

BANKRUPTCY REFORM CAN IMPACT COMMERCIAL REAL ESTATE COUNSEL

by MICHAEL D. RUBENSTEIN

Bankruptcy reform may not be foremost on the minds of lawyers who represent commercial landlords and tenants. But Congress has significantly changed one of the U.S. Bankruptcy Code's provisions, such that lawyers ignore it at their peril. Because Bankruptcy Code §365 governs executory contracts and unexpired leases, a bankruptcy filing can impact a commercial lease of real property, which the code calls a lease of nonresidential real property.

Prior to the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), §365 was one of the most potent weapons a debtor had, because it gave the debtor power to accept or reject an executory contract or unexpired lease.

In general, accepting a contract or lease means the debtor assumes the benefits and burdens of the contract or lease, which will continue largely as if the bankruptcy had not occurred. Rejecting a contract or lease, on the other hand, means the debtor is walking away from the agreement.

The code provides that rejection is deemed to be a breach of the lease by the debtor, occurring immediately prior to the debtor's bankruptcy filing. The breach happens by operation of law, and it occurs at the time of the filing of the petition — even though the rejection occurs many months later. Thus, the nondebtor party has a pre-petition claim for damages

against the debtor. Generally, the bankruptcy court treats the rent owed from the date of the filing of the petition through the date of rejection as an administrative expense of the estate.

Section 365 also enhances the debtor's ability to assign its leases to third parties. Thus, the code appeared to give the debtor a nearly unfettered right to analyze its leases, consider their economic benefit, incorporate that benefit into its plan of reorganization and discard those that did not fit the plan.

As with many other aspects of BAPCPA, the changes to §365 were Congress' attempt to correct perceived abuses by debtors and the bankruptcy courts. Of course, Congress also took away some of the protections landlords had come to expect from the Bankruptcy Code, the most significant of which are discussed below.

Section 365 traditionally gave the debtor a tremendous amount of flexibility in deciding whether to assume or reject a lease. Section 365 (d) (4) gave the debtor 60 days to make that decision with respect to a lease of commercial real estate. The code also gave the court great discretion to extend this period.

Over the years, it became commonplace for bankruptcy judges to extend this period many times, often until plan confirmation. This gave the debtor leverage and foisted a great deal of uncertainty on the commercial landlord. BAPCPA has reduced debtors' flexibility and shifted leverage to the landlords.

A debtor now has 120 days to assume or reject a lease of nonresidential real property with only a single



extension of not more than 90 days available; a debtor seeking the extension must make that motion within the 120-day period. Thus, the debtor must make the decision to assume or reject in no more than 210 days. Extensions beyond 210 days are only possible if the landlord consents in writing.

The significance of this change to §365 is tremendous. A debtor will, in many cases, be forced to decide whether to assume or reject relatively early in the bankruptcy. Whether this change will result in courts confirming plans earlier or simply in debtors making such decisions prior to plan confirmation is not clear. However, a debtor's decision to assume an unexpired lease in advance of confirmation may well determine the course of the reorganization.

Practical Effect

Given this change in the law, Congress appears to have recognized that there will be an increase in cases where the debtor assumes a lease only to later reject it. Under the prior law, the landlord would have had an administrative-expense claim for the entire balance due. Under BAPCPA, the administrative-expense claim is limited to two years of rent, with any excess being treated as a pre-petition debt and subject to the code's established limits on such claims.

In the years preceding the enactment of BAPCPA, the courts had allowed debtor-tenants to assume their leases and assign them to third parties, even if such assignments violated use or tenant-mix provisions in the leases. Some courts determined these provisions to be void as violations of §365's limits on anti-assignment clauses. In BAPCPA, Congress rejected this approach and amended §365 to make clear that a debtor may not assign a lease to a third party whose use of the property would violate the lease.

While many aspects of the pre-revision §365 favored debtors over their landlords, there was one aspect of the law that seemed to favor landlords. Under §365, a debtor had to cure all defaults at the time of assuming the lease or contract.

Prior to BAPCPA, courts were not consistent in their approach to the cure of nonmonetary defaults, which are

any defaults other than failure to make payments under a lease or contract. One such example is the going-dark provision in many leases that limits the number of days a tenant in, for instance, a shopping mall can be closed before violating its lease. Some courts disregarded all nonmonetary defaults and focused solely on those the debtor could cure via payment. Others held that the debtor could not choose to assume a pre-bankruptcy lease until it cured all defaults, even those where such cure was impossible.

In BAPCPA, Congress attempted to bring order to this area of the law. Section 365 now provides that the debtor must cure all defaults save for nonmonetary defaults that the debtor cannot cure when assuming the lease, such as nonmonetary defaults that occurred in the past — for example, failing to maintain appropriate insurance coverage.

Even if the debtor is excused from curing those nonmonetary defaults, the code now makes it clear that, in the case of commercial leases, the debtor is bound to obey those provisions of the lease going forward. The new law also provides that, with respect to nonmonetary defaults, the debtor is obligated to provide compensation for those nonmonetary defaults.

It is unclear how the courts will interpret this compensation provision. Landlords would be wise to include language in their post-BAPCPA leases that assign a monetary penalty for such nonmonetary defaults. Absent such language in a lease, the landlord may find the bankruptcy courts hostile to such claims.

While various changes to the Bankruptcy Code may not intrigue commercial real estate lawyers, they must be aware of them; BAPCPA's revisions to §365 substantially change the playing field. ■■■

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