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The Intersection of Chapter 11 and Real Estate

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Bankruptcy and real estate law frequently intersect. Real estate lawyers need to be aware of bankruptcy issues as they negotiate and document transactions, and bankruptcy lawyers face real estate issues in almost every case they work on. In a subset of these cases, including single-asset real estate cases, developer bankruptcies and retail cases, real estate issues are likely to predominate. This article highlights a few of the most significant issues where bankruptcy and real estate law intersect. It also explains how certain of the 2005 amendments to the Bankruptcy Code (BAPCPA) impact those issues.

Leases

Bankruptcy Code §365 addresses executory contracts and unexpired leases. This section allows the debtor (whether the landlord or the tenant) to assume or reject a lease within a specified time after filing bankruptcy. If a debtor rejects a lease, the rejection constitutes a breach as of the petition date and gives rise to a claim for damages by the other party. To assume a lease, the debtor must cure existing defaults (at least monetary ones—non-monetary defaults are

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discussed below) and, if the debtor is in default, it must also provide the other party with adequate assurance of the debtor's (or its assignee's; see the next paragraph) ability to perform its

obligations under the lease in the future.

Regarding assignment: Leases assumed by the debtor may be assigned to third parties notwithstanding anti-assignment provisions in the lease. In the case of an assignment, there must be an "adequate assurance of future performance" showing regardless of whether the lease is in default. In other words, the debtor must show that its assignee is capable of performing its obligations under the lease.¹

The Code contains more detailed requirements for "adequate assurance" that only apply in the context of "shopping center" leases, where issues such as tenant mix, the nature of the various tenants' businesses and the rights of other tenants play an important role in the operation of the shopping center. The

¹ In addition, where the debtor, as lessee, seeks to assign the lease, §365(l) provides that the landlord may demand a security deposit under the assigned lease that is substantially the same as what the landlord would require upon initially leasing the premises to a similar tenant.

Code does not define a "shopping center," but there is guidance in the case law.

Section 365(b)(3) provides that "adequate assurance of future performance" under a shopping center lease includes assurance (1) of the source of rental payments and the stability of the assignee's operations, (2) that the assumption or assignment will not breach any provisions relating to a radius, location, use or exclusivity provision, either in the assigned lease or in any other lease, financing agreement or master agreement relating to the shopping center and (3) that assumption or assignment will not disrupt the shopping center's tenant mix or balance. In order to take advantage of these additional protections, landlords should anticipate these issues when drafting lease documents and otherwise be prepared to formulate a position that the leased premises

constitute a "shopping center." Moreover, the availability of these additional protections means that landlords should understand the interests of other tenants in order to properly assess the debtor's offer of adequate assurance.

Time Limit for Assumption

There are several important deadlines imposed by §365 that affect a debtor's ability to assume a lease. Most importantly, §365(d)(4) provides a time limit for a debtor-tenant to assume or reject a lease of nonresidential real property. BAPCPA altered this provision. Prior to the amendments, a debtor-tenant had 60 days from the petition date to assume a lease of nonresidential real property, after which time the lease would be deemed rejected unless the court ordered an extension of this 60-day period. In practice, such extensions were granted routinely, often for the full

duration of a debtor's bankruptcy case. As a result, rejection and assumption motions could be filed by the other party to a lease at any time—from the first day of the case to the date of confirmation of a chapter 11 plan.

Under BAPCPA, the initial 60-day period has been extended to 120 days, but there are strict limitations on the provisions for extensions after this initial period; for example, the court may grant one 90-day extension “for cause” upon the motion of the debtor or the lessor. After that, the court has no discretion to grant further extensions absent the landlord's written consent (or the landlord's own motion).

These provisions provide more leverage for landlords than in the past. If the debtor has not assumed its lease after 210 days, it is within the landlord's discretion whether to permit the debtor to continue under the lease.

Landlords (and their secured lenders) will significantly benefit from the certainty of knowing promptly whether space leased to a debtor will remain leased under the current terms, or be vacated and therefore available for re-leasing to a new tenant. On the other hand, although the 210-day period may prove to be sufficient in cases where the debtor is a small business with limited leased space, the fixed period is likely to be (and indeed, anecdotal experience suggests that it has already been) a great burden to debtors who have many leases, such as retailers, or even one large lease. The 210-day period may also be an insufficient amount of time for a tenant—who is probably dealing with many problems requiring urgent attention—to fully analyze its lease and its business operations and determine whether assumption, assignment or rejection of the lease makes the most sense.²

In addition, the tightening restrictions on the ability of a debtor to delay the decision on whether to assume or reject a lease has tremendous implications for the marketability of “designation rights.” Designation rights are rights sold by the debtor to a buyer that permit the buyer to direct the debtor to assume and assign the lease to a qualifying third party. When the practice was to grant the debtor numerous

extensions of the assumption period, these rights could be attractive to third parties who saw value in the debtor's leasehold interests and who could use the time provided by the Code to locate buyers for the debtor's leases. Now, with all but the first extension of the assumption period subject to the consent of landlords, designation rights may be a less valuable asset to the debtor.

Cure of Non-monetary Defaults

Curing a monetary default under a lease is a fairly straightforward process. In an effort to clarify the obligations for cure of a non-monetary default, §365(b)(1)(A) was amended in 2005 to provide that the debtor is not required to cure non-monetary defaults in order to assume an unexpired lease of real property if it would be impossible to cure such defaults by performing non-monetary acts at and after the time that the debtor assumes the lease. Think of a default arising from violation by a tenant of a “going dark clause,” *i.e.*, the tenant has failed continuously to operate its business as required by the lease. Until the government reveals that it acquired time travel technology from the “aliens” being held at Roswell, N.M., there is no way to go back in time and cure that default, so under new §365(b)(1)(A), post-assumption performance plus compensation for the landlord's financial losses resulting from such default constitute cure.

This provision eliminates the argument formerly available to landlords that a lease could not be assumed because of the impossibility of curing a historical, non-monetary default. In exchange, however, the amendment expressly provides for monetary compensation in connection with the assumption and cure of defaults under a lease. Accordingly, landlords will need to be prepared to calculate the amount of their pecuniary loss resulting from non-monetary defaults. If, for example, a debtor fails to operate under a lease for some period of time, then resumes operations and seeks to cure defaults and assume the lease, what will the landlord's measure of damages be for the non-monetary default? A claim for such losses should include any additional services (*e.g.*, security, upkeep and maintenance) that the landlord was required to provide during the time that the debtor was not operating. In a multi-tenant situation, it should also include reductions in rent paid

by other tenants (if any) who themselves suffered economic losses from the debtor's failure to operate.

Landlord's Bankruptcy

People in the real estate industry have a better sense of the rights of a *tenant* in bankruptcy regarding assumption, assignment and rejection of leases than they do about the rights of a landlord-debtor. In the first instance, the landlord, just like a tenant, can choose to assume or reject a lease. If the lease is assumed, the parties will go forward, with the landlord continuing to perform and the tenant continuing to pay rent.

If the landlord rejects the lease, then §365(h) gives the tenant two options: (1) treat the lease as terminated or (2) retain its rights under the lease (including its rent obligations and the rights of use, possession, quiet enjoyment, assignment, subletting and hypothecation) and continue to occupy the property for the remainder of the term, including any renewals or extensions. If the tenant elects to continue under the lease, it must continue to pay rent, but it may offset any rent against services that the landlord—having rejected the lease—no longer provides. A tenant that elects to continue under the lease does not, however, have any claims against the landlord in addition to the right to setoff rent.

Finally, where the landlord rejects a “shopping center” lease, and the tenant elects to remain, §365(h) provides that the landlord's rejection of the lease does not alter the enforceability of radius, location, use, exclusivity or tenant mix or balance provisions under nonbankruptcy law. In other words, those provisions, which protect other tenants and the overall integrity of the shopping center, remain enforceable after rejection of the lease.

Contracts for the Sale of Real Property

Contracts for the sale of real property are covered by Code §365 as executory contracts. Section 365(i) contains provisions regarding the debtor's rejection of a contract to sell real estate that are somewhat analogous to the provisions described above regarding rejection of a lease by the landlord. Specifically, if the debtor, as seller, rejects a contract to sell real estate and the buyer is already in possession, the buyer may either treat the contract as terminated or remain in possession. If the buyer treats

² Decisions regarding leases often go well beyond the terms of the lease itself. It is not simply a question of whether the lease is above or below market. Instead, the debtor must consider, among other issues, whether it is likely to be able to reorganize, and if so whether the lease is necessary for the reorganized business model, and how the value of the lease to the reorganized business compares to the “market value” of the lease. Thus, the assumption/rejection decision is often closely tied to the debtor's reorganization strategy. In a complex case, it is often difficult to make these decisions within 210 days.

the contract as terminated (or is not in possession when the contract is rejected), §365(j) grants the buyer a lien on the real property for the recovery of any portion of the purchase price that the buyer has already paid.

If, on the other hand, the buyer is in possession and elects to remain in possession, the Code requires that the buyer continue to make all payments due under the sale contract. The buyer may, however, offset against purchase price payments any damages incurred after the rejection of the contract as a result of the debtor's nonperformance. The debtor must deliver title to the buyer in accordance with the sale contract, but is relieved of all other obligations under the contract. The buyer's offset rights constitute its sole claim for damages arising after the rejection date. Real estate creditors, whether they are landlords or lenders, should be aware well in advance of the filing of a bankruptcy case how their claims may be treated under the Code.

Claims Arising under a Lease

The type of claim that will arise under a lease depends on whether the debtor assumes or rejects the lease and, if the debtor rejects the lease, whether it had previously assumed it. In addition, prior to the time that the debtor decides whether to assume or reject a lease, §365(d)(3) requires the debtor to perform all of its obligations under a lease (including payment of rent) until the lease is assumed or rejected.

As discussed above, if the debtor-tenant assumes a lease, the landlord is entitled to a cure of all monetary defaults and compensation for any losses incurred as a result of non-monetary defaults. The cure payment ordinarily must be paid upon assumption or within a very short time period thereafter.

If a debtor rejects a lease that has not previously been assumed, the landlord likely will have a claim with two components: rejection damages arising from the early termination of the lease by the debtor, and unpaid pre-petition rent. Such claims will likely be allowed as general unsecured claims and would be paid *pro rata* with other unsecured nonpriority claims. Section 502(b)(6) caps the landlord's claim for rejection damages at the greater of one year's rent or 15 percent, not to exceed three years, of the remaining term of the lease; there is no cap on the amount of unpaid pre-

petition rent.

Understand that the formula is a cap, not a measure of actual damages. The debtor may still argue that the landlord's actual damages are less than the amount resulting from the §502(b)(6) calculation. For instance, the landlord ordinarily has a duty to mitigate its damages by, among other things, attempting to relet the premises. Any mitigation of damages by the landlord is applied to the total amount of the landlord's claim before the cap is calculated. In some instances, potential mitigation may reduce damages below the §502(b)(6) cap. However, if the landlord holds a security deposit, that deposit is credited against the capped amount of the claim, not the total amount of the claim. There is no corresponding cap on rejection damages where the landlord is the debtor that rejects the lease and the tenant elects not to continue under the lease after rejection.

If a debtor assumes a lease but subsequently rejects it, the other party to the lease has an administrative priority claim for damages arising out of the rejection, and that claim must be paid in full. Debtors obviously try not to do this, but especially with the newly shortened time periods for assumption or rejection, debtors will sometimes find that they made the wrong decision to assume a lease. For example, on the 210th day of the case, the debtor may have thought it would be able to reorganize and therefore would need to maintain its leases, but some time thereafter it may find that reorganization was impossible and that the leases are therefore unnecessary.³

Issues Specific to Secured Claims

Lenders with claims secured by real property may face a host of issues, including, among other things, the valuation of their claim and the value of their collateral, adequate protection of

their security interest, priming by post-petition lenders, sale of their collateral by the debtor, and the treatment of their claim under a chapter 11 reorganization plan.

A secured claim is "secured" under §506(a) to the extent of the creditor's interest in the debtor's interest in the property, and it is unsecured to the extent that the creditor's collateral is worth less than the amount of the creditor's claim. For example, if a lender has a debt of \$80 million, secured by an office building with a value of \$65 million, then it has a \$65 million secured claim and a \$15 million unsecured deficiency claim. To the extent the collateral is worth more than the creditor's claim, the creditor is generally entitled to accrue during the bankruptcy case interest and reasonable fees, costs or charges as provided in the creditor's agreement with the debtor. Most courts have held that if a creditor is entitled to interest, the debtor does not have to pay it currently; the interest may accrue during the bankruptcy case and be paid at the end of the case. However, current interest payments are sometimes negotiated as part of a financing or cash collateral arrangement.

A debtor may surcharge collateral, under §506(c), for the reasonable and necessary costs and expenses of preserving or disposing of the collateral. However, this right is sometimes waived as part of a financing or cash collateral arrangement.

Secured creditors who are concerned about deterioration in the value of their collateral during the bankruptcy case may move under §362(d) to vacate or modify the automatic stay to permit foreclosure or other remedies or to provide them with "adequate protection." Secured creditors may also move for adequate protection where the debtor seeks to use the lender's cash collateral (*i.e.*, rents) to operate its business or seeks to grant a post-petition lender an equal or senior lien on the secured creditor's collateral under §364(d).

Adequate protection can be a fuzzy concept, but it may consist of, among other things, periodic cash payments, replacement liens or commitments to preserve the value of the lender's collateral. A common arrangement is for the lender to receive monthly interest payments as "adequate protection." If the secured creditor's form of adequate protection is insufficient, §507(b) grants the secured creditor a "super-priority" administrative claim, with priority over all other administrative expenses. Of course, in a situation where

³ Prior to the recent amendments to the Code, if a debtor assumed a lease and later rejected it, the landlord was entitled to an administrative priority claim for all damages arising from the subsequent rejection of the assumed lease over the period remaining on the lease. However, after BAPCPA, §503(b)(7) now caps the landlord's administrative priority claim for damages arising from rejection of a previously assumed lease. Claims are limited to the sum of all monetary obligations due under the lease (excluding penalties and obligations relating to the failure to operate) for the two-year period following the later of the date of rejection or actual turnover of the premises, with no reduction or setoff for any reason except for sums received or to be received from a nondebtor. Any additional claims for the remaining lease term are treated as general unsecured claims and are subject to the statutory cap on lease rejection damages under §502(b)(6). This new cap on administrative claims for post-assumption rejection may be seen as counter-balancing the more restrictive timing for assumption of contracts under §365(d)(4); *i.e.*, to the extent that the amendments to §365(d)(4) might cause debtors to assume a lease more hastily than they previously would have, the amendments to §507(b)(7) limit the extent of administrative priority treatment given to claims arising from the post-assumption rejection of such leases.

all of the assets are encumbered, a “super priority administrative expense” may be worthless.

BAPCPA added a provision to §362(d) affording relief from the automatic stay to creditors with claims secured by real estate if the court finds that the bankruptcy petition was part of a scheme to hinder, delay or defraud the lienholders by conveying part or all of the real property without the consent of the secured creditor or court authorization, or by serial bankruptcy filings. In connection with the sale of a secured creditor’s collateral by the debtor, §363 contains prerequisites to such a sale. Section 363(k) permits a secured creditor to credit bid the amount of its claim at a sale by the debtor, thus ensuring that the creditor either gets its collateral or that the sale price exceeds the amount of the creditor’s secured claim.

In chapter 7, where the assets of the debtor’s estate are liquidated by a trustee, a secured creditor will generally either recover the proceeds of the sale of its collateral or take possession of its collateral. In a chapter 11 reorganization, the debtor has several options under §1129.

If a secured creditor does not accept the treatment proposed by a reorganization plan proposed by the debtor, that plan may still be “crammed down” on the secured creditor provided that either (a) the secured creditor retains its lien and receives cash payments totaling the value of the claim with a present value equal to the creditor’s interest in the collateral; (b) the property is sold subject to the creditor’s right to bid its debt, with the creditor’s lien attaching to the sale proceeds; or (c) the creditor realizes the “indubitable equivalent” of its claim (this term is not defined, but it usually refers to conveyance of the collateral to the secured lender in satisfaction of its debt—sometimes referred to as a “dirt for debt” plan).

As noted above, when the secured creditor’s claim exceeds the value of the collateral, the claim is bifurcated into a secured portion (equal to the value of the collateral) and an unsecured portion (equal to the excess claim above the value of the collateral). However, in chapter 11, under §1111(b), a secured creditor may elect to have the full amount of its claim treated as secured, even if the amount of the claim exceeds the value of the collateral. If a creditor makes this election, it is entitled to receive payments over time equal to the full amount of its debt, with a present value equal to the

value of the collateral.

Whether a secured creditor should make this “1111(b)” election is a complicated and fact-specific question; it will depend on, among other things, the amount being paid on unsecured claims (including the secured creditor’s deficiency claim) and on whether the secured creditor believes that the collateral securing its claim was undervalued. The circumstances under which election makes sense are rare. It is, however, a provision that real estate lenders should keep in mind when a borrower files chapter 11.

Single-Asset Real Estate Bankruptcies

The Code contains certain provisions that only apply in a “single-asset real estate” case. The term “single-asset real estate” is defined in §101(51B) as real property constituting a single property or project, other than residential real property with fewer than four residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.

Under prior law, in order to qualify as a single-asset real estate case, the debtor must have owed no more than \$4 million in noncontingent, liquidated secured debts. Under BAPCPA, the \$4 million amount cap has been eliminated from the definition because the cap resulted in the exclusion of most commercial property reorganization cases from the special protections afforded to lenders in single-asset real estate cases. As a result, single-asset real estate provisions will apply in all bankruptcy cases that otherwise meet the definition of a single-asset real estate case, regardless of the amount of secured debt. The removal of the \$4 million cap certainly will make the Code’s single-asset real estate provisions applicable to many more cases.

In a single-asset real estate case, a creditor with a loan secured by a lien on single-asset real estate is entitled to relief from the automatic stay unless the debtor has either (1) filed a plan that has “a reasonable possibility of being confirmed within a reasonable period of time”⁴ or (2) is making monthly payments to the creditor equal to interest at the nondefault contract rate on the

value of the creditor’s interest in the real estate. Such payments may be made from rents or other income generated by the property.

Real estate lenders need to understand the advantages available to them if a bankruptcy court determines that a case is a single-asset real estate case. Lenders also will need to be prepared to establish the value of their interest in the debtor’s property in order to enforce their rights to contract rate interest payments. Undoubtedly, there will be significant litigation over whether there is a reasonable possibility that a proposed plan will be confirmed within a reasonable time under §362(d)(3)(A). ■

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⁴ By the later of (a) 90 days after the petition date (subject to extension) or (b) 30 days after the court determines that the case is a single-asset real estate case.