing and vacuum the carpets and / or sweep the floors
  - Subsequently, Filene's Basement took over the lease from Raleigh Stores Corporation and exercised an option to renew the lease
- The Landlords (Connecticut / DeSales) filed a proof of claim consisting of a claim for rent unpaid as of the petition date, plus a claim for future rent capped by section 502(b)(6) of the Bankruptcy Code
  - Connecticut / DeSales subsequently amended the claim to add damages claims relating to the costs of:
    1. Removing abandoned furniture and fixtures from the leased premises, and
    2. Satisfying a mechanic's lien that a creditor of Filene's had imposed against the landlord's property related to servicing the buildings elevators
  - Connecticut / DeSales asserted that the new claims were not subject to the 502(b)(6) cap

Filene's Basement Case Study *(cont'd)*

- Filene's objected to the landlord's claim asserting that the claim exceeded the amount allowed by section 502(b)(6) because
  1. the landlord improperly calculated the cap, and
  2. the additional damage claims should have been included within the cap
- Different approaches in valuation were preferred
  - "Time approach"
    - The time approach was favored by the debtors and other unsecured creditors
  - "Rent approach"
    - The rent approach was favored by the landlords
- Judge Kevin Carey ruled in favor of the debtors, saying that the "time" approach was the best approach and reducing claims accordingly

Filene's Basement: Claims Calculation

"Rent Approach"

- Calculating a claim through the "rent" approach means determining the total base rent and other "rent" amounts due for the remainder of the lease and multiplying that by 15 percent
  - What qualifies as "rent" is nebulous: unclear whether fees and expenses can be included
- Claims to unpaid rent are not limited by 502(b)(6)
  - Unpaid rent refers to amounts that were due but not paid on the Rent Cap date
- In the case of Filene's, the calculation would be based on the sum of base rent and other "rent" amounts multiplied by 15 percent

Rent-based Approach	
Sum of base rent and "rent-based" items	$ 13,009,242.00
Percent of rent allowed by 502(b)(6)	15%
Total rent	**$ 1,951,386.30**

"Time Approach"

- Calculating a claim through the "time" approach means determining the total time left on the lease, multiplying it by 15 percent, and multiplying that proportion of the time remaining on the lease by the applicable rented rate
- Time left on a lease may be secured
- In the case of Filene's, this means taking 15% of the amount of time left on their lease and finding how much was due for that period

Time-based Approach	
Time left on lease	85 months
Percent of time allowed by 502(b)(6)	15%
Amount of time remaining on lease	12.75 months
Total Rent Due	**$ 1,845,524.25**

What's Included under the Section 502(b)(6) Cap

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- In *McSheridan*, the Ninth Circuit Bankruptcy Appellate Panel established a three-part test that must be met for a charge to constitute "rent reserved" under section 502(b)(6)(A):
  1. The charge must: (a) be designated as 'rent' or 'additional rent' in the lease; or (b) be provided as the tenant/lessee's obligation in the lease;
  2. The charge must be related to the value of the property or the lease thereon; and
  3. The charge must be properly classifiable as rent because it is a fixed, regular or periodic charge. *McSheridan*, 184 B.R. 91, 99-100 (B.A.P. 9th Cir.1995).
- *Saddleback Valley Community Church v. El Toro Materials Co. (In re El Toro Materials Co.)*, 504 F.3d 978 (9th Cir. 2007) (overruling *McSheridan*).
  - In *El Toro*, the Ninth Circuit partly overruled *McSheridan* and articulated a more narrow reading of section 502(b)(6).
  - Determined that "capping rent claims but allowing uncapped claims for collateral damage to the rented premises will follow congressional intent by preventing a potentially overwhelming claim for lost rent from draining the estate, while putting landlords on equal footing with other creditors for their collateral claims." *Id.* at 980.

Section 502(b)(6) Cap – Damage to Premises

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- If a tenant destroys the leased premises or leaves equipment or waste on the premises, should the landlord's claim for damages resulting from these actions be capped? Is the landlord's claim for "damages resulting from the termination of a lease of real property"?
- Courts that apply the provision narrowly do not cap damages that the landlord would have suffered regardless of the premature termination of the lease. Courts that apply the provision expansively cap all of a landlord's damages, including damages arising from the tenant's past failure to maintain or repair the premises.

Section 502(b)(6) Cap – Damage to Premises

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- *In re El Toro Materials Co., Inc.*, 504 F.3d 978 (9th Cir. 2007):
  - A debtor left one million tons of its wet clay "goo," mining equipment and other materials on the leased property after rejecting the lease. Landlord brought an adversary proceeding seeking damages of $23 million for the cost of removing the mess under theories of waste, nuisance, trespass and breach of contract.
  - Bankruptcy court determined that the claims were not limited by section 502(b)(6). The Bankruptcy Appellate Panel reversed the bankruptcy court and the landlord appealed. The Ninth Circuit determined that the landlord's claims for waste, nuisance and trespass did not result from the rejection of the lease—instead, those claims resulted from the "pile of dirt" allegedly left on the property.
- "*Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it?*"
  - Held that if debtor had assumed instead of rejecting the lease, the pile of dirt would still be allegedly trespassing on the landlord's land and the landlord still would have the same basis for its theories of nuisance, waste and breach of contract.

Section 502(b)(6) Cap – Damage to Premises

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- *In re Foamex Intern., Inc.*, 368 B.R. 383 (Bankr. D. Del. 2007):
  - Held that even though damages arising from breach of a repair and maintenance lease covenant did not constitute "rent reserved" for purposes of calculating a lessor's claim under section 502(b)(6)(A), the lessor's claim for damages arising from debtors' breach of the covenant nevertheless was not a claim separate from termination damages in general and thus was limited by the statutory cap.
  - Noted that although there were well-reasoned decisions on both sides of the argument and no controlling decision in the Third Circuit, it considered the view adopted by *McSheridan* to be the better view, particularly in light of the fact that the Third Circuit had adopted the reasoning of *McSheridan* in a non-bankruptcy context in *First Bank Nat. Ass'n v. F.D.I.C.*, 79 F.3d 362, 15 A.D.D. 40 (3d Cir. 1996), a case dealing with damages related to a disaffirmed lease under the Financial Institutions Reform, Recovery and Enforcement Act of 1989.
  - Agreed that lessors are entitled to one claim and that this single, capped claim governs all time intervals, meaning prepetition and post-petition breaches of the lease and any resulting damages.
  - Decided before *El Toro*; *see In re Filene's Basement, LLC*, No. 11-13511 (KJC), 2015 WL 1806347, at *10 (Bankr. D. Del. Apr. 16, 2015) (applying *El Toro* to abandonment claim)

Section 502(b)(6) Cap – Attorneys' Fees

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- *1500 Mineral Spring Associates, LP v. Gencarelli*, 353 B.R. 771 (D.R.I. 2006):
  - Upholding a bankruptcy court decision limiting landlords' claims for past and future rent to the amount provided by section 502(b)(6). The court held that under section 502(b)(6), a landlord is entitled to recover only for rent and expenses already accrued and, within limits, for future rent, and that attorney's fees and other expenses claimed as damages for early termination of the lease are not recoverable thereunder, citing case authority stating that the statutory cap amount represents the maximum recoverable as a result of the termination of the lease, thereby precluding the payment of attorney's fees as additional damages.
- *In re Kupfer*, 852 F.3d 853 (9th Cir. 2016):
  - Holding that a claim asserted by commercial lessors in debtor-tenants' Chapter 11 case, for fees attributable to litigation of their claims for **future rent**, was **subject to statutory cap**, as claim for damages resulting from termination of leases, as claim would not have arisen were the leases not terminated; however, damages for **past rent**, which lessors could claim independent of fact that leases had been terminated, and **fees attributable to that portion of the litigation were not capped**.

Section 502(b)(6) Cap – Mechanics' Liens

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- *In re Filene's Basement, LLC*, No. 11-13511 (KJC), 2015 WL 1806347, at *12 (Bankr. D. Del. Apr. 16, 2015):
  - Applied the standard set forth in *El Toro*
  - Mechanics' liens exist independent of whether the lease is terminated and not subject to cap.

Issues Relating to Security Deposits, Guarantees and Letters of Credit

- Landlords may seek treatment of security deposits, third-party guarantees and letters of credit as additional rent
- Tenant Security deposits are credited against the capped claim made by a landlord
  - Excess security deposits are refunded to the debtor
- Third Party guarantees and pledges are separate under a lease
  - Since 502(b)(6) only caps an estate's liability and not the actual damages suffered by the landlord, the landlord can seek the difference between the amount owed under the lease and the amount recovered from the estate of the tenant
  - Under Section 502(e)(1)(A), a claim filed by the guarantor is limited to the same extent as the landlord's claim is against the debtor
- With letters of credit, often referred to by banks as "standby letters of credit," a bank promises that it will pay the landlord a certain amount of money by a certain time, as long as specified conditions are met
  - A letter of credit issued by a bank should be superior to a third-party guarantee because it should allow the landlord to avoid the credit risk of the third-party guarantor
  - The proceeds from a letter of credit draw are not considered property of the estate. Instead, the proceeds are viewed as similar to a third-party guarantor payment, which is not credited against the landlords allowed capped claim

Treatment of Claims Arising from Lease Rejections: Letters of Credit

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- Independence principle: "[T]he obligations of the issuer of the letter is independent [of] the account party's estate and thus not subject to the automatic stay invoked by the account party's petition."

  4 COLLIER ON BANKRUPTCY ¶ 502.03[7][h] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).

- Does the independence principle mean that the application of the proceeds from a landlord drawing on a letter of credit must be offset to reduce the landlord's claim under the section 502(b)(6) cap?

Majority View: Independence Principle Reduces Landlord's Lease Rejection Claim

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- *In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197 (3d Cir. 2003) is the principal case:
  - The Bankruptcy Court analogized letters of credit to security deposits, relying on *Oldden v. Tonto Realty Co.*, to determine that letters of credit are subject to the statutory cap under section 502(b)(6).
    - *In re PPI Enters.*, 228 B.R. 339, 350 (Bankr. D. Del. 1998); *see also Oldden v. Tonto Realty Co.*, 143 F.2d 916, 918 (2d Cir. 1944) (holding that a security deposit should be deducted from the allowable claim rather than the total damages provided for under the lease).
  - The Third Circuit concluded that letters of credit are a form of security deposits after indicating that the Court was "not inclined to disturb the rationale" behind the Bankruptcy Court's decision.
    - *In re PPI Enters.*, 324 F.3d at 209-10.
- Cases following *PPI*:
  - *In re AB Liquidating Corp.*, 416 F.3d 961, 964-65 (9th Cir. 2005) (affirming the application of a letter of credit against the section 502(b)(6) cap rather than the landlord's gross damages).
  - *In re Connectix Corp.*, 372 B.R. 488, 495 (Bankr. N.D. Cal. 2007) (concluding that landlord's pre-petition draws on the letter of credit were subject to section 502(b)(6)).

Minority View: Independence Principle Does Not Reduce Landlord's Lease Rejection Claim

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- A minority view holds that the independence principle does not operate to reduce the landlord's lease rejection claim.
  - *See, e.g.*, *Musika v. Arbutus Shopping Ctr., L.P.*, 257 B.R. 770, 772 (Bankr. D. Md. 2001).

- For the avoidance of doubt, none of the modern reported case law would subject the landlord to the section 502(b)(6) cap to limit the amount the landlord could recover under a letter of credit established as a security deposit.
  - The impact in cases like *PPI* extends only to reducing the amount of the landlord's claim against the bankruptcy estate.

Treatment of Claims Arising from Lease Rejections: Debtor as Guarantor

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- Although section 502(b)(6) does not explicitly reference guarantors, courts have found the statutory cap applies to lessors' claims against a debtor-guarantor.
  - *In re Arden*, 176 F.2d 1226, 1229 (9th Cir. 1999) (noting that "it is the claim of the lessor, not the status of the lessee–or its agent or guarantor–that triggers application of the Cap").
  - *In re Flanigan*, 374 B.R. 568, 575-76 (Bankr. W.D. Pa. 2007) (concluding that the plain language and legislative history of section 502(b)(6) support a cap on a landlord's damages when the debtor is the guarantor of a lease).
  - *In re Episode USA, Inc.*, 202 B.R. 691, 695 (Bankr. S.D.N.Y. 1996) (same).
  - *In re Ancona*, 2016 WL 828099, at *7 (Bankr. S.D.N.Y. Mar. 2, 2016) (same).
- Courts note that nothing in the plain language of the statute "precludes [its] application in instances where a lessor is asserting its claim against a guarantor of a lease obligation."
  - *In re Flanigan*, 374 B.R. at 573 (citing *In re Arden*, 176 F.3d at 1229).

Free and Clear Sales: Interplay between Sections 363(f) & 365(h)

Section 365(h) Rights when Debtor is Lessor or Sub-Lessor

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- Operation of section 365(h): If a debtor landlord has rejected a real property lease, non-debtor tenant lessees have the right to remain in possession of the property and other ancillary rights.
  - Debtor can only reject its obligation to provide future services to the tenant under the lease (§ 365(h)(1)(A)(ii)).
  - Tenant can offset damages caused by the debtor's nonperformance of the lease against rent it owes (§ 365(h)(1)(B)). Alternatively, the non-debtor has the right to treat the rejection of the lease as a termination of the lease (§ 365(h)(1)(A)(i)).
- While a retail debtor is typically a tenant and not a landlord, issues arise in the context of a debtor that is an owner and operator of a resort, casino, or shopping center with retail tenants or where a debtor is a sub-lessor.

Interplay between sections 363(f) & 365(h)

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- Majority Approach: Sections 363(f) and 365(h) are in conflict with one another. Section 365(h) rights of a debtor's tenant should prevail over section 363(f).
  - Debtor-lessor cannot sell the leased premises free and clear of the lessee's interest in the premises.
  - *See, e.g.*, *In re Haskell, L.P.*, 321 B.R. 1, 8-9 (Bankr. D. Mass. 2005); *In re Taylor*, 198 B.R. 142, 164-66 (Bankr. D.S.C. 1996); *In re Churchill Props.*, 197 B.R. 283, 286 (Bankr. N.D. Ill. 1996).
- Minority Approach: Sections 363(f) and 365(h) are not in conflict when at the time of a free and clear sale of the leased premises under section 363(f) the lease has not yet been rejected.
  - Thus, the debtor-lessor can sell the leased premises free and clear of the lessee's possessory interest.
  - *See, e.g.*, *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC* (*In re Qualitech Steel Corp.*), 327 F.3d 537 (7th Cir. 2003); *In re Downtown Athletic Club of New York City, Inc.* (*Cheslock-Bakker & Assocs., Inc.*), 2000 WL 744126, *4-5 (S.D.N.Y. June 9, 2000); *In re R.J. Dooley Realty, Inc.*, 2010 WL 2076959, *6-8 (Bankr. S.D.N.Y. May 21, 2010).

Ninth Circuit Aligns with Minority View: *In re Spanish Peaks Holdings II, LLC*

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- Debtors owned and operated a vast resort in Big Sky, Montana. During better times, the debtors, as landlords, entered into two commercial real estate leases: (i) a lease for restaurant space ultimately assigned to appellant Pinnacle; and (ii) a lease for commercial real estate to appellant Opticom.
- After the debtors filed for Chapter 7 bankruptcy, the trustee undertook to sell substantially all of the debtors' assets free and clear of liens, claims, and interests pursuant to section 363(f).
- Both Pinnacle and Opticom objected to approval of the sale procedures, arguing that section 365(h) gave them the right to retain possession of their respective premises notwithstanding the sale.
- After additional objections, further motion practice, briefing and a two-day hearing, the bankruptcy court held that the sale was free and clear of any leasehold interest of Pinnacle and Opticom under section 365(h). The district court affirmed.

Ninth Circuit Aligns with Minority View: *In re Spanish Peaks Holdings II, LLC*

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- The Ninth Circuit affirmed, reasoning that "[w]here there is a sale, but no rejection (or a rejection, but no sale), there is no conflict between section 363(f) and section 365(h)."
  - *Montana Opticom, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holdings II, LLC)*, No. 15-35572, --- F.3d ----, 2017 WL 4156370 (9th Cir. July 13, 2017).
- In this case, neither lease had been the subject of a rejection order or deemed rejected under section 365(d)(1) at the time of the sale. Section 365(h), therefore, was not implicated.
- The court noted that the lessee's ability to demand adequate protection under section 363(e) provided a "powerful check on potential abuses of free-and-clear sales." *Id.* at *6.
  - In this case, neither objecting tenant preserved their right to pursue adequate protection on appeal because each had failed to seek adequate protection in the underlying bankruptcy court proceedings until well after the sale had been approved by the bankruptcy court and had closed.

Dishi & Sons v. Bay Condos LLC

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- The *Dishi* decision addresses the scenario that neither *Qualitech Steel* nor *Spanish Peaks Holdings II* had to reach–whose rights will prevail when a lease under which a non-debtor tenant has invoked its section 365(h) rights already has been rejected or deemed rejected to the bankruptcy court's consideration of a free and clear sale under section 363(f).
- The court reasoned that section 365(h) functions merely to preserve a tenant's rights that are "appurtenant to the real property," and subsequently concluded that, under appropriate circumstances, a sale free and clear under section 363(f) could trump whatever rights a tenant of a debtor-lessor would otherwise have under section 365(h).
  - *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 707 (S.D.N.Y. 2014).
- The *Dishi* court departs from most other cases in its narrow interpretation of the language of sections 363(f)(1) and 363(f)(5).
  - Section 363(f)(1) should be construed to refer only to hypothetical voluntary sales by the debtor under applicable law. *Id*. at 708-11.
  - Section 363(f)(5) refers "only to those situations where the trustee, as owner of the property, could compel the interest holder to accept a money satisfaction for its interest." *Id*. at 710.

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Section 365(h) Rights: Revel AC

- *In re Revel AC, Inc.*, 802 F.3d 558 (3d Cir. 2015):
  - Tenant had invested $16 million in the debtor's casino and had obtained a lease for its nightclubs on the property. Tenant objected to the debtor's proposed sale only to the extent that it purported to extinguish its lease.
  - The debtor asked the bankruptcy court to follow the Seventh Circuit's decision in *Precision Indus., Inc. v. Qualitech Steel SBO, LLC*, 327 F.3d 537 (7th Cir. 2003), which held that section 365(h) doesn't disable section 363(f)'s authority to sell property subject to a lease free and clear of that lease and instead triggers only when a debtor seeks to reject a lease under section 365. According to the debtor, "it could satisfy one of § 363(f)'s five conditions — namely § 363(f)(4) — because a bona fide dispute exists with respect to the validity of [Tenant's] lease."
  - In essence, the debtor argued that, because its lease with Tenant was based on a percentage of the revenue derived from Tenant's operations, "it was not a 'true lease' … entitled to benefit from the applicable protections" contained in section 365(h).

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Section 365(h) Rights: Revel AC

- *In re Revel AC, Inc.*, 802 F.3d 558 (3d Cir. 2015):
  - The bankruptcy court held that Tenant was "akin to" a partner of the debtor, not a mere tenant, and agreed with the debtor that there was "a bona fide issue in dispute" as to the validity of Tenant's lease. It then approved the sale free and clear of Tenant's section 365(h) rights.
  - On appeal of Tenant's motion to stay the decision pending appeal, the Third Circuit had to address the merits of Tenant's objection to the sale order. Instead of finding any purported conflict between sections 363(f) and 365(h), the Third Circuit held that Revel had failed to satisfy the requirement of section 363(f)(4) (stating that a sale can be "free and clear" of an interest if such interest is "in bona fide dispute"), thus prohibiting [Revel]from invoking § 363(f) and selling its assets free of [Tenant's] lease.
  - The Third Circuit held that Revel failed to cite a single authority suggesting that a percentage-lease clause disqualifies a purported lease from being a bona fide lease, and, moreover, the lease itself provided explicitly for a landlord-tenant relationship, nothing more. As the court stressed, "any dispute regarding the validity of [Tenant's] lease was fanciful, if not, disingenuous."
  - The bankruptcy court later held that Revel and Tenant had a "true lease under New Jersey law," thus protecting Tenant's right to remain in possession under section 365(h).

Current Considerations in Lease Negotiation and Store Closing from a Business Perspective

- Landlord negotiations will often drive the decision behind lease rejection
  - The rapidly evolving retail landscape has changed the dynamic in favor of the tenant.
  - What is the appropriate timing to approach a landlord for a rent reduction?
  - What level of rent concession can be expected?
  - What is the occupancy of the mall or overall retail complex?
  - What is the status of anchor tenants who typically drive traffic?
- More broadly the plans to close underperforming stores and rationalize the store base will focus the landlord negotiations
  - Are traditional retail metrics such as sales per square foot still important with the rise of digital platforms?
  - What impact will a review of the market rents leases have?
  - How are online sales in a store's geographic location considered in the overall decision?
  - What role does a four-wall cash flow analysis play in making the determination to reject a lease?
  - What strategy is preferred pre-petition for a consensual restructuring – e.g., swapping spaces or locations?
  - What are the consequences of not letting the tenant out of a lease or providing needed rent concessions?
  - What impact does the requirement to assume or reject a lease within 210 days of filing have?

Use of Lease Rejection Procedures

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- Now commonplace in larger chapter 11 cases where debtors may have numerous leases and contracts
  - *See, e.g.*, *In re Marsh Supermarkets Holding, LLC*, Case No. 17-11066 (BLS) (Bankr. D. Del. June 5, 2017); *Vestis Retail Group, LLC*, Case No. 16-10971 (LSS) (Bankr. D. Del. May 16, 2016); *In re The WetSeal, Inc.*, Case No. 15-10081 (CSS) (Bankr. D. Del. Feb. 5, 2015).
- In Delaware, rejection procedures typically involve:
  - Debtor's filing and service of a rejection notice and proposed order
  - Lease counterparties and other parties in interest typically have at least 14 days to object to the proposed lease rejection
  - If no objections, Debtor may submit the proposed order
  - If an objection is timely filed then a hearing to resolve the dispute will be scheduled on at least seven (7) days notice to objecting party, debtor, and other interested parties
  - Landlord is generally **not** given relief from automatic stay to setoff or apply any security deposit it is holding without further order of the court
  - A rejection claim bar date is typically established as the later of (x) the general bar date and (y) 35 days after entry of the applicable rejection order

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