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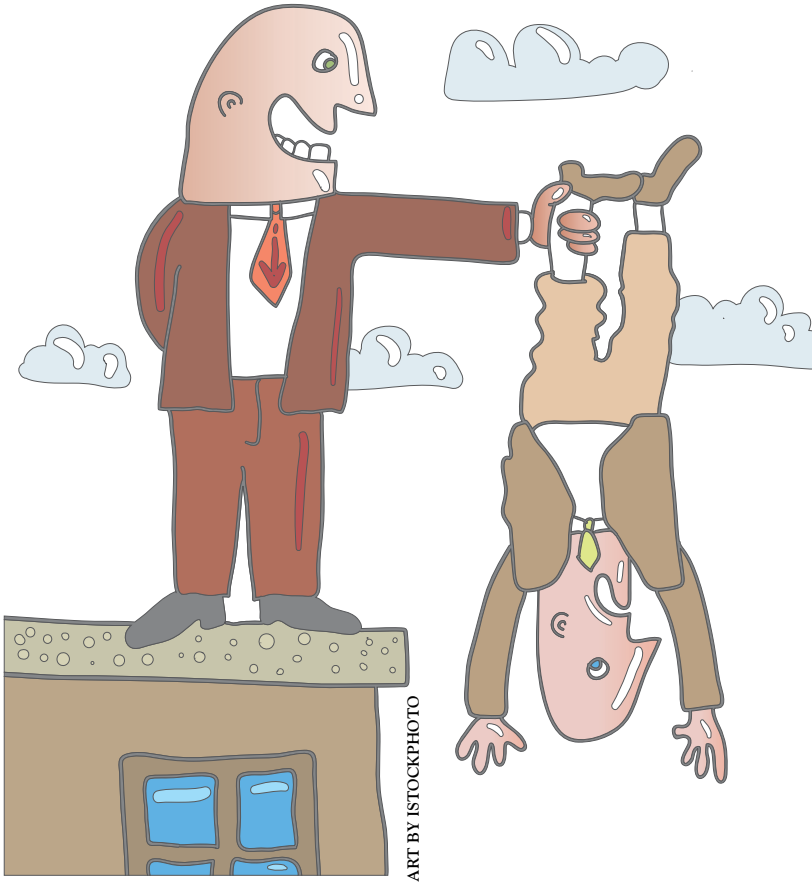
Enforcing Bankruptcy Termination Lease Clauses Against Assignees



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BY MICHAEL A. LYNN, MELISSA BROWN AND JAY P. MAYESH

THE BANKRUPTCY termination clause, sometimes known as an ipso facto clause, permits a landlord to terminate a lease if the tenant files for bankruptcy. Before 1978, an ipso facto clause was enforceable against a tenant that filed for bankruptcy. However, these clauses came to be seen by Congress as hampering a debtor's rehabilitation efforts, and in 1978, to further the goal of preserving a debtor's assets and providing the debtor an opportunity to formulate a plan of reorganization, Congress enacted various new provisions under the Bankruptcy Reform Act that invalidated contractual ipso facto clauses against debtors in bankruptcy.[1]

But what happens if the original tenant assigns the lease to a third party, and the original tenant later files for bankruptcy? Can the landlord invoke the bankruptcy termination clause against the assignee and terminate the lease? Or is the assignee substituted as the tenant for purposes of determining the enforceability of the clause?

There is a split of authority among the New York courts that have considered the issue. Compare *85 Nassau Co. v. T&S Holding Corp.*, New York Law Journal, Sept. 11, 1974, p. 2, col. 1 (App. Term. 1st Dept. 1974) and *Staples, Inc. v. Moses*, 9 Misc.3d 1102(A), 806 N.Y.S.2d 448, 2005 WL 2107865 at *1 (Sup. Ct. N.Y. Cty., July 13, 2005) (Acosta, J.) (refusing to enforce bankruptcy termination clauses against subsequent assignees) with *Inip Co. v. Bailey, Green & Elger Inc.*, 78 Misc.2d 235, 356 N.Y.S.2d 436 (Dist. Ct., 2d Dist. Nassau Cty. 1974) (enforcing bankruptcy termination clause against subsequent assignee).

The better reasoned authority is that where there has been a valid assignment of a lease with notice to the landlord, the landlord may not later use the bankruptcy of the former tenant as a basis for terminating the lease against the subsequent assignee. The rationale that courts have invoked for refusing to enforce the bankruptcy termination clause against the subsequent assignee rests on principles of contract law and equity.

Refusal to Enforce

In *85 Nassau Co.* the Appellate Term refused to enforce a bankruptcy termination provision against the subsequent assignee as a matter of contract law.

In that case, the landlord and tenant entered into a 21 year lease. Under a modification agreement made a year later, the tenant (and any succeeding tenant under the lease) was given the right to assign the lease without the prior consent of the landlord, provided that the assignee assumed the lease and the original tenant named in the lease was not released from liability thereunder.

Shortly after signing the modification agreement, the original tenant assigned the lease to T&S Holding Corp., which remained solvent and was never in default of the lease. Four years later, while T&S Holding was in possession of the lease and making regular payments of rent to the landlord,

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the original tenant filed for bankruptcy.

A month later, the landlord served a notice terminating the lease under the bankruptcy termination clause and brought a hold-over summary proceeding to evict the assignee. The trial term held that the notice of termination was ineffective and dismissed the petition. On appeal, the Appellate Term affirmed, stating:

> Read reasonably, the lease and modification agreement make manifest the intention of the parties to substitute the assignee as Tenant under the bankruptcy clause of the lease, subject only to the contractual obligation of the original tenant to make good any default under the lease by the substituted tenant… To read the lease otherwise would be to construe it unrealistically…and give landlord an unreasonable advantage over the tenant in occupancy.… Had the parties intended that the bankruptcy of the named tenant, although out of possession could terminate the lease, they could easily have so stated in the lease or modification agreement. (citations omitted).

85 Nassau Co. v. T&S Holding Corp., N.Y.L.J. Sept. 11, 1974, p.2, col. 1.

Contrasting Decision

By contrast in *Inip*, a different judge, presented with almost the identical set of facts, reached the opposite conclusion.

There, the landlord had entered into a 20 year lease of commercial property with the original tenant in 1968. A year later, the original tenant assigned the lease.

Just as in *85 Nassau Co.*, the lease in *Inip* provided that the assignee assumed all of the terms, covenants and conditions of the lease and the original tenant was not released from liability. Four years after assigning the lease to Bailey, Green & Elger Inc., the original tenant filed for bankruptcy. Upon learning of this, the landlord sought to terminate the lease.

In construing the bankruptcy termination provision of the lease, the *Inip* court held that the lease could be terminated, finding that it was "basic elementary law that the [original tenant] remained in privity of contract with the landlord even after the assignment…and its liability on the express covenants and conditions in the lease survived any assumption of the lease by [the assignee]." The *Inip* court reasoned that the landlord and tenant bargained for certain rights and responsibilities in the lease and that "[j]ust as in any contractual arrangement, neither party may rid itself of contractual liability 'merely by abandoning it.'" *Inip*, 78 Misc. 2d at 237.

More Recent Ruling

More recently, in *Staples, Inc. v. Moses*, the New York Supreme Court, in deciding a motion for a preliminary injunction, concluded that *85 Nassau Co.* and not *Inip* was the better, if not controlling, view of the law.

In *Staples*, the landlord entered into a long-term lease with Grand Union.[2] Grand Union was permitted to assign its interest in the lease without the landlord's consent and, as in *85 Nassau Co.* and *Inip*, the assignee assumed all obligations of the original tenant, but the original tenant remained on the hook if the assignee failed to perform any of its obligations under the lease. The landlord was permitted to terminate the lease if a petition of bankruptcy was filed by or against the tenant.[3]

> Courts are especially sensitive to over-reaching by landlords and take a dim view of their attempts to obtain an economic windfall—e.g., terminating an economically unfavorable (below market rent) lease so that a much higher rental can be obtained from a new tenant.

In July 1990, Grand Union assigned its interest in the lease to an entity known as 9319 5th Corp. Notice of the assignment was given to the landlord and, thereafter, the landlord accepted rent from the assignee.

In March 1992, 9319 5th Corp. assigned its interest in the lease to Staples, Inc. Notice of the assignment was provided to the landlord.

In connection with the assignment of the lease to Staples, the landlord executed an estoppel certificate in which it acknowledged that "the tenant's notice address under Lease from and after the assignment shall be Staples, Inc., Attn: Lease Administrator, P.O. Box. 9328, Framingham, MA 01701." At all times after March 1992, Staples paid the rent for the premises directly to the landlord, and the landlord accepted the rent.

In late January 1995, four years after Grand Union had already assigned all of its right, title and interest in the lease to 9319 5th Corp., Grand Union filed the first of three voluntary petitions for bankruptcy under Chapter 11 of the Bankruptcy Code. A second petition for relief was filed in 1998, and a third was filed in October 2000.

Notwithstanding the filing of these bankruptcy petitions, the landlord continued to accept rent payments from Staples. In March 2005, some 10 years after Grand Union had initially filed for bankruptcy, the landlord sought to terminate the lease because of bankruptcy.

Staples filed a declaratory judgment action in the Supreme Court of the State of New York seeking an order declaring that the landlord's notice of lease termination to it was invalid and that the lease continued in full force and effect. Staples also moved, by order to show cause, for a preliminary injunction preventing the landlord from taking any steps to evict Staples from the premises or otherwise interfere with Staples' possession of the premises until such time as the court declared and adjudicated the parties' rights under the lease.

In granting Staples' motion for a preliminary injunction, Judge Acosta found that Staples had demonstrated a likelihood of success on the merits of its claim that the landlord had no legal basis to terminate the lease, concluding that "in remarkabl[y] similar circumstances," the Appellate Term of the First Department ruled in favor of the assignee in *85 Nassau Co. v. T&S Holding Corp.*, and that that decision was the better, if not controlling view. Judge Acosta chose not to follow *Inip* "given the clear state policy against lease forfeiture and its drastic remedy." *Staples, Inc. v. Moses*, 2005 WL 2107865 at *2.[4]

Forfeiture Is Frowned Upon

Several New York courts have refused to enforce bankruptcy termination clauses against tenants (and subtenants) where the termination would result in forfeiture of the lease.[5] *Queens Blvd. Wine & Liquor Corp. v. Blum*, 503 F.2d 202 (2d Cir. 1974); *In re Sapolin Paints, Inc.*, 5 B.R. 412 (Bankr. E.D.N.Y. 1980); *151 West Associates*, 92 A.D.2d 76, 459 N.Y.S.2d 605 (1st Dept. 1983).

In *Queens Blvd.*, the Second Circuit emphasized that the bankruptcy would not prejudice the landlord "except to deny it a windfall in the form of increased rent," whereas enforcement of the clause "would destroy a now profitable debtor by depriving it of its most valuable asset—its location." 503 F.2d at 206-07.

In re Sapolin Paints also refused to enforce a

bankruptcy termination clause, and described §365 of the Bankruptcy Code as "codify[ing] and mak[ing] universal what courts of bankruptcy have been doing on an ad hoc basis pursuant to their general equity power." 5 B.R. at 424.

Finally, in *151 West Associates*, 92 A.D.2d at 80, in affirming the judgment of the trial court, the First Department observed that:

> The law is well settled that equity does not favor forfeitures. The record does not reveal any actual harm suffered by the landlord as a result of Printsiples' financial difficulties, whereas a forfeiture in this case would assuredly operate to the detriment of the defendants, especially to that of the subtenant Futterman, who has expended in excess of $80,000 in connection with the move to, and utilization of, its current premises. Other than accepting the agreement between its creditors and Norcnote Associates, Printsiples is not claimed to have failed to perform any of the terms of its lease with plaintiff. Nor is there any allegation that the subtenant, Futterman-Schlang Industries, Ltd., was ever in default. In addition, the rent was paid regularly and on time. The landlord was, therefore, not damaged and would, in all likelihood, allow Futterman to remain in possession at a higher rental. This appears simply to be a situation where the plaintiff, seeking to obtain a greater return on its property, has focused attention on paragraph 16(a) as a means of canceling the lease. Therefore, Special Term properly denied the plaintiff's motion for summary judgment, but should have granted summary judgment to defendant. (citations omitted).

Non-New York Courts Agree

Other cases outside of New York have similarly held—based on principles of contract law and/or equity—that a landlord may not terminate a lease because of the bankruptcy of the former tenant when there has been a valid assignment of the lease with the landlord's knowledge.

In *Waukegan Times Theatre Corp. v. Conrad*, 324 Ill.App.622, 59 N.E. 308 (Ill. App. Ct. 2nd Dist. 1945), an Illinois appellate court held that the landlord could not terminate a lease that had been assigned by the original tenant to a third party because of the original tenant's bankruptcy. There, the bankruptcy took place after the assignment of the lease.

Recognizing that the rule of law in leases is that leases are most strongly construed against the lessor, and that if there is any doubt or uncertainty as to the meaning of the lease provision, it is to be construed in favor of the lessee, the court construed the lease provision against the landlord and held that the bankruptcy of the tenant referred to the assignee and not the original tenant.

The court held that "it is to be remembered that [the original tenant] was forced out of the picture, and [the assignee] was welcomed as successor, by [the landlord], and it would be highly inequitable to impose upon [the assignee], a forfeiture of its rights thereunder, with resulting great financial loss, when [the assignee] is ready, willing and able to carry out and perform all the terms of the lease, with no loss to [the landlord]." 324 Ill. App. at 638.

The California Court of Appeals found *Waukegan Times Theatre* persuasive and adopted the rule that a bankruptcy termination clause, "unless its language plainly otherwise requires, [should] be interpreted as referring to the bankruptcy of the tenant in possession; i.e., the bankruptcy of the original lessee if there has been no assignment of his interest in the lease, or, if there has been an assignment, the bankruptcy of the assignee." *A.J. Flagg v. Andrew Williams Stores, Inc.*, 127 Cal. App. 2d 165, 273 P.2d 294 (Cal Ct. App. 1st App. Dist. 1954).

The New Mexico Supreme Court reached the same conclusion in *Stamm v. Buchanan*, 55 N.M. 127, 227 P.2d 633 (N.M. 1951). In addition to agreeing with the reasoning of *Waukegan Times Theatre*, the *Stamm* court identified an additional basis for holding that the bankruptcy of the tenant could not be used to enforce a bankruptcy termination clause against an assignee—"a fair construction of the lease itself." 227 P.2d at 638.

Reviewing the language of the lease at issue, the court concluded that "[t]he instances are too many in which the use of the word 'Lessee' can only mean the assignee, after a valid assignment, to deny it that meaning in the termination clause…" Id. at 638.

In short, the courts have taken a pragmatic approach to deciding these cases.

The factor common in all of the cases denying forfeiture is that the party whose bankruptcy was asserted to support the claim of lease termination no longer occupied the premises at the time of the lease termination whereas in cases upholding forfeiture, the original tenant continued to occupy the premises.

There is an element of fairness as well running through the cases. Where the original tenant is no longer in possession of the premises and the landlord is accepting rent from the assignee, the landlord is not harmed by the original tenant's bankruptcy (other than possibly foregoing the right to seek payment from the original tenant if the assignee fails to pay its rent).

On the other hand, there will often be substantial harm to the assignee of the premises, particularly where the assignee has made significant economic improvements to the property. Courts are especially sensitive to over-reaching by the landlord and take a dim view of attempts by the landlord to terminate the lease to obtain an economic windfall, e.g., terminating an economically unfavorable (below market rent) lease so that the landlord can obtain a much higher rental from a new tenant.

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1. Section 365(e)(1) of the Bankruptcy Code provides that: [n]otwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or an unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned…on the commencement of a case under [the bankruptcy code]. 11 U.S.C. §365(e)(1) (2005).

2. The original 1958 lease was between a predecessor of the landlord and a predecessor of Grand Union.

3. Section 5(a) of the lease provides: "If as of the date fixed at the commencement of the term of this lease, or if at any time during the term hereby demised, there shall be filed against Tenant in any court pursuant to any statute either of the United States or New York a petition in bankruptcy or insolvency or for reorganization or for the appointment of a receiver or trustee of all or a portion of Tenant's property, and within 90 days thereof Tenant fails to secure a discharge thereof, or if Tenant makes an assignment for the benefit of creditors or petitions for or enters into an arrangement, this lease, at the option of the landlord, exercised within a reasonable time after notice of the happening of any one or more of such events, may be cancelled and terminated and in which event neither Tenant nor any person claiming through or under Tenant by virtue of any statute or of an order of any Court, shall be entitled to possession or to remain in possession of the premises demised but shall forthwith quit and surrender the premises and the Landlord, in addition, to the other rights and remedies Landlord has by virtue of any other provision herein or elsewhere in this lease contained or by virtue of any statute or rule of law, may retain as liquidated damages any rent, security, deposit or moneys received by it from Tenant or others on behalf of Tenant."

4. The dispute between Staples and the landlord was referred to arbitration before the American Arbitration Association. The arbitrator found that there was no legal or equitable basis to enforce the bankruptcy termination clause against Staples. On Aug. 21, 2007, Judge Acosta granted Staples' petition to confirm the arbitration award.

5. Forfeiture is a drastic remedy that has never been favored by the courts of New York, and they have expressly declined to enforce bankruptcy termination clauses where the forfeiture would work substantial hardship on the tenant and provide a windfall to the landlord. Generally, where the landlord seeks termination of the lease on the grounds that the tenant has breached some provision, forfeiture will be permitted only where the breach is substantial. See *Madison 52nd Corp. v. Ogust*, 49 Misc.2d 663, 664-65, 268 N.Y.S.2d 126, 128-29 (N.Y. City Civ. Ct. 1966), aff'd, 52 Misc.2d 935, 277 N.Y.S.2d 42 (App. Term, 1st Dept. 1966); *Rubinstein Bros. v. Ole of 34th St., Inc.*, 101 Misc.2d 563, 566-67, 421 N.Y.S.2d 534, 537 (N.Y. City Civ. Ct. 1979); *Fly Hi Music Corp. v. 645 Restaurant Corp.*, 64 Misc.2d 302, 304, 314 N.Y.S.2d 735, 737-8 (N.Y. City Civ. Ct. 1970), aff'd, 71 Misc.2d 302, 335 N.Y.S.2d 822 (App. Term,1st Dept. 1972). In all of these cases, the courts have reaffirmed the basic principle that forfeiture is a drastic remedy that should be tolerated under nothing but the most extreme of circumstances.