

# The Art of Control: Bankruptcy Code Amendments Benefit Shopping Center Landlords (Part I)

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On April 20, 2005, President Bush signed into law legislation known as the Bankruptcy Abuse, Prevention and Consumer Protection Act of 2005 (the "Act"). Although widely reported as a consumer bankruptcy reform bill, the Act significantly improves upon some protections that shopping center landlords already enjoy under § 365 of the Bankruptcy Code (the "Code").<sup>1</sup> The benefits conferred by the Act will task shopping center landlords and their counsel with learning the art of controlling their real estate in retail debtor Chapter 11 reorganizations.

## Summary

The Act materially limits a debtor's ability to extend the time to assume, assume and assign, or reject nonresidential real property leases under 11 U.S.C. § 365(d)(4) of the Code beyond seven months. In contrast to prior law, where bankruptcy courts could (and did) grant further extensions for "cause," under the Act, shopping center landlords *must* consent to *any* extension of time for the debtor to decide whether to assume, assume and assign, or reject beyond the first 210 days of a bankruptcy case.

## History

Prior to the Act, once a retail tenant filed a bankruptcy petition, § 365(d)(4) afforded a debtor-tenant under a nonresidential real property lease an initial 60-day period to determine whether it would assume, assume and assign, or reject its lease. A debtor could obtain an extension of the initial 60-day period by demonstrating "cause" in a motion filed with the bankruptcy court. Because § 365(d)(4) neither defined "cause" nor specifically limited either the length or the number of extensions a debtor could obtain, attempts by commercial landlords to restrict a debtor's time to assume, assume and assign, or reject leases met with varying degrees of success. As a result, bankruptcy courts regularly granted multiple extensions, spanning periods of months or years.

The floor statement of Sen. Orrin G. Hatch (R-Utah) summarized some of the concerns of and problems experienced by shopping center landlords under the prior version of § 365(d)(4):

Presently, Section 365(d)(4) provides a retail debtor 60 days to decide whether to assume or reject its lease. A bankruptcy judge may extend this deadline for cause—and therein is the problem. Some experts believe that too many bankruptcy judges have allowed this exception essentially to eliminate any notion of a reasonable and firm deadline on a retail debtor's decision to assume or reject a lease. Some bankruptcy judges have been extending this deadline for months and years, often to the date of confirmation of a plan.

This situation can be troublesome. For example, a shopping center operator is a compelled creditor. It has little if any choice but to continue to provide space and services to the debtor in bankruptcy. Yet the current Code permits a retail debtor as long as years to decide what it will do with its leases. Coupled with the increased use of bankruptcy by retail chains, the Bankruptcy Code is seen by some to be tipped unfairly against the shopping center operator. Some stores curtail their operations or go dark, and still the lessor cannot regain control of its space.

## New Procedures

The Act amends § 365(d)(4) to require a debtor to assume, assume and assign, or reject a nonresidential real property lease by the earlier of 120 days (previously 60 days) after entry of an order for relief (usually the date the bankruptcy petition is filed) or the date an order confirming a plan of reorganization is entered. If the debtor does not meet that initial deadline, the lease is deemed rejected, and the premises must be immediately surrendered to the landlord, unless the debtor obtains an extension of the initial 120-day period. The bankruptcy court may grant the debtor a single 90-day extension beyond the initial 120-day period, provided the debtor demonstrates cause.<sup>2</sup> Thereafter, unless the landlord gives prior written consent, the bankruptcy court cannot grant a further extension to the debtor.

While the Act doubles the debtor's initial period to assume, assume and assign, or reject leases to 120 days, the practical effect of this change is minimal in light of bankruptcy courts' routine granting of extensions under the prior statute. The Act does not change a debtor's burden to remain current on all postpetition lease obligations under § 365(d)(3), and a landlord may still seek affirmative relief from the bankruptcy court within the initial 120-day period if the debtor fails to perform under the lease.

## The Tradeoff

Many a debtor's counsel included an argument in motions to extend the time under § 365(d)(4) in which the debtor should not be forced to assume its shopping center leases prematurely—because of the administrative liability that such an assumption would create. Various courts have held that postpetition rent due under a shopping center lease is afforded a first priority administrative expense status under § 507, meaning that it is on a par with other costs of administering the estate, such as professional fees. See *In re LPM Corp.*, 300 F.3d 1134, 1138 (9th Cir. 2002) and *Cukierman v. Uecker (In re Cukierman)*, 265 F.3d 846, 849 (9th Cir. 2001). Prior to the Act, if a debtor assumed a shopping center lease, but later “rejected” (i.e., breached) that lease, a landlord would have an administrative claim for all rent and charges due under the lease for the remainder of the lease term, not subject to any cap. See *Nostas Associates v. Costich (In re Klein Sleep Products, Inc.)*, 78 F.3d 18 (2nd Cir. 1996). In what some might consider the logical response to limiting a debtor to 210 days to make a decision about assuming, or assuming and assigning a shopping center lease (without a landlord's consent), the Act also added subsection (7) to § 503(b) of the Code to limit the debtor's administrative rent liability to two years' rent following the later of rejection of the lease and turnover of the retail space. The remainder of the claim for rent due under the lease is an unsecured claim and subject to the limits imposed by § 502(b)(6).

## The Practical Effect and New Strategies

The maneuvering in which retail debtors and shopping center landlords have previously engaged following the tenant's bankruptcy filing will continue under the Act, albeit in a more compressed time frame. Issues and disputes relating to control of the shopping center leases, which previously played out between the debtor and the shopping center landlord over many months or years, will, in all likelihood, be pushed to the fore in the first six months of the case, and old ideas may take on new shapes.

### *Designation Rights*

In certain types of bankruptcy cases, particularly those involving “big box” tenants (or, put another way, not traditional in-line space), the debtor has sought and, in many instances, obtained the right to sell “designation rights” under § 365. In those instances, the debtor will enter into an agreement with a third party whereby the third party will pay the carrying costs for the retail sales space for a period of time (6 to 12 months is not uncommon), in exchange for what is known as designation rights. During the designation-rights period, the party acquiring the designation rights will market the retail sales space and, in those instances in which it believes it has found a suitable end user, will “designate” the lease for the debtor to assume and assign to the end user.

Designation rights have been utilized in a number of Chapter 11 reorganizations, including the *Ernst Home, Best Products, Sun TV, Montgomery Ward* (both cases), *Service Merchandise, Troutman* and *Hechinger* cases. Under the Act, prolonged designation-rights periods, often a source of frustration for shopping center landlords, will (absent a landlord's consent) become a thing of the past. In those retail cases where they are advantageous to the debtor, designation-rights motions will likely be brought much earlier in a Chapter 11 case. Shopping center landlords may very well see designation-rights motions as part of the series of “first day motions,” which are commonplace in Chapter 11 retail reorganizations.

### *Adequate Protection*

In exchange for consenting to an extension under § 365(d)(4), the shopping center landlord may also look for some form of adequate protection from the debtor. While not traditionally considered to be a landlord issue, several courts have held that adequate protection under 11 U.S.C. § 363(e) is available to real property lessors. See, *inter alia*, *In re R.B. Furniture, Inc.*, 141 B.R. 706 (Bankr. C.D. Cal 1992); *In re Attorneys Office Management, Inc.*, 29 B.R. 96 (Bankr. C.D. Cal 1983); *In re MS Freight Distribution, Inc.*, 172 B.R. 976 (Bankr. W.D. Wash. 1994); and *In re Ernst Home Center, Inc.*, 209 B.R. 955 (Bankr. W.D. Wash. 1997). Traditionally, adequate protection is thought of as some form of money or a cash payment. Under the Act, the ongoing dispute regarding the payment of so-called “stub rent” (i.e., the rent and charges that accrue under the shopping center lease from the date the bankruptcy petition is filed until the end of the month in which the petition is filed), and whether it is payable under an “accrual theory” or a “billing date theory,” may be re-cast. Shopping center landlords may (and should) condition any consent under the new version of § 365(d)(4) upon the payment of stub rent to the extent the debtor has not paid. Some might consider that a form of adequate protection under § 363(e). Adequate protection may also take other non-monetary forms.

The time of year in which a debtor files may affect the shopping center landlord's approach as to what it may accept as adequate protection for (or a condition of) its written consent to an extension beyond the 210th day of the case. Most shopping center landlords want as many stores open and operating as possible during the back-to-school and the fall holiday sales seasons. A shopping center landlord might require a debtor to remain open and operating through December 31 in order to eliminate the possibility of a lease being rejected and a store “going dark” during peak sales periods. The forms that adequate protection may take are only as limited as the creativity of the debtor, the shopping center landlord, and their respective counsel.

## Re: Thinking Approaches

If bankruptcy judges follow the law, the Act provides shopping center landlords with greater control over their leases with retail debtors. The benefits of the Act may be tempered, based upon conflicting objectives between different shopping center landlords in the same reorganization, but the true test will be what business solutions are crafted as a retail Chapter 11 case approaches the 210th day after filing. Future control of shopping center leases in retail reorganizations may well evolve into an art form, and will likely require even greater creativity by the attorneys involved in such cases.

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<sup>1</sup> The Act's effective date is October 17, 2005 (the "Effective Date"). The provisions of the Act will not apply to cases filed before the Effective Date. Thus, the limitations on a debtor's ability to extend the time to assume, assign, or reject a nonresidential real property lease discussed here will apply only to those cases filed on or after the Effective Date.

<sup>2</sup> Notwithstanding the many revisions to the Code, the Act did not define "cause" under § 365(d)(4).

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