Thursday, November 4, 2021
2:15 PM – 3:30 PM

Workshop 17

Is the Earthquake Over Or Should We Brace For Aftershocks?: Landlord-Tenant Bankruptcy and Lease Renegotiation Issues During and After COVID-19

Presented to

2021 U.S. Law Conference
San Francisco Marriott Marquis
San Francisco, CA
November 3-5, 2021

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1. Introduction

2. Did COVID-19 Cause a Seismic Shift in Commercial Landlord-Tenant Relationships?

(a) Brick and Mortar Destruction?

(i) Life Changes

(A) COVID-19 has had a dramatic effect on how Americans live their lives, including increased online shopping, dramatic shifts in purchasing behavior and industry-specific growth and recessions. It is unclear what the immediate future, let alone the next 5 years will hold for brick and mortar landlords and tenants. Did COVID-19 just accelerate long-term trends that were already underway?

(B) What is the future of retail shopping centers? According to Moody Analytics, one-fifth of American malls will either be renovated, repurposed, or razed to make way for new properties, with a higher (as much as 50%) rate expected in slow growth cities in the North and Midwest. But Moody's also observes that "the American mall is not, in fact, dead."[1]

[1] *Some Malls Are Fated to Die. Here's What Will Happen to the Rest*, GlobeSt.com (by Lynn Pollack), June 28, 2021.

(ii) 2020 Tsunami of Retail, Restaurant and Fitness Club Bankruptcies

(A) A far from all-inclusive list:

(1) Pier 1 Imports

(2) Modell's Sporting Goods

(3) Chinos Holdings (J. Crew)

(4) Nieman Marcus

(5) Stage Stores

(6) Tuesday Morning

(7) JC Penney

(8) 24 Hour Fitness

(9) GNC

(10) CEC Entertainment (Chuck E. Cheese)

(11) Brooks Brothers

(12) Ascena Retail Group (Ann Taylor)

(13) Lord & Taylor

(14) RTI Holding Company, LLC (Ruby Tuesday)

(15) Guitar Center

(b) Governmental Responses

(i) Federal Legislation

(A) CARES Act provided much needed financial relief to tenants through the Paycheck Protection Program (PPP), although such funds were initially unavailable to Chapter 11 debtors.

(B) CARES Act also raised the debt limit for Small Business Reorganization Act (SBRA) Chapter 11 cases (subchapter V) to $7,500,000, initially through March 27, 2021 but further extended through March 27, 2022.

(C) The Consolidated Appropriations Act (CAA) amended Bankruptcy Code provisions related to assumption and rejection of non-residential real property leases and the debtor-tenant's performance pending assumption or rejection.

(ii) State/Local Response

(A) Government-ordered "stay at home" shutdowns and restrictions adversely affected brick and mortar industries, precluding or limiting operations.

(B) Eviction moratoria and other local rules and regulations may affect contractual rights and remedies between landlords and tenants.

3. Tenant Bankruptcy Issues – A Widening Chasm between Landlords and Tenants?

(a) Post-Petition Deferred Rent – Is it a Manipulation of the Code?

(i) Statutory overview – Sections 105, 305(a) and 365(d)(3)

(A) Section 305 states that the bankruptcy court can "suspend" all proceedings in a case, at any time, if it serves the interests of the creditors and the debtor.

(B) Bankruptcy Code section 365(d)(3), as amended by the 1984 "Shopping Center Amendments," provides that the bankruptcy court, for "cause," may extend the debtor's time for performance of lease obligations that arise within 60 days of the order for relief, "**but the time for performance shall not be extended beyond such 60-day period**."

(C) Section 105(a) permits the bankruptcy court "to issue and order or judgment necessary or appropriate to carry out the provisions of this title." As the Supreme Court instructed in *Law v. Siegel*, 571 U.S. 415, 421, 134 S.Ct. 1188 (2014), "[i]t is

hornbook law that § 105(a) does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code."

(D) Contrary to popular belief, there were rent deferral decisions under Section 365(d)(3) prior to COVID-19:

(1) *In re Papercraft, Inc.,* 126 B.R. 926 (Bankr. W.D. Pa. 1991) (denying extension, rejecting Creditors' Committee's argument that general unsecured creditors would suffer irreparable harm if debtor was required to pay rent prior to the rejection of debtor's headquarters lease)

(2) *In re DWE Screw Products, Inc*., 157 B.R. 326, 329 (Bankr. N.D. Ohio 1993) (granting extension based on dispute as to whether a single lease, which contained a purchase option, was intended to operate as a purchase agreement)

(3) *In re Tandem Group*, 60 B.R. 125, 127-128 (Bankr. C.D. Cal. 1986) (denying extension where debtor sought relief extending beyond 60-day statutory period)

(4) *In re Pac-West TeleComm, Inc*., 377 B.R. 119, 125-126 (Bankr. D. Del. 2007) (denying extension, observing that "simply being in bankruptcy," "cannot constitute 'cause' under section 365(d)(3). Finding otherwise would make the extension automatic rather than discretionary.")

(E) Does the Bankruptcy Code support lengthy rent deferrals and, if so, what is the standard of proof?

(1) Section 365(d)(3), on its face, appears to allow rent deferrals ***only*** during the first 60 days of a bankruptcy case

(2) Legislative history of Section 365(d)(3) makes it clear that "[a]t the end of this period, the amounts due during the first 60 days would be required to be paid." 130 Cong.Rec. S8994-95 (daily ed. June 29, 1984) (remarks of Senator Hatch)

(3) It appears that throughout 2020, "COVID = cause."

(4) As amended by CAA, Section 365(d)(3) (new subparagraph (B)), allows a *small business debtor* in a Subchapter V (Small Business Reorganization Act) Chapter 11 case to further extend the time to perform post-petition obligations under an unexpired lease of nonresidential real property beyond the initial 60 days. This further extension may be granted if the debtor has experienced or is continuing to experience a material financial hardship due, directly or indirectly, to COVID-19. Post-petition lease obligations under this amended deferral period that are unpaid at the time of confirmation of a Subchapter V plan may be paid over time through the plan, pursuant to Bankruptcy Code section 1991(e) (and thus not part of the "cure" due upon lease assumption under Section 365(b)). This change will "sunset" in two years after the date of its enactment, i.e., on December 27, 2022.

(ii) Section 365(d)(3) – Beyond the 60 Day Statutory Limitation?

(A) At least two courts used their equitable powers to ignore the express statutory limitations of Section 365(d)(3), noting extraordinary circumstances of COVID-19 pandemic

(1) *In re Modell's Sporting Goods, Inc.*, Case No. 20-14179 [Docket Nos. 115, 166, 294, 371] (Bankr. D. N.J. March 23, 2020) (relying on the "suspension" of the case under Section 305 to defer rent beyond 60 days)

(2) *In re Pier 1 Imports Inc.,* Case No. 20-30805 [Docket Nos. 438, 493] (Bankr. E.D. Va. Mar. 21, 2020) and 615 B.R. 196 (May 10, 2020) (relying on Section 105 to permit deferral of rent beyond 60 days during debtors' "Limited Operations Period")

(iii) 365(d)(3) – The Southern District of Texas Holds Firm; 60 Days is the Limit

(A) Facing requests for rent deferrals in at least three large Chapter 11 cases, the Bankruptcy Court for the Southern District of Texas stuck by the express language of the statute, refusing to extend relief beyond 60 days.

(1) *In re Stage Stores, Inc.*, Case No. 20-32654 (Bankr. S.D. Tex. May 11, 2020) (consensual resolution)

(2) *In re J.C. Penney, Inc.*, Case No. 20-20182 (Bankr. S.D. Tex. May 28, 2020)

(3) *In re CEC Entertainment, Inc.*, Case No. 20-33163 (Bankr. S.D. Tex. June 28, 2020)

(iv) Who got it right?

(A) Legislative History – Payment due at the end of the 60 day period.

(B) Pre-COVID Analysis – Amounts deferred post-petition are due and owing on the 61st day after the petition date, and cannot be deferred thereafter. See *In re Tandem Group, supra,* and *In re Simbaki, Ltd*., 2015 Bankr. LEXIS 1142 *19 (Bankr. S.D. Tex. 2015) ("The Bankruptcy Code prohibited the Court from extending Simbaki's time for performance of its rent obligation because it did not arise within 60 days after the order for relief.")

(C) Does the rationale of *Pier 1* work? *Pier 1* relied on *In re Circuit City Stores, Inc*., 447 B.R. 475 (Bankr. E.D. Va. 2009), a stub rent decision, for the proposition that Bankruptcy Code section 365(d)(3) does not say what happens if the debtor fails to pay deferred rent on the 61st day. What about the Legislative history of Section 365(d)(3) ("required to be paid")? Should the landlord be satisfied with having only an administrative claim for the deferred rent, payable either on assumption of the lease or confirmation of a plan? Does this eviscerate the "timely" performance requirement of Section 365(d)(3)? Do the CAA amendments, adding new Section 365(d)(3)(B), support landlord arguments that financing of deferred rent through a plan is limited to SBRA cases? Are contempt, conversion or dismissal potential remedies for non-payment?

(v) What is the role of "adequate protection" under Bankruptcy Code section 363(e)?

(A) The majority of cases hold that a landlord is entitled to adequate protection of its right to receive post-petition rent. *See, e.g., Memphis-Shelby County Airport Authority v. Braniff Airways, Inc. (In re Braniff Airways, Inc.),* 783 F.2d 1283, 1286-1287 (5th Cir. 1986); *In re P.J. Clarke's Restaurant Corp*., 265 B.R. 392, 404 (Bankr. S.D.N.Y. 2001) (noting that a "landlord's right to adequate protection seems to follow clearly from the language of §363(e)…"); *In re Ernst Home Center, Inc*., 209 B.R. 955, 965-966 (Bankr. W.D. Wash. 1997).

(B) Is the landlord suffering a diminution in value, resulting from the deferral of rent, entitled to adequate protection?

(C) The *Pier 1* Conundrum – Judge Huenekkens concluded that deferred rent not indicative of a diminution in value, so debtor required only to make payment of *direct* obligations arising under lease (such as direct obligations to utilities and taxing authorities that, if not paid, would result in termination of service or the imposition of liens). Adequate assurance did not include payment to landlords of "triple net" pass-through obligations. *See In re Pier 1 Imports, Inc.*, 615 B.R. 196, 202-03 (Bankr. E.D. Va. 2020).

(D) Did *Pier 1 Imports* get it right?

(1) Deferred rent may not be paid in full if estate becomes administratively insolvent. Is too much risk being shifted to debtor's landlords?

(2) Since commercial properties are frequently valued on the income approach, doesn't an interruption in income translate to a loss of value?

(3) Should landlord be entitled to accrual and payment of interest on deferred post-petition rent, particularly if the lease clearly provides for it?

(4) It is well-established that the mere allowance of an administrative priority claim for accruing post-petition rents is not adequate protection. *In re Attorneys Office Management, Inc.*, 29 B.R. 96, 99 (Bankr. C.D. Cal. 1983) ("In §361(3) it is made clear that an administrative claim under §503(b)(1) in itself will not constitute adequate protection.").

(E) One potential form of adequate protection would be to prevent the debtor from waiving the bankruptcy estate's rights against their secured lenders under Bankruptcy Code sections 506(c) (surcharge) and 552 (the "equities of the case" exception to the lender's secured lien) in connection with debtor-in-possession financing under the deferred rent is paid.[2] Such relief was granted in pre-COVID cases but received little traction in 2020.

4. Pre-Petition Rent Deferral Issues

(a) Negotiating with a struggling tenant – potential pitfalls

(i) Deferred rent – pre-petition agreement to defer rent obligations to a later date treated as pre-petition obligation even if subject to a lease amendment

(A) *In re Gantos, Inc.*, 181 B.R. 903, 909 (Bankr. W.D. Mich. 1995). Rent that became due pre-petition but which was deferred, even by amendment, remained a pre-petition obligation for the purposes of §§ 365 and 502(b)(6)

(B) *In re Malease 14FK Corp*., 351 B.R. 34 (E.D.N.Y. 2006) (deferred rent considered past rent for purposes of § 502(b)(6) cap on lease rejection damages)

(C) But see *In re Jillian's Ent. Holdings*, 372 B.R. 342, 349 (Bankr. W.D. Ky. 2007), determining that rent that became due pre-petition but which was deferred by amendment became, as a result of the amendment, a post-petition obligation for the purposes of § 365.

(1) Would preclude payment of deferred rent as cure obligation and might eliminate deferred rent from calculation of lease rejection damages.

(D) See also *In re Cukierman*, 265 F.3d 846 (9th Cir. 2001) (interpreting § 365(d)(3) as a "bright-line rule, encompassing all obligations contained in a bargained-for agreement," suggesting deferred rent coming due post-petition is due on a current basis).

(b) Preference Liability for Pre-petition Deferred Rent Payments?

(i) The New 547(j) Exception – Deferred rental payments are not subject to preference suits

(A) To encourage landlords to enter into rent deferral agreements without fear of later disgorgement should the tenant later file for bankruptcy and reject the lease, Bankruptcy Code section 547 was amended, through the CAA, to exempt "covered payment of rental arrearages" made to a creditor within the 90-day period preceding the bankruptcy filing and that otherwise might have been recoverable as avoidable preferential transfers made outside the ordinary course of business.

(B) In order to qualify for this exemption, any such payments must have been made on account of (i) a lease that was entered into before the bankruptcy filing, (ii) a lease that was amended *after* March 13, 2020, and (iii) a lease amendment that deferred or postponed payments otherwise due under the lease. Deferred payments are not exempt to the extent attributable to late fees, penalties or interest imposed pursuant to any such post-March 13, 2020 lease amendment.

(C) New Section 547(j) is structured as an exclusion from the definition of a preferential "transfer" under Section 547, rather than as an affirmative defense. As a result, landlords and suppliers are relieved from the potential burden, expense and delay

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[2] In denying a Section 506(c) waiver in *In re Sports Authority Holdings, Inc*., Case No. 16-10527 (MFW) (Bankr. D. Del.), Judge Walrath observed that where a Chapter 11 case is being run for the "benefit of the lenders," then "the lenders are going to have to pay the cost of that. And that includes all administrative. It includes the rent." April 26, 2016 hearing transcript [Docket No. 1463] at 194:10 to 195:16.

of proving, under the prior version of Section 547 and existing case law, that deferred rent payment agreements become "ordinary course" during the COVID-19 pandemic. *See, e.g., Wiscovith-Rentas v. Villa Blanca VB Plaza, LLC*, 543 B.R. 345, 361 (1st Cir. BAP 2016) ("There is 'no precise legal test' to determine whether a preferential transfer was made in the ordinary course of business between the debtor and the creditor.").

(D) Section 547(j) apples to all bankruptcy cases ("any case … under title 11, United States Code) commenced before the 2-year anniversary of its enactment, i.e., cases filed by December 27, 2022. As a result, "covered payment[s] of rental arrearages" based on pre-petition agreements would still be shielded from preference exposure even if received after December 2022 so long as the tenant's bankruptcy case was filed before the "sunset" date

5. State law Protections – Impossibility, Frustration of Purpose

(a) State law may alter obligation to pay rent under lease.

(i) Leases typically governed by state law to extent not superseded by federal statute (like *ipso facto* clauses) or negotiated-for allocation of risk.

(A) If state law or contract terms precludes performance, tenant may have exception to 365(d)(3) post-petition payment obligations.

(ii) Application of Contractual *Force Majeure* or Common Law Theories in Bankruptcy Context

(A) *In re Hitz Restaurant Group*, 616 B.R. 374 (Bankr. N.D. Ill. 2020) gained great notoriety by being one of the first cases to address the application of a force majeure provision in a commercial lease during the COVID-19 pandemic

(1) The lease in dispute in *Hitz* included a force majeure clause which excused performance by a party of "any of its obligations [that] are prevented or delayed, retarded or hindered by . . . laws, governmental action or inaction, orders of government."

(2) The debtor-tenant, relying on Governor Prtizker's order requiring "all businesses . . . that offer food or beverages for on-premises consumption to suspend service," argued, in response to the landlord's motion to compel payment of post-petition rent, that the governor's executive order triggered application of the force majeure clause in the lease and therefore excused the tenant's obligation to pay rent.

(3) After the tenant acknowledged that it could still operate through take-out service during the shutdown, the bankruptcy court engaged in an analysis of the percentage of contract rent that should be excused. Neither party provided the court with adequate information to determine the appropriate amount of a potential rent reduction, with the landlord apparently not addressing the issue and the tenant only stating that approximately 25% of the restaurant's square footage could have been used for permitted services. The bankruptcy court interpreted the tenant's estimation as an admission that it owed at least 25% of the rent and ordered that amount to be paid within two weeks of its ruling.

(4) Biggest lesson of *Hitz* is the re-affirmation of the unpredictability of bankruptcy court determinations of lease interpretation disputes.

(B) *In re CEC Entertainment, Inc.*, 625 B.R. 344, 356 (Bankr. S.D. Tex. 2020).

(1) Neither contractual force majeure provisions that excluded application to the payment of rent, nor the common law doctrines of impossibility and frustration of purpose, excused or extended the time for the payment of post-petition rent. Case looked at California, North Carolina and Washington law.

(2) Chuck E. Cheese also asked the bankruptcy court to abate rent, pursuant to its equitable powers. Judge Isgur rejected this request, reasoning that "While the Bankruptcy Code allows the Court to delay performance of

CEC's lease obligations, the Code expressly prohibits delays beyond sixty days after the order for relief. That period has expired."

(3) State law may work both ways in an aggressively negotiated landlord friendly lease. While state law may afford relief from performance in certain instances, parties may contract away their rights to cease performance.

(C) *In re Cinemex USA Real Estate Holdings, Inc.,* 627 B.R. 693 (Bankr. S.D. Fla. 2021)

(1) Cinemex brought a motion to excuse/reduce rent on the grounds that the COVID-19 pandemic frustrated the purpose of the lease and rendered performance impossible.

(2) During the period when Governor DeSantis closed movie theaters in the state (March 20) until they were allowed to reopen on June 5, 2020, the bankruptcy court found that rent was excused under the equitable doctrines of impossibility of performance and frustration of purpose. Due to the particular language of the lease, the court also found that "the term of the Lakeside Lease (unless that lease is rejected) is extended by the amount of time the movie theater was closed."

(3) After June 5, when Florida theaters were allowed to reopen at 50% capacity, rent was not excused or reduced and the debtor was required to pay full contractual rent. Cinemex was permitted to operate the theaters and its decision not to reopen was a "financial decision" that did not meet the standard of frustration of purpose or impossibility. This is key portion of opinion – the debtor-tenant's decision to remain closed for business reasons once governmental restrictions were lifted was not chargeable to the landlord.

6. Assumption and Rejection in the Near Future – CAA Amendments and New Deadlines – now 300 days

(a) Consolidated Appropriations Act extends deadlines to assume or reject nonresidential leases under Bankruptcy Code section 365(d)(4)

(i) A tenant now has 210 days to assume, assume and assign, or reject unexpired non-residential real property leases (increased from prior 120 days)

(A) An additional 90 days still available on a showing of "cause" for extension, for a potential total of 300 days (increased from 210 days), with further extensions requiring

(1) That pesky "cause" standard again…what does it mean and how do you prove it?

a) Will the standard for "cause" become tougher given the 90-day extension of the initial time to assume or reject (210 days being the former maximum time, absent landlord consent)?

(ii) This change will "sunset" in two years after the date of its enactment, i.e., on December 27, 2022.

(A) Effects of increased time?

(B) Meaningful and, if so, why? Will debtors' lenders not allow cases to "linger," reducing impact of extended statutory period?

7. Negotiating Leverage – Desperation or Dream?

(a) Early and Mid-COVID Outlook – did desperation and/or paranoia destroy landlords' negotiating power?

(i) Did increasing vacancies and uncertainty about future potential tenants deteriorate negotiating power in and out of bankruptcy cases?

(ii) Did availability, or fact, of bankruptcy court-ordered rent deferrals alter the playing field?

(iii) Did the threat of bankruptcy "chill" pre-petition deals or did landlords simply expect to be "re-traded" once bankruptcy was filed?

(iv) Consider the role played by the landlords' own lenders.

(b) Later in the COVID cycle – and the power of potential

(i) Did "bounce back" potential deter landlords from conceding to tenant demands during lease negotiations?

(c) Outlook – who has the upper hand today?

(i) We want to hear from you!

(d) The Role of Bankruptcy Plan Sponsors and Lenders in Negotiations

(i) Do plan sponsors, senior lenders equitizing debt for a controlling stake of the company, or buyers leverage negotiations with landlords as a condition precedent to reorganization or potential sale? Examples:

(A) Studio Movie Grill -- Goldman Sachs

(B) Chinos/J. Crew -- Anchorage Capital Group

8. Negotiating Post-Petition Rent Modifications

(a) Effective Date Provisions:

(i) In negotiating post-petition lease modifications, landlords must be sensitive to the effective date of the proposed modifications. Debtors will seek to have the benefit of rent relief immediately or at the beginning of the next calendar month, while maintaining "optionality" as to whether to assume or reject the lease, even as modified, or to "re-trade the deal" later with further lease modifications deals under the threat of lease rejection. Landlords will want the commitment to assume the lease in exchange for economic concessions.

(ii) An example of a customary (pre-COVID-19) post-bankruptcy lease amendment provision, conditioning the effectiveness of the change in economic terms upon bankruptcy court approval and/or the assumption of the lease, is as follows:

(A) *The effectiveness of this Amendment is conditioned upon approval of this Amendment by the Bankruptcy Court pursuant to a final order (the "Approval Order") in form and substance acceptable to Landlord which, among other things, provides for the assumption of the Lease, approval of this Amendment and the authorization for the Tenant to perform hereunder, and which is not stayed pending appeal. Following execution of this Amendment by the parties, Tenant, at its sole cost and expense, with Landlord's reasonable cooperation, shall promptly, but in no event later than _____, 2020, file a motion and use its reasonable efforts to obtain entry of the Approval Order by the Bankruptcy Court by no later than ____, 2020*.

(iii) In the COVID-19 environment, the threat of lease rejection, and potential for a prolonged vacancy following lease rejection, has changed the dynamics and negotiating leverage in lease modification negotiations and made traditional effective date provisions less common, as debtor-tenants seek to preserve the right to assume or reject the lease, even after the lease modification. An example of such as provision, in common use throughout 2020 and into 2021, is as follows:

(A) *Nothing in this Amendment is intended or shall be deemed to: (i) be an assumption or rejection of the Lease pursuant to section 365 of the Bankruptcy Code; (ii) be a determination that the Lease is a postpetition contract or agreement; or (iii) impair, prejudice, waive or otherwise affect any rights of Landlord or Tenant and its estate in connection with the Bankruptcy Proceeding or under the Bankruptcy Code, including, without limitation, the rights of the Tenant and its estate to reject the Lease or the rights of Landlord to contest or otherwise oppose such rejection. For the avoidance of doubt, the parties hereby acknowledge and agree that the Lease shall remain a prepetition contract or agreement subject to rejection under section 365 of the Bankruptcy Code by the Tenant and its estate notwithstanding the parties' entry into this Amendment, and in the event that the Tenant and its estate reject the Lease, nothing in this Amendment or under the Lease, is intended*

or shall be deemed to change the character or priority of any claims arising from or related to such rejection and the Tenant reserves the right to object to any and all claims filed by the Landlord on any and all bases. All of the Tenant's rights to seek (i) assumption, assignment, or rejection of the Lease, as amended herein, and any contract or document related thereto and (ii) the sale or other disposition of any property located at the Leased Premises are fully reserved. This Lease Amendment is intended to be an ordinary course amendment of an unassumed prepetition contract, and not to be a post-petition agreement.

(B) Note that this provision also seeks to avoid having to obtain bankruptcy court approval, purporting to characterize the amendment as being in the "ordinary course" for purposes of Bankruptcy Code section 363(b).

(iv) Another, and more blunt, example requires bankruptcy court approval for the lease amendment, but allows the debtor-tenant to take the immediate benefit of its terms:

> *This Agreement shall become effective and binding on Landlord and Tenant only upon (i) the execution of this Agreement and (ii) entry of an order in the Bankruptcy Court (which may be an order confirming Tenant's chapter 11 plan), authorizing Tenant's assumption of the Lease, as amended by this Agreement (the "Effective Date"). Without limiting the foregoing,* ***the Parties agree to abide by the terms of this Agreement to the extent inconsistent with the Original Lease immediately upon execution pending the occurrence of the Effective Date.***

(A) This clause plainly shifts the risk of failure of the tenant's reorganization to the landlord, potentially leaving the landlord with only a claim against the bankruptcy estate for the "delta" between pre- and post-modification rent should the reorganization effort fail or if the debtor-tenant subsequently decides to reject the lease.

(v) Prior to 2020, landlords frequently bargained to "hold the money," requiring the tenant to pay existing rent pending the assumption of the lease and/or confirmation of a Chapter 11 plan, but with rent relief retroactive to an earlier date. Following lease assumption, the tenant would receive the benefit of a credit, in some cases worth several months' of rent, upon satisfaction of the conditions. Such an arrangement places the execution risk in the Chapter 11 case on the debtor (and its post-petition lender). An example of a so-called "tailwind" provision (as in the debtor receives the benefit of a tailwind on emergence from bankruptcy) is as follows:

(A) *Following the satisfaction of the conditions to the effectiveness of this Agreement, as provided in Paragraph x, above, Tenant shall be entitled to a credit equal to the difference between (i) the Basic Rent under the Lease paid by Tenant from and after the Effective Date and (ii) the modified Basic Rent provided by Paragraph x, above (the "****Credit****"). The Credit shall first be applied to the balance of all unpaid Basic Rent and any additional rent and charges which accrued under the Lease prior to the Effective Date and any subsequently-billed adjustments or reconciliations for any prior calendar year or fiscal quarter before application to any future accruing obligations. Landlord will provide Tenant with a written reconciliation delineating the rent and charges that accrued under the Lease prior to the Effective Date.*

(B) Whether and when market conditions shift to bring tailwind provisions "back into vogue" remains to be seen.

(b) Claim Recapture Provisions:

(i) A claim recapture provision is intended to "reinstate" a landlord's potential claim to one based on the lease prior to the current modification in the event the tenant filed bankruptcy and rejects the lease, as amended, notwithstanding the recent lease restructuring. By way of example, if a lease amendment reduced a tenant's rent obligation from $200,000 toy $100,000 a year, and the tenant ultimately filed for bankruptcy and rejected the lease, the landlord's lease rejection damages claim would be based on the $200,000 annual rent, not the reduced amount.

(ii) An example of a claim recapture provision is as follows:

If the Lease is rejected in the Chapter 11 Cases, Landlord may assert an administrative claim for all unpaid post-petition obligations under the Original Lease, without regard to this Agreement, but which claim shall be reduced by any payments made by Tenant under this Agreement or the Original Lease, and Landlord's rejection damages claim shall be calculated as if this Agreement had never been entered into.

(iii) Claim recapture provisions are frequently used where a lease amendment is concluded prior to a tenant's commitment to ultimately assume the lease, either pre-petition or after the Chapter 11 case is filed but prior to the assumption of leases through a plan or by motion, examples of which are discussed above.

(iv) There do not appear to be any reported cases expressly enforcing a claim recapture provision. Such clauses would appear to not fall under the prohibition on so-called *ipso facto* clauses contained in Bankruptcy Code section 365(e). Under Section 365(e), a lease provision providing for the termination or modification of an executory contract or unexpired lease conditioned on the debtor's insolvency or financial condition, the commencement of a bankruptcy case or the appointment of a receiver or custodian, is inoperative in a bankruptcy case. A claim recapture provision, triggered on the subsequent rejection of the lease, falls outside the scope of the statute.

(v) While claim recapture provisions are attractive in principle, a landlord must assess, as a practical matter, their significance. If a bankruptcy case "melts down" and multiple (or all) of debtor's leases are rejected, what is the preserved claim really worth (as in pennies on the dollar or even zero)?

9. Landlord Bankruptcy Issues

(a) Three shopping center landlord bankruptcies in 2020-2021

(i) *In re CBL & Associates Properties, Inc*., Case No. 20-35226 (Bankr. S.D. Tex.), filed November 1-2, 2020

(ii) *In re Pennsylvania Real Estate Investment Trust* ("PREIT"), Case No. 20-12737 (Bankr. D. Del.), filed November 1, 2020, prepackaged Chapter 11 plan confirmed November 30, 2020 and effective December 10, 2020

(iii) *In re Washington Prime Group, Inc*., Case No. 21-31948 (Bankr. S.D. Tex.), filed June 13, 2021

(iv) Notice that there have been no lease rejections in either CBL or PREIT

(v) Is the fear of rejection of leases by a debtor-landlord overblown?

(b) Bankruptcy Code Section 365(h)

(i) limits the effect of rejection when the debtor landlord seeks to reject an unexpired lease of real property and grants the non-debtor tenant special protections.

(ii) Purpose:

(A) "strike a balance" between rights of debtor landlord and non-debtor tenant by allowing lessee to retain right to possess property for remainder of term, while permitting rejection to free the debtor of other burdensome obligations that it may have assumed under the lease. *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 546 (7th Cir. 2003) ("Qualitech").

(iii) Upon rejection of the lease by the landlord, tenant has 2 options:

(A) treat lease as terminated, vacate property, and assert general unsecured rejection damages claim; or

(B) if lease term has already commenced, retain its rights for the remainder of lease term under Bankruptcy Code section § 365(h)(1)(A).

(1) What kind of rights?

a) Amount and timing of rent payment

b) Use, possession, quiet enjoyment

c) Subletting, assignment, or hypothecation

(2) Under pre-1994 version of Section 365(h), a rejecting debtor-landlord or trustee could avoid the application of restrictive uses. *See, e.g., In re Arden & Howe Assocs*., 152 B.R. 971 (Bankr. E.D. Cal. 1993) (non-debtor tenant remaining in possession could not enforce restrictive use covenant against trustee of debtor-landlord). Section 365(h)(1) now provides that, if the tenant elects to retain its rights following the landlord's rejection of a lease in a shopping center, the rejection "does not affect the enforceability under applicable nonbankruptcy law of any provision in the lease pertaining to radius, location, use, exclusivity, or tenant mix or balance."

(iv) If tenant elects to retain rights, it can offset against rent due under the lease post-rejection damages resulting from debtor's failure to perform obligations under lease, but will not have right against estate for rejection damages claim. 11 U.S.C. § 365(h)(1)(B).

(v) These special protections are extended to any "successor, assign or mortgagee" permitted under the terms of the lease. 11 U.S.C. § 365(h)(1)(D).

(c) Section 365(h) Protections vs. Section 363(f) Sale

(i) § 363(f) allows the sale of property of the debtor free and clear and all liens, claims and encumbrances if:

(A) under non-bankruptcy law, the sale can be free and clear of such interest;

(B) consent of the interest holder;

(C) if a lien, the sale price is greater than all liens on the property;

(D) the interest is in bona fide dispute; or

(E) the interest holder could be compelled by a court to accept a monetary satisfaction.

11 U.S.C. § 363(f).

(ii) If a party in interest requests, the court shall prohibit or condition the sale of property as necessary to provide adequate protection of interests in the property.

(iii) Conflicting Authorities on Whether Property Can Be Sold Free and Clear of an Existing Lease:

(A) *Qualitech*, 327 F.3d 537

(1) Leases are "interests" in real property and debtors can sell free and clear of such interests.

(2) Section 365(h) is limited to lease rejection, not a sale of debtor's property. A debtor can extinguish a tenant's leasehold interest.

(3) These courts rely on general principles that a statute should be afforded its plain meaning and that two statutes should be construed to avoid conflict.

(4) When Congress did intend to subordinate or condition section 363(f), it expressly did so. But, there is no limitations in the plain language of sections 363 or 365 and no legislative history for either section demonstrating congressional intent to exclude leasehold interests from the reach of 363(f).

(5) "Any interest" = all forms of interest in real property, including lessee's possessory interest.

(B) Contrary Cases - *In re Zota Petroleums, LLC*, 482 B.R. 154 (Bankr. E.D. Va. 2012); *In re Haskell, L.P.*, 321 B.R. 1 (Bankr. D. Mass. 2005); *In re Taylor*, 198 B.R. 142, 162 (Bankr. D. S.C. 1996)

(1) Section 365(h) provides the debtor-landlord its sole remedy as to the lease; thus, a debtor cannot extinguish a tenant's leasehold interest in a sale free and clear under Section 363(f).

(2) These courts rely on Section 365(h)'s legislative history to show Congress' desire to protect a tenant's interests in its leasehold estate and reason that

permitting a debtor to sell a lease free and clear would undermine this desire and cannot be the result Congress intended.

(3) These cases look to the general principle of statutory construction -- the more specific provision should control over the general. So, the specific provisions protecting tenants in Section 365(h) should trump the general provisions of Section 363(f) regarding a debtor's ability to sell its property free and clear.

(C) Middle Ground Example - *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696 (S.D.N.Y. 2014) (real property can be sold pursuant to § 363 free and clear of a lessee's interest, but § 363(e) adequate protection could take the form of continued possession).

(D) *In re Spanish Peaks Holdings II, LLC*, 872 F.3d 892 (9th Cir. 2017) provided some additional guidance:

(1) The court noted that the requirement of adequate protection of an interest to be determined by a 363(f) sale constitutes a "powerful check" on potential abuses of free-and-clear sales.

(2) A sale free and clear of the tenant's leasehold interest could only be consummated upon satisfaction of one of the five provisions of 363(f).

(3) Timing is critical. *Spanish Peaks* emphasized timing in that the relevant leases were not rejected prior to the sale. "Under our interpretation, then, section 365 was not triggered." (862 F.3d at 1156).

(4) Was decision influenced by the fact that the impacted restaurant leases were recent below-market leases with insiders?

(E) Practical Suggestions

(1) Record lease

a) Lease in *Qualitech* was not recorded. Outside of the ground lease context, most shopping center leases prohibit recordation.

b) Court may protect lessee under first category of Section 363(f). *In re Bedford Square Assocs., L.P.*, 247 B.R. 140 (Bankr. E.D. Pa.).

c) There still may be an issue with Section 363(f)(5) if court can order a money satisfaction. But are there sufficient funds in estate after sale?

(2) Request adequate protection "early and often." According to *Spanish Peaks*, "a bankruptcy court must provide adequate protection for an interest to be terminated by a sale if the holder of the interest requests it." (862 F.3d at 1156). If sale proceeds are unavailable, isn't continued possession, akin to that provided by Section 365(h), the only realistic form of adequate protection?

(d) Security Deposits Held By Landlord-Debtor.

(i) Is the security deposit property of the estate under Bankruptcy Code section 541? State law matters. In many states, a security deposit merely establishes a debtor-creditor relationship. Compare California Civil Code section 1950.7(b) ("The claim of a tenant to the payment or deposit shall be prior to the claim of any creditor of the landlord, except a trustee in bankruptcy.") with New York General Obligations Law § 7-103 (security deposit or advance payment of rent under lease "shall be held in trust by the person with whom such deposit or advance shall be made and shall not be mingled with the personal moneys or become an asset of the person receiving the same.")

(ii) While a tenant should always file proof of claim, that may be "too little too late." Consider whether a tenant's rights to funds held by the debtor-landlord may be "swept" up as part of liens granted in connection with debtor-in-possession financing in the first few weeks of the bankruptcy case.

(iii) This issue is more than hypothetical. By way of example, in *In re Knotel, Inc.* Case No. 21-10146 (Bankr. D. Del.), an office subtenant in New York (where a security deposit is

considered trust funds and thus not property of the debtor-sublandlord) was determined to have waived its potential priority or secured position by failing to raise arguments prior to approval of debtor-in-possession financing. This example highlights the need for tenants to retain counsel and analyze potential issues at the earliest stage of a landlord bankruptcy.