

# THE NASSAU LAWYER

## WHAT HAPPENS IF THE LANDLORD FILES FOR BANKRUPTCY PROTECTION?

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### Overview

In general, Section 365 of the Bankruptcy Code (the "Code") affords a trustee or a debtor in possession certain rights far greater than those available outside of bankruptcy. This Section allows a trustee or debtor-in-possession a somewhat unfettered right to assume or reject executory contracts or unexpired leases. Section 365 even goes so far as to supplant certain restrictions or provisions contained in the body of the underlying contracts or leases that might otherwise limit assumption or assignment. It is for this reason that Section 365 provides additional protections for parties to certain types of agreements. The focus here is on the owner/landlord who seeks protection by filing for relief under Chapter 11 of the Code and such entities' effort which restrict a debtor's unfettered right as to reject a real estate lease thereby divesting itself of an undesirable or below market lease. The advice here is equally applicable to equipment or personal property operating leases where the lessor seeks to relieve itself of onerous operating responsibilities.

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### When the debtor is the lessee

By way of background, the analysis is a simple one when the debtor is the lessee. In this circumstance, the debtor can determine during the course of the case to assume or reject a lease utilizing its business judgment. Section 365 describes the conditions and time periods during which an unexpired lease may be assumed or rejected. Initially, the debtor has sixty (60) days from the date of the bankruptcy filing to render a determination to assume or reject a real property lease, which time period may be extended for cause. In fact, it is not uncommon for this time period to be extended through confirmation of the plan of reorganization provided that the debtor is timely and fully satisfying its other obligations under the lease (i.e., paying rent). See, *In re Klein Sleep Products, Inc.*, 78 F.3d 18, 35-36 (2d Cir. 1995). For personal property leases, unless cause is shown, the debtor has until confirmation of a plan of reorganization to render such a determination. By forestalling a decision on assumption until the debtor has formulated, and/or even confirmed a plan, the estate is saved the unnecessary burden of incurring an administrative expense before it is certain that the debtor can support and satisfy such obligation (the full balance of the lease becomes an obligation of the debtor or reorganized debtor once assumed). In this circumstance, the landlord is not otherwise harmed as presumably such extensions are granted or obtained with the caveat that the debtor stay current on its rent and other related rent obligations and the

prospect for reorganization is likely.

### When the debtor is the lessor

Problems arise concerning the treatment of unexpired leases when the debtor is the lessor or sub-lessor of the property rather than the lessee. Ordinarily, debtors acting as lessors are reluctant to reject unexpired leases since the lessor's interests in the lease and the rents accruing thereunder are assets of the estate. However, because the basic provisions of Section 365 of the Code allow the debtor the authority to reject the unexpired lease even as a lessor, the question has arisen as to the effect this rejection has upon the lessee's or sub-lessee's rights and how to balance the competing interests.

It is well settled that a lease of real property creates an estate in the land that vests in the lessee. See, *In re Tri-Glied, Ltd.*, 179 B.R. 1014, 1021 (Bankr. E.D.N.Y. 1995); see, also, *In re Taylor*, 198 B.R. 142, 158 (Bankr. S.D.S.C. 1996). The vast majority of leases contain contractual obligations requiring performance in the future, such as the lessee's covenant to pay rent and the lessor's covenant to supply heat or deliver maintenance. See, *Tri-Glied at 1023; Taylor at 165*. When the debtor has executed a lease as lessor, a rejection of the lease results merely in the cancellation of covenants requiring performance in the future by the debtor. See, *Lee Road Partners, Ltd. v. FW Woolworth Company* (*In re Lee Road Partners, Ltd.*), 155 B.R. 55 (Bankr. E.D.N.Y. 1993), *aff'd*, 169 B.R. 507

(E.D.N.Y. 1994). Rejection does not terminate the lease completely so as to divest the lessee of its estate in the property. *See, Megafoods Stores, Inc. v. Flagstaff Realty Assocs.* (In re Flagstaff Realty Assocs.), 60 F.3d 1031, 1034 (3d Cir. 1995); see, also, *In re Taylor*, 198 B.R. at 165.

Section 365(h) of the Code deals directly with the problems arising from the bankruptcy of the lessor and rejection of a lease by the debtor. This Section provides that the lessee under a rejected lease has the option of either retaining the estate and remaining in place (which includes all enforceable renewal terms which the tenant may insist upon unilaterally), and other rights such as the right to sublet, assign or hypothecate the lease and to use and possess the premises. *See, In re Taylor*, supra, at 164. Alternatively, the lessee may elect to treat the lease as terminated and assert a claim for damages flowing from that breach against the estate. *Id.*; see, also, *In re Milstead*, 197 B.R. 33 (Bankr. E.D. Va. 1996).

If the lessee elects to remain in possession, the effect of the rejection will be to relieve the debtor/landlord of other ancillary duties contained in the lease, such as duties to provide heat, trash disposal or cleaning staff, except for such duties and/or performance required of lessors under applicable non-bankruptcy law irrespective of lessor's bankruptcy, i.e., the obligation to accept rent. *See, In re Taylor*, supra, at 166; *In re Flagstaff Realty Assocs.*, supra, at 1034; *Acme Precision Bldg., Ltd. v. Dayton Forging & Heat Treating, Inc.*, 23 B.R. 79, 84 (Bankr. S.D. Ohio 1982). However, the lessee may offset all damages arising from the rejection against future rent reserved under the lease, subject to limitations. *See, Home Express Inc. v. Arden & Howe Assocs., Ltd.* (In re Arden & Howe Assocs. Ltd.) 152 B.R. 971 (Bankr. E.D. Cal. 1993). First, the setoff may be only to the extent of any rent accruing under the lease. *See, In re Flagstaff Realty Assocs.*, at 1035. This means that the lessee may not affirmatively and independently seek damages based on the rejection as a claim against the estate. *Id.* Second, the damages that

may be offset by the lessee are limited to those caused by nonperformance by the debtor/trustee after the date of rejection. *See, In re Arden & Howe Assocs., Ltd.*, supra, at 975. If the claim for damages accrued before rejection, it may be asserted as a claim against the estate. *Id.*; see, also, *Acme Precision Bldg., Ltd.*, at 84.

These rights left to the tenant/lessee serve to limit the debtor's unfettered right to reject the lease. For example, in supporting its motion to reject, the debtor must include an analysis of the benefit to the estate resulting from such rejection. If the debtor cannot relet the property to some other tenant because the lessee elects to retain possession under Section 365(h) of the Code, then presumably the landlord will have a more difficult time showing "benefit" since the tenant is likely to retain the below market lease. Thus, Section 365(h) of the Code protects the lessee's possessory rights to the property, and in so doing limits a debtor/lessor from rejecting an undesirable lease.

#### **When the debtor is both the lessee and lessor**

The issue becomes more complicated when the debtor is both the lessee and sub-lessor. Thus, the interplay between the various subsections of 365 of the Code and the competing interests of the sub-lessee, the debtor (as lessee and sub-lessor) and the overlandlord, all come into play. One issue which arises is whether the debtor (acting as a sub-lessor) can, upon the rejection of the sub-lease, oust the sub-lessee from possession, despite the preservation of the possessory interest expressed in Section 365(h) of the Code. The answer is integrally linked to what the debtor does with respect to the underlying lease with the overlandlord.

If the debtor rejects the prime lease, there appears little doubt that the sub-lessee cannot continue to occupy the leased premises after the debtor's rejection of the prime lease. *See, In re Stalter & Co., Ltd.*, 99 B.R. 327 (E.D. La. 1989). This is so because the sub-lease depends upon the continuing viability of the prime lease, and the demise of the prime lease leads to the demise of the sub-lease without any rights under Section 365(h) of the Code. *See, In re Childworld Inc.*, 142

B.R. 87, 89 (Bankr. S.D.N.Y. 1992). If the debtor assumes the prime lease, however, can it then reject the sub-lease, and, if so, is the sub-tenant entitled to the benefits of the preserved possessory interests afforded under Section 365(h) of the Code? *See*, 11 U.S.C. §365(h). In the event the debtor assumes the prime lease, then the rights of the sub-lessee continue and the provisions of Section 365(h) of the Code are available to the sub-lessee as if they were the lessee. Often times, these rights can be altered by pre-bankruptcy agreements which can have the sub-lessee attorn to the overlandlord or which have the overlandlord independently recognize the sublease providing the sub-lessee with rights under the lessee's default.

These rights, remedies and options should be carefully considered before a bankruptcy filing is prepared so as to alleviate the debtor's burden under real property leases. The same holds true for fully evaluating motions to reject leases in cases already filed. The rights under leases can be the most valuable or most burdensome asset of businesses in today's climate. How those leases are handled requires careful planning.



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