Bankruptcy Code Amendments – Principal Real Estate Provisions

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On April 20, 2005, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Action of 2005 (the "Act") into law. While the media has primarily focused on how the Act impacts an individual's ability to obtain a discharge of debts through chapter 7 of the Bankruptcy Code,[1] the Act also includes provisions that will have a significant impact on business reorganizations under chapter 11.

This article addresses the most significant aspects of the Act that materially alter the Bankruptcy Code's provisions governing a single asset realty entity's chapter 11 case, as well as the rights of lessors and lessees with respect to commercial real property leases. Given that the Act amends the Bankruptcy Code, this article describes the applicable pre-Act Bankruptcy Code provisions and the relevant aspects of the Act as they pertain to such provisions. This article also discusses certain practical issues that participants in the commercial real estate industry may wish to consider in light of such amendments. Although certain provisions of the Act apply to cases pending as of the date of its enactment, the amendments discussed in this article will only apply to bankruptcy cases filed on or after October 17, 2005.[2]

SINGLE ASSET REAL ESTATE CASES

Single-asset real estate bankruptcy cases typically share a common storyline. The single asset real estate (SARE) borrower is unable to satisfy its non-recourse mortgage obligations due to a downturn in market conditions. The mortgagee commences a foreclosure proceeding under applicable state law, and the borrower files for chapter 11 protection on the eve of the foreclosure sale in order to obtain the benefit of the Bankruptcy Code's automatic stay, which prevents such sales from proceeding.[3] The typical SARE chapter 11 case is essentially a two party dispute – borrower and mortgagee – and does not involve certain of the principal

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goals of the chapter 11 process such as preserving jobs and the debtor's going concern value.[4] The primary issue in the chapter 11 case is whether the lender will take control of the property. Accordingly, the outcome of this dispute will not materially impact the number of employees necessary to operate and maintain the property and, in light of overall market conditions, will not materially affect the value of the property.[5]

In order to address the abuse of the chapter 11 process, particularly the automatic stay, by SARE debtors, Congress amended the Bankruptcy Code in 1994 to provide for special rules applicable to certain SARE debtors' bankruptcy cases.[6] Pursuant to this prior amendment, the pre-Act Bankruptcy Code defined "single asset real estate" as:

> real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto having aggregate noncontingent, liquidated secured debts in an amount no more than $4,000,000[.][7]

As the pre-Act Bankruptcy Code's definition of "single asset real estate" was expressly limited to a property or project that had secured debt of no more than $4 million, the special rules applicable to the automatic stay in a single asset real estate case had, as a practical matter, limited application.[8] As discussed below, a key component of the Act's amendments is the deletion of this dollar limitation.

The 1994 amendments to the Bankruptcy Code enacted specific rules applicable to a secured lender's request to lift the automatic stay in a single asset real estate bankruptcy case. Pursuant to these rules, the bankruptcy court was required to grant relief from the automatic stay unless, within 90 days after the commencement of the bankruptcy case, (i) the debtor "has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time;" or (ii) the debtor begins making monthly payments to the secured lender "in an amount equal to interest at a current fair market rate on the value of the creditor's interest in the real estate."[9] The bankruptcy court was authorized to extend this 90-day period for "cause" and was required to grant any such extension within that 90-day period.[10]

The Act amends these provisions in several material respects. First, the $4 million secured debt limit set forth in the definition of "single asset real estate" has been deleted.[11] Accordingly, the automatic stay provisions applicable to single asset real estate cases will be applicable to all such cases, regardless of the amount of secured debt.

Second, with respect to the debtor's ability to prevent the lifting of the automatic stay by making monthly payments, such payments must be "in an amount equal to interest at the then applicable nondefault contract rate of interest" under the applicable credit agreement.[12] In this manner, the secured lender will obtain the benefit of its bargained for nondefault interest rate and is no longer faced with the risk that the bankruptcy court could determine that the "fair market rate" is lower than the contract rate.

Third, and perhaps most important, the debtor has the discretion to make monthly payments from rents or other income generated from the property and may do so without prior bankruptcy court approval or notice to the secured creditor, even if the creditor has a valid security interest in such rents or income.[13] This provision is a substantial departure from the Bankruptcy Code's requirement that a debtor may only use cash that is subject to a creditor's security interest upon first receiving the creditor's consent or bankruptcy court approval to use such cash.[14] Absent this amendment, a SARE debtor would only be permitted to use cash subject to a security interest (defined as "cash collateral" by the Bankruptcy Code)[15] over the secured creditor's objection by demonstrating adequate protection of such security interest.[16] Pursuant to this amendment, a secured lender may very well find itself unable to prevent a debtor from using the income generated from the property to make monthly interest payments, even as scheduled maintenance or improvement projects (which would maintain or improve the property's value) are delayed due to a lack of funds. In this case, the secured lender may wish to consider asserting that it is entitled to adequate protection of its underlying security interest in the real property, the value of which may be declining due to, among other things, the debtor's inability to properly maintain the property due to inadequate cash flow.[17] Of course, whether the bankruptcy court will determine that the secured lender is entitled to adequate protection, and whether the SARE debtor is able to provide adequate protection, will depend on the particular facts before the court in each instance.[18]

Finally, with respect to when the debtor is required to file a plan of reorganization or commence monthly payments, the debtor must do so within

the later of the 90-day period noted above and 30 days after the bankruptcy court determines that these automatic stay provisions regarding single asset real estate apply.[19] It is useful to note that this 30-day deadline does not include a carve-out for the bankruptcy court to extend this deadline for cause. Accordingly, if there is a dispute as to whether the single asset real estate provisions apply in a particular bankruptcy case, and should that litigation extend beyond the initial 90-day period of such case, the debtor is apparently unable to obtain an extension of the 30-day period to either file a qualifying plan of reorganization or to begin making monthly interest payments. Therefore, a SARE debtor faced with this situation, and believing that there is cause to extend the 90-day period, would be well served to seek such relief during such period, even while continuing to contest the applicability of the single asset real estate provisions.

TIME PERIOD TO ASSUME OR REJECT NONRESIDENTIAL REAL PROPERTY LEASES

Frequently, among a chapter 11 debtor's principal assets – particularly if the debtor is a retailer – are its nonresidential real property leases. Pursuant to Section 365 of the Bankruptcy Code, the debtor-lessee may elect to reject the lease, assume the lease, or to assume and assign the lease to a third party.[20]

If the debtor rejects the lease, the rejection is treated as a breach of the lease that occurred immediately prior to the filing of the bankruptcy petition, and the lessor holds a claim that is subject to limitation pursuant to a formula set forth in the Bankruptcy Code.[21] As a general matter, in order for a debtor to assume a lease, the debtor must either cure, or provide adequate assurance that it will promptly cure, any defaults under the lease and compensate the lessor for losses arising from such defaults.[22] As discussed below, the Act clarifies the debtor's obligation to cure non-monetary defaults under the lease. In addition, the debtor must provide adequate assurance that it will be able to perform under the assumed lease.[23]

Under the pre-Act Bankruptcy Code, the debtor-lessee had an initial 60-day period within which to elect to reject or assume its unexpired leases.[24] The Bankruptcy Code provides that in the event that the debtor does not make this election within this time period, the lease is automatically deemed rejected.[25] However, the bankruptcy court may extend this period "for cause,"[26] and it was not uncommon in large and complex chapter 11 cases for a bankruptcy court, pursuant to a series of

extensions, to ultimately extend this period through the conclusion of the bankruptcy case.[27]

In requesting such extensions, the debtor typically asserts that it requires additional time to test its business plan and to determine which locations are profitable. In addition, where a debtor is reasonably confident that a location may not be profitable, the debtor may request additional time to market the lease so that the debtor's estate may obtain the value of a below market lease by assigning it to a third party. Lessors, particularly shopping center lessors, have asserted that the lengthy extensions create uncertainty regarding the status of their property, particularly with regard to the risk of having a "dark store" during the critical holiday shopping period.

The Act significantly limits the debtor's ability to obtain an extension of its time to assume or reject its nonresidential leases. The Bankruptcy Code, as amended, provides for the initial 60-day period to be extended to 120 days, and the Bankruptcy Court may thereafter only extend the period for an additional 90 days.[28] The Bankruptcy Court may further extend this 210-day period (i.e., 120 days plus 90 days) on a lease-by-lease basis, but only with the "prior written consent of the lessor in each instance."[29] As the House Committee Report on the Act noted, "this provision is designed to remove the bankruptcy judge's discretion to grant extensions of time for the retail debtor to decide whether to assume or reject a lease after a maximum period of 210 days from the time of [the commencement of the bankruptcy case]."[30]

This modification will have a significant impact on debtors, such as retailers, who must analyze their operations at numerous locations in order to develop a business plan that becomes the foundation for the negotiations regarding a plan of reorganization. Taking the case of a retailer that files for chapter 11 protection during the first quarter of a calendar year, the 210-day period will not permit the retailer to experience the following complete holiday shopping season without having to either first obtain each applicable lessor's consent for a further extension of this time period or, with respect to the leases with respect to such consent is not obtained, to elect to reject or assume such leases.

The Act does not set any specific requirements or parameters for the terms pursuant to which a debtor and a lessor may agree to an extension of this time period. However, the Bankruptcy Code provides that any proposed use of a debtor's property outside the ordinary course of the debtor's business must be approved by the bankruptcy court.[31] As a general

matter, a debtor must demonstrate a sound business purpose for the proposed action.[32] Assuming that entering into, and performing under, an agreement to extend the time to reject or assume a nonresidential lease would not be in a debtor's ordinary course of business, the bankruptcy court would then apply the foregoing standard in considering approval of agreements to extend this time period.

A significant risk associated with assuming a lease before a debtor's business plan is fully tested in the marketplace is that the debtor may subsequently determine that its decision to assume was a mistake. If the debtor rejects a lease that it has previously assumed, courts in pre-Act cases have held that the lessor's damage claim was an administrative expense[33] and was therefore required to be paid in full before any distribution under a plan of reorganization is made in respect of unsecured claims.[34] Furthermore, such claim was not subject to the Bankruptcy Code's limitation on damages arising from the rejection of a lease for nonresidential real property.[35] Given this result, the Court of Appeals for the Second Circuit has noted that:

> bankruptcy courts will rarely find that assuming liability for all future rent under a long-term lease is in the best interests of the estate – including the interest of the general creditors – unless the rental terms are highly advantageous. They will therefore block assumption of such leases except in unusual cases.[36]

The Act addresses this concern by amending the Bankruptcy Code to provide that the lessor's administrative claim arising from the rejection of a previously assumed contract is limited to the obligations under the lease for the 2-year period following the later of the rejection date and the date of actual turnover of the premises. The Act further provides that the lessor's administrative claim may not include any amounts arising under the lease relating to a failure to operate or any penalty provisions.[37] This administrative claim is not subject to reduction or setoff for "any reason whatsoever except for sums actually received or to be received from an entity other than the debtor,"[38] such as a new tenant for the subject premises. The remaining claim of the lessor under the lease is treated as a prepetition claim and is subject to the damages limitation formula set forth in the Bankruptcy Code. While this provision mitigates the cost associated with an ill-advised assumption of nonresidential real property leases, a debtor's missteps with respect to assumption of these leases could very well materially reduce the recoveries for unsecured creditors.

CURE OF NONMONETARY DEFAULTS UNDER NONRESIDENTIAL REAL PROPERTY LEASES

As noted above, in order to assume a lease, a debtor must cure, or provide adequate assurance that it will promptly cure, defaults under unexpired leases.[39] Under the pre-Act Bankruptcy Code, courts did not establish a consistent standard with respect to whether a debtor was required to cure monetary defaults, often referred to as historical defaults, such as failing to continuously operate as required by the lease prior to the filing of the bankruptcy petition.[40] Unlike a missed payment under a lease, which can be cured by the payment of money, it is not possible to cure a historical default (i.e., the debtor cannot correct the fact that it did not conduct business in a certain location where the lease included a prohibition on "going dark"). Accordingly, where a court concluded that a debtor was required to cure any historical defaults, that debtor was effectively prevented from assuming that lease.[41]

The Act clarifies the requirement that a debtor cure nonmonetary defaults under leases of real property, providing that a debtor is not required to cure such defaults "if it is impossible for the [debtor] to cure such default by performing nonmonetary acts at and after the time of assumption."[42] However, if such nonmonetary default occurred under a lease for nonresidential real property, the default must be cured by "performance at and after the time of assumption in accordance with such lease."[43] As discussed below, this provision may have the effect of restricting a debtor's ability to assume and assign its nonresidential real property leases to third parties. The Act also clarifies the requirement that the debtor must compensate the lessor for any pecuniary losses resulting from such nonmonetary defaults, other than penalty rates or penalty provisions set forth in the lease relating to such defaults.[44]

Regarding the requirement that the nonmonetary default be cured by performance at and after assumption, consider the case where a retail debtor has, in violation of a continuous operation provision, failed to operate in a certain leased premises prior to the bankruptcy case. The lease is below market, and the debtor seeks to assume and assign the lease to a third party in order to capture the lease's value for the benefit of the debtor's creditors. Given that the proposed assignee would likely need to build out the space to meet its requirements, the assignee would not be able to immediately conduct business at that location. Placing this situation within the context of the requirement discussed above, the debtor, in seeking to assume and assign the lease, may therefore not be

able to convince a court that the assignee would immediately cure the debtor's default of failing to continuously operate in those premises. As described below, certain courts, in the context of an assignment of a lease of nonresidential property, have permitted the debtor to assign such a lease notwithstanding that the assignee will not comply with all of the lease's terms and conditions. In this manner, this amendment may have the effect of preventing assumption and assignment of a lease where the debtor failed to comply with a nonmonetary obligation, and the assignee is unable to cure such default.

ASSUMPTION AND ASSIGNMENT OF SHOPPING CENTER LEASES

Section 363(f)(1) of the Bankruptcy Code provides that, subject to certain exceptions not applicable to the present discussion, the debtor may assign a lease or executory contract to a third party notwithstanding a provision in the applicable agreement, or in applicable law, "that prohibits, restricts, or conditions the assignment of such contract or lease[.]"[45]Courts have employed this provision to conclude that certain lease terms that restrict the permitted use of the premises are de facto anti-assignment provisions and are therefore not enforceable in connection with the assignment of a lease and the assignee's future use of the premises.[46]

The Bankruptcy Code includes specific requirements regarding adequate assurance of future performance that apply with respect to the assumption, or assumption and assignment, of a lease of real property in a shopping center.[47] These include adequate assurance that (i) percentage rent "will not decline substantially[,]" (ii) the tenant will be subject to the lease's provisions, including those regarding radius, location, use, or exclusivity, and (iii) the shopping center's tenant mix or balance will not be disrupted. Courts, however, have not employed a consistent approach regarding whether the pre-Act Section 363(f)(1) permits assignment notwithstanding that the assignee will not satisfy such shopping center requirements, such as with respect to the use of the premises.[48] The Act amends Section 363(f)(1) so that it is expressly subject to the satisfaction of such requirements.[49] As noted in the House Committee Report, "assumption or assignment of a lease of real property in a shopping center must be subject to the provisions of the lease, such as use clauses."[50]

CONCLUSION

The Act's amendments of the Bankruptcy Code will have a material impact on SARE cases, and the negotiations between lessors and debtor-lessees under nonresidential real property leases with respect to the debtor's assumption, rejection, or assumption and assignment of the same. The amendments substantially restrict the bankruptcy court's discretion with respect to extensions of a debtor's period to assume or reject leases and to approve assignments of leases for premises in shopping centers. In this manner, the amendments include several material provisions that strongly favor the secured creditor of a SARE debtor and the lessor of nonresidential real property. However, as is the case with any amendment to a statute, the true test of the Act's impact can only be measured as courts apply the new rules to disputes between debtors, secured creditors, lessors and other parties in interest in chapter 11 cases over the next several years.

NOTES

1. See, e.g. Associated Press, *Bankruptcy Bill Now Law*, N.Y. Times, April 21, 2005, at C12; Associated Press, *Bush Signing Overhaul of Bankruptcy Rules*, Cincinnati-Kentucky Post, April 20, 2005, at A2; *Bankruptcy Law Puts Focus on Personal Responsibility*, Palm Beach Post, April 25, 2005, at 17A; Stephen Labaton, *House Passes Bankruptcy Bill; Overhaul Now Awaits President's Signature*, N.Y. Times, April 15, 2005, at C5; *Senate OK's Homestead Protection Hike*, Las Vegas Sun, April 25, 2005, at B3.

2. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1501, 119 Stat. 23, 216 (2005).

3. Erich J. Stegich, *Note: The National Bankruptcy Review Commission: Proposals for Single Asset Real Estate*, 5 Am. Bankr. Inst. L. Rev. 531, 533 (1997); Nat'l Bankr. Comm'n, Bankruptcy: The Next Twenty Years, Final Report at 661 (1997) (hereinafter Commission Report).

4. *Commission Report* at 662.

5. Id.

6. Pub. L. No. 103-394, 108 Stat. 1406.

7. 11 U.S.C.A. § 101(51B).

8. *Commission Report* at 663; see also Stegich, *supra* note 3, at 539-40 ("It is unclear why Congress, at the last minute, decided to place this limit on single asset filers. The four million dollar cap is especially puzzling considering that most single asset chapter 11 debtors have debt in excess of four million dollars.")

9. 11 U.S.C.A. § 362(d)(3).

10. Id.

11. Pub. L. No. 109-8, § 1201, 119 Stat. 12, 192-93 (2005). In addition, the "single asset real estate" definition has been amended to exclude a family farmer.

12. Id.

13. Id.

14. 11 U.S.C.A. § 363(a) & (c)(2).

15. 11 U.S.C.A. § 363(a).

16. 11 U.S.C.A. § 363(c)(2) & (e).

17. 11 U.S.C.A. § 363(e).

18. Section 361 of the Bankruptcy Code provides that adequate protection of a secured creditor's interest in a debtor's property may take the form of cash payments, replacement liens, or such other relief as may be granted by the court, including the grant of an administrative expense claim, that will result in the secured creditor realizing the "indubitable equivalent" of its interest in the debtor's property. See 11 U.S.C.A. § 361.

19. Pub. L. No. 109-8, § 444, 119 Stat. 12, 117 (2005).

20. 11 U.S.C.A. § 365(a) & (f).

21. 11 U.S.C.A. §§ 365(g)(1) & 502(b)(6).

22. 11 U.S.C.A. § 365(b)(1)(A) & (B).

23. 11 U.S.C.A. § 365(b)(1)(C).

24. 11 U.S.C.A. § 365(d)(4).

25. Id.

26. Id.

27. See e.g. In re Spiegel, Inc., Case No. 03-11540 (BRL) (Bankr. S.D.N.Y.), Order Pursuant to 11 U.S.C. § 365(d)(4) Extending the Period Within Which the Debtors May Assume or Reject Unexpired Leases of Nonresidential Real Property, dated April 21, 2005 (extending time period to assume or reject leases through and including the earlier of (i) the effective date of a plan of reorganization, and (ii) June 30, 2005, without prejudice to the debtors' ability to seek additional extensions).

28. Pub. L. No. 109-8, § 404, 119 Stat. 23, 104-05 (2005).

29. Id.

30. H.R. Rep. No. 109-31 at 86-87 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 152-53.

31. 11 U.S.C.A. § 363(b)(1).

32. See e.g. Myers v. Martin (In re Martin), 91 F.3d 389, 395 (3d Cir. 1996) (citing Fulton State Bank v. Schipper (In re Schipper), 933 F.2d 513, 515 (7th Cir. 1991)); Committee of Equity Sec. Holders v. Lionel Corp (In re Lionel Corp.), 722 F.2d 1063, 1070 (2nd Cir. 1983) (same); In re Delaware and Hudson Ry. Co., 124 B.R. 169 (D. Del. 1991) (noting that Third Circuit has adopted "sound business judgment" test for section 363(b) asset sales).

33. See e.g. In re Klein Sleep Products, Inc., 78 F.3d 18, 28 (2d Cir. 1996); In re Monica Scott, 123 B.R. 990, 991 (Bankr. D. Minn. 1991).

34. 11 U.S.C.A. § 503(b)(1)(A).

35. *Klein Sleep,* 78 F.3d at 28.

36. Id. at 29.

37. Pub. L. No. 109-8, § 445, 119 Stat. 12, 117-18 (2005).

38. Id.

39. 11 U.S.C.A. § 365(b)(1)(A).

40. See e.g. In re New Breed Realty Enterprises, Inc., 278 B.R. 314, 320-22 (Bankr. E.D.N.Y.) (discussing judicial interpretation regarding a debtor's obligation to cure historical defaults in order to assume a lease or executory contract); see also Weintraub, Historical Defaults and Cross-Defaults: Here a Default, There a Default, Everywhere a Default, Default, Default, 26 Cal. Bankr. J. 286 (2003).

41. In re Bankvest Capital Corp., 290 B.R. 443, 447 (1st Cir. BAP 2003) ("In practice, if debtors had to cure non-monetary defaults, many leases could not be assumed because the cure would be impossible to accomplish.")

42. 11 U.S.C.A. § 365(b)(1)(A); Pub. L. No. 109-8, § 328, 119 Stat. 12, 100 (2005).

43. Id.

44. Id.

45. 11 U.S.C.A. § 365(f)(1).

46. See e.g. In re Rickel Home Centers, Inc. 240 B.R. 826, 832 (D. Del. 1998), app. dismissed, 209 F.3d 291 (3d Cir. 2000), cert. denied, 531 U.S. 873 (2000) (finding that restriction on use to home improvement centers is a de facto anti-assignment clause and permanently striking these clauses from the applicable leases); Hannaford Bros. Co. v. Ames Dep't Stores, Inc. (In re Ames Dep't Stores, Inc.), 316 B.R. 772, 794-95 (Bankr. S.D.N.Y. 2004) (while "a bankruptcy court has the clear power to invalidate provisions in leases assigned by debtors even when those provisions indirectly restrict the debtors' ability to assign the leases, a bankruptcy court retains discretion in determining whether a lease provision hinders the possibility of assignment to a sufficient degree to render it unenforceable.")

47. 11 U.S.C.A. § 365(b)(3).

48. See e.g. In re Trak Auto Corp., 367 F.3d 237, 244 (4th Cir. 2004) (holding that the debtor may not assign a lease for premises within a shopping center to a proposed assignee who would not comply with the lease's use restriction); *Rickel,* 240 B.R. at 831-32 (permitting assignment of shopping center lease notwithstanding proposed assignee's inability to comply with, among other things, lease's restrictive use covenant).

49. Pub. L. No. 109-8, § 404, 119 Stat. 12, 104-05 (2005).

50. H.R. Rep. No. 109-31 at 86-87 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 152-53.