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NONRESIDENTIAL REAL PROPERTY LEASES IN BANKRUPTCY

Josiah M. Daniel, III

Josiah M. Daniel, III
Partner
Vinson & Elkins LLP
Trammell Crow Center
2001 Ross Avenue, Suite 3700
Dallas, TX 75201-2975
Tel 214.220.7718
Fax 214.999.7718
jdaniel@velaw.com

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I. INTRODUCTION

II. LEASE ASSUMPTION AND REJECTION RULES AND PROCEDURES

- A. Overview of Conditions for Assumption or Rejection of Leases
- B. Duty to Perform, Prior to Assumption or Rejection, Obligations of Nonresidential Real Property Leases
- C. Time Limit for Assumption or Rejection
- D. Necessity of Court Approval for Rejection; the Business Judgment Test
- E. Assignment of Lease by the Debtor

III. LANDLORD'S CLAIM FOR DAMAGES IN RESPECT OF A REJECTED LEASE AND THE STATUTORY CAP ON ALLOWANCE

- A. In General
- B. Determination of "Damages Resulting from Termination of a Lease"
- C. Calculation of the "Cap"
- D. Letter of Credit as a Functional Security Deposit

IV. CONCLUSION

* Partner in the Restructuring and Reorganization Practice Group of Vinson & Elkins L.L.P. (Dallas, Texas office).

I. INTRODUCTION

Whatever the line of business, a financially troubled business enterprise does business at one or more locations that it holds as tenant real estate leases. Often the business plan for restructuring the firm will contemplate either retaining and/or closing leased locations, be they retail stores, manufacturing plants, distribution centers, offices, or other premises. The availability of relief with respect to outstanding nonresidential real property leases and the anticipation of landlords' rights can be material factors in determining the advisability of seeking reorganization under Chapter 11 of the Bankruptcy Code. Similarly, if the tenant has defaulted in the payment of rent or has requested to renegotiate the terms of a lease, the lessor will also be keenly interested to ascertain what might happen to the lease if the lessee were to seek relief under the Bankruptcy Code. Moreover, after a reorganization case has been commenced, the effectuation of lease rejection and the allowance of the claim of a lessor are often matters of high consequence, both for the debtor and for the landlord.

The Bankruptcy Code and the Federal Rules of Bankruptcy Procedure provide generally for the assuming and the rejecting of unexpired leases of nonresidential real property.¹ However, the precise procedure for *assumption* or *rejection* of leases, and the rules for calculating the *allowed claim* a landlord may assert after rejection, are not elaborated in the tersely worded precepts of the Code.² A survey of the reported case law demonstrates that the general concept of lease rejection comprises a number of discrete issues that require resolution during the course of a Chapter 11 proceeding, including the procedural steps necessary to reject a lease, the time period within which rejection or assumption must take place, the performance of lease obligations prior to rejection, and, perhaps most importantly, the determination of the amount of damages a lessor may properly claim following the rejection of a lease. The courts have developed specific judicial guidelines on such issues to supplement the general and formal requirements of the Bankruptcy Code and the Bankruptcy Rules.

While the courts have not been unanimous in their interpretations and resolutions of the functional issues and fine points of lease assumption and rejection and rejection-damage-claim allowance, sufficient decisions are of record to identify the position of the majority of courts on each of such issues. This article focuses on Chapter 11 cases and nonresidential real property leases and synthesizes the jurisprudence regarding and rejection of nonresidential real estate leases under which a debtor in possession is the tenant. In addition, it explains the rules for the calculation and limitation of landlords' resulting claims for damages and posits a flow chart and a spreadsheet methodology as aids for conveniently understanding and computing the maximum limit on landlords' damage claims.

II. LEASE ASSUMPTION AND REJECTION RULES AND PROCEDURES

Any attempt to understand the relative positions of the landlord and the tenant in a bankruptcy case of the latter must begin with analysis of the procedures and legal issues regarding assumption and rejection of unexpired real estate leases pursuant to § 365 of the Bankruptcy Code.³ Section 365

¹ 11 U.S.C. § 365; FED. R. BANKR. P. 6006 & 9014. All statutory references in the text are to the Bankruptcy Code (the "Code"), which is Title 11 of the United States Code.

² *See, generally*, 3 COLLIER ON BANKRUPTCY ¶ 502 [b][7][d], at 502-59 to 502-64 (15th ed.); L. Cherkis, COLLIER REAL ESTATE TRANSACTIONS AND THE BANKRUPTCY CODE ¶ 3.03[2] & [3], at 3-85 to 3-94.2.

applies to specifically trustees cases under all chapters of the Bankruptcy Code; but it also applies to debtors in possession in Chapter 11 cases because § 1107(a) provides that a debtor in possession has "all the rights . . . and shall perform all the functions and duties" of a trustee. Among such rights is the right to assume or reject a lease.⁴ Section 365(a) provides that a trustee or the debtor in possession may assume or reject any unexpired lease in effect at the commencement of a bankruptcy case.⁵

A. Overview of Timeline and Conditions for Assumption or Rejection of Nonresidential Real Property Leases

Sections 365(d)(3) and (4) of the Bankruptcy Code require, with respect to a nonresidential real estate lease, that the debtor make its election to assume or reject the lease during the first 120 days of the case, which time period may be extended "for cause" for an additional 90 days (for a total of 210 days), and that the debtor "timely perform all the obligations of the debtor" under the lease arising during the interim period prior to assumption or rejection and meanwhile continuous postpetition pre-assumption or rejection performance is required.

Three conditions for *assuming* an unexpired lease are set forth in § 365(b): prior to the assumption of a specific lease, a debtor in possession must (1) cure all defaults, except "ipso facto"

³ In pertinent part, § 365 provides as follows:

(a) [T]he trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor. . . .

. . . .

(d) (3) [T]he trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title. . . .

(4) [I]f the trustee does not assume or reject an unexpired lease of nonresidential real property under which the debtor is the lessee within 60 days after the date of the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such lease is deemed rejected, and the trustee shall immediately surrender such nonresidential real property to the lessor.

11 U.S.C. § 365(a) & (d) (3) & (4). Section 365 applies to "true" or "bona fide" leases, not to disguised mortgages or secured transactions. *In re Petroleum Products, Inc.*, 72 B.R. 739, 742 (Bankr. D. Kan. 1987).

⁴ *In re Financial News Network, Inc.*, 149 B.R. 348, 350 (Bankr. S.D.N.Y. 1993).

⁵ Section 365(a) applies to leases that exist prior to bankruptcy, not to leases entered into postpetition. *In re Airport Executive Ctr., Ltd.*, 138 B.R. 628, 629 (Bankr. M.D. Fla. 1992). Leases that were validly terminated prior to bankruptcy may not be assumed by the debtor. 11 U.S.C. § 365(c)(3). Similarly, terminated leases need not be rejected. Whether or not a lease has been terminated prepetition is a question of state law. *In re Arden & Howe Assoc., Ltd.*, 152 B.R. 971, 974 (Bankr. E.D. Cal. 1993); *In re S.E. Nichols, Inc.*, 120 B.R. 745, 748 (Bankr. S.D.N.Y. 1990).