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Bankruptcy Reform's Impact On Commercial Leases

Recent amendments to the bankruptcy code should prove beneficial to commercial retail landlords

By Kelly A. Kulak and Allison Lange

Recent amendments to the United States Bankruptcy Code may have a significant impact on the outcome of bankruptcy cases involving commercial retail leases, particularly shopping center leases. 11 U.S.C. § 101, et. seq. These modifications should prove beneficial to commercial retail landlords.

The two most significant changes with respect to commercial leases in the Bankruptcy Abuse, Prevention and Consumer Protection Act of 2005 (the "Reform Act") are: (1) restricting the time a debtor has to assume or reject a lease (§365(d)(4)); and (2) narrowing the scope of the "anti-assignment" provision (§365(f)(1) of the Code. Other changes to the Code that affect commercial landlords include the change to Section 365(b)(1)(A), which has been

Kulak and Lange are attorneys in the real estate department of Cole, Schotz, Meisel, Forman & Leonard of Hackensack.

amended to allow certain previously incurable, nonmonetary defaults to be cured by performance at and after the time of assumption of the lease; and lastly, a new subsection (7) has been added to Section 503(b), which limits the administrative claim of a landlord to two years of rent following the later of (i) rejection of the lease, or (ii) delivery of the leased premises to the landlord.

Commercial landlords, especially retail shopping center landlords, have been at odds with retail tenant debtors for years. The source of the contention is the competition between the debtor's interest in maximizing its estate and reorganizing its business to once again become profitable, and the landlord's interest in maintaining control over its shopping center or other real property and also maintaining desirable occupancy rates on such properties. The Reform Act attempts to level the playing field by balancing the competing interests of a commercial landlord and tenant. Time will tell if these changes will actually provide a commercial landlord with adequate measures to protect its interest in maintaining control over its real estate.

The Reform Act extends the time in which a commercial tenant can assume or reject a lease to the earlier of (i) 120 days from the date of the bankruptcy court order for relief; or (ii) the date of

entry of an order confirming a plan. Although this period is actually longer than the 60 days currently granted under the Code, the Reform Act restricts a tenant's right to request successive extensions to decide whether to assume or reject a lease; such extensions were previously routinely granted, often until an order confirming a plan of reorganization was entered. Now, a court may grant one 90-day extension "for cause" and any further extensions may only be granted upon the prior written consent of the landlord. Although the Reform Act does not specify what type of "cause" will warrant an extension, and the courts will likely be inclined to grant such requests, the requirement that the consent of the landlord is needed for any further extensions is critical for several reasons. First, the landlord is no longer sitting in limbo for a lengthy period of time speculating whether the debtor tenant will assume or reject the lease, which, if rejected, could force the landlord to market its space in less favorable market conditions or to less attractive tenants. It also provides the landlord the ability to better manage its shopping center by allowing the landlord to maintain control over the shopping center. Further, the landlord gains bargaining power to negotiate alternative provisions in the lease to accommodate the competing needs of both parties.

Another significant change accomplished by the Reform Act pertains to the "anti-assignment" provision of the Code. Courts have typically interpreted this provision liberally in favor of the

right of a debtor tenant to assign its lease to a tenant that would not otherwise be permitted to operate in the shopping center by the terms of the lease. Bankruptcy courts have viewed use restrictions, limits or conditions on assignments, go-dark prohibitions, radius restrictions and other similar operating restrictions as having the effect of diminishing the value of a lease and a debtor tenant's ability to assign or sell its leases. Therefore, bankruptcy courts would often decree such provisions unenforceable by invoking the anti-assignment prohibitions of the Code (§365(f)), thereby emphasizing the need to protect and maximize the value of a tenant's leasehold estate and diminishing a landlord's right to maintain control over its real estate and to benefit from its negotiated position. The change to the anti-assignment provision crystallizes the legislature's intent to preserve a landlord's right to enforce lease restrictions on use, assignment, alterations and other operating issues in shopping center leases. This modification is critical to a shopping center landlord because it protects a landlord's right to control the tenant mix of its shopping center, and it accentuates the landlord's ability to rely on operating restrictions bargained for with a tenant that are necessary for operating a successful shopping center.

The Reform Act also attempts to balance the competing interests of the shopping center landlord and the debtor

retail tenant by changing the language of § 365(b)(1)(A), which will permit certain previously incurable, nonmonetary defaults to be cured by an assignee of the debtor tenant. Currently under the Code, if there has been a nonmonetary default, the trustee may not assume the lease unless, at the time of the assumption of the lease, the trustee cures the default or provides an adequate assurance that the breach will be promptly cured. Under the Reform Act, a trustee may now assume a lease where the tenant is in default because the tenant ceased operations in violation of the "go-dark" provision of its lease, by curing the default at or after the time of assumption by resuming operations. Although this is beneficial to the debtor tenant, the Reform Act also provides a benefit to the landlord by permitting a landlord compensation for pecuniary losses resulting from the default. For example, if the landlord loses rental income because of cotenancy provisions contained in other leases affecting the shopping center, the landlord may be compensated for such losses.

A change made by the Reform Act that balances the scale between the rights of a landlord and a debtor tenant is the addition of a new subsection to Section 503(b), which limits a landlord's administrative claim after a lease is assumed and is later rejected. New Subsection (7) of Section 503(b) provides that a landlord is only entitled to receive, after a lease has been assumed

but is subsequently rejected, rent for a period of two years following the later of (i) the date the lease has been rejected, or (ii) the date the leased premises are delivered to the landlord, without reduction or setoff for any reason, except for sums actually received or to be received from an entity other than the debtor. A claim for the rent for the balance of the term and other remaining sums due to the landlord become a claim under Section 502(b)(6) and are unsecured and subject to the cap of Section 502(b)(6) (which is the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of (i) the date of the filing of the petition; or (ii) the date on which the landlord repossessed the premises, or the tenant surrendered the premises to the landlord; plus any unpaid rent due under such lease, without acceleration, on the earlier of such dates).

The Reform Act will certainly impact the outcome of bankruptcy cases involving commercial retail leases and the rights of a landlord and debtor tenant. It remains to be seen, however, how bankruptcy courts will interpret such changes and whether the Reform Act will have the effect of balancing the scales of the competing interests by aiding landlords in maintaining control of their real property and giving certainty to the future of shopping centers with a debtor tenant. ■