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CELEBRATING 25 YEARS

Real Property Law Section—Silver Anniversary Reflections. 3

By Nargis Choudhry

Letter from the Chair of the Executive Committee of the California State Bar Real Property Law Section.

The Yesterday, Today, and Tomorrow of Our Investment Real Estate Marketplace 5

By Marvin B. Starr

This article explores the ever-changing characteristics of the California investment real estate marketplace over the past 40 years, and what might be yet to come.

25 Years of Commercial Leasing: What a Long, Strange, Cyclical Trip It Has Been 12

By Richard C. Mallory, Christopher P. Campbell, and Mark Mengelberg

In the last 25 years, commercial leases have grown considerably, both in length and in breadth. This article discusses, in brief, the changes to the leasing landscape over the past 25 years, addresses key areas of growth, and contemplates the future of commercial leasing transactions.

"The High Wire Balancing Act"—A Specialist Reflects on the Volatile and Evolving Field of Landlord-Tenant Law in California Since 1980. 23

By Robert J. Sheppard; Edited by Jaime C. Uziel

The landscape of California landlord-tenant law has dramatically changed over the past 25 years. A San Francisco lawyer specializing in landlord-tenant law examines the most significant changes in that landscape, and presents theories on the political, economic, and legal forces driving the courts and lawmakers who try to find balance in the "high wire act" of landlord-tenant law.

California Land Use Law: A Quarter Century of Key Legal Developments . . 32

By Cecily T. Talbert, Daniel J. Curtin, Jr., and Bryan W. Wenter

Over the past 25 years, the laws regulating land use in California have dramatically expanded. This article discusses eight areas of development in land use law which have most significantly affected California's growth and development during this period, and are likely to continue to affect growth and development in the coming decade: General Plans; Takings; Exactions; the California Environmental Quality Act; Initiatives and Referenda; Vested Rights; Housing Elements and Affordable Housing; and Water Supply.

MCLE Test No. 5—California Land Use 43

Recent Bankruptcy Law Amendments Affecting Commercial Real Estate—A Historical Perspective 45

By Phillip K. Wang

This article discusses recent and historical amendments to certain bankruptcy code provisions affecting real estate, offers assistance in subsequent interpretation of the amended bankruptcy provisions, and touches upon developments to the treatment of letters of credit and security deposits.

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Recent Bankruptcy Law Amendments Affecting Commercial Real Estate—A Historical Perspective

by Phillip K. Wang

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I. INTRODUCTION

Many California real estate markets have boomed recently; this is due, in large part, to an enormous influx of capital from debt and equity sources. It is not surprising that bankruptcy has been a rare topic of discussion for real estate professionals. There have been plenty of headlines about airline bankruptcies and feature stories about new consumer bankruptcy issues, but real estate and bankruptcy, together, have garnered little attention in the recent past.

While the Bankruptcy Code¹ has been amended seven times during the last 25 years—in 1984, 1986, 1988, 1990, 1992, 1994, and 2005—the most recent amendment, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, was likely the most significant for real property practitioners and business persons. On April 20, 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA” or the “2005 Amended Act”) was signed into law. Most of BAPCPA became effective 180 days after enactment and applies to cases filed on or after October 17, 2005. The 2005 Amended Act includes substantial changes and limitations on filing of Chapter 7 cases by individuals, which were primarily sought by credit card companies for a number of years and continue to be the subject of controversy. Although the focus of BAPCPA and of the publicity surrounding it has been changes impacting consumer debtors, there are some significant changes in other provisions of the Bankruptcy Code that impact Chapter 11 business cases, and cases that involve real property in particular. In addition, there have been other recent developments such as the treatment of security deposits and letters of credit in calculating a landlord’s “capped” claim in a debtor-tenant’s bankruptcy.

This article briefly analyzes the amendments to certain bankruptcy code provisions affecting real estate, offers assistance in subsequent interpretation of the amended provisions, and touches on recent developments to the treatment of letters of credit and security deposits.

II. RECENT AMENDMENTS TO BANKRUPTCY LAW AND DEVELOPMENTS

A. Deadline to Assume or Reject Commercial Real Estate Leases

Practitioners who represent real estate developers and others who own commercial space may confirm that they have been frustrated by their experiences as landlords in a bankruptcy case. A reorganization in bankruptcy is, by its nature, designed to give a business time to reorganize. For example, retail businesses as debtors often wish to wait through a business cycle before assuming all of their obligations to their landlords. The bankruptcy courts were authorized to extend the deadline to assume or reject leases under such circumstances. The reality has been that the deadline was often extended for many months

and, especially in large cases, might delay the landlords’ ability to exercise their rights *for years*. Under BAPCPA, these rules were amended considerably in favor of landlords.

Under Section 365 of the Bankruptcy Code, debtors can assume or reject any executory contract or unexpired lease subject to court approval and certain limitations. It is an area of the law that has been described as a “thicket . . . where . . . lurks a hopelessly convoluted and contradictory jurisprudence.”² “[I]n no area of bankruptcy has the law become more psychedelic . . .”³

1. Prior Law

There has been a long standing principle in bankruptcy law that a trustee had the power to assume or renounce title to property that was beneficial or burdensome, as the case may be, to the estate.⁴ This concept is at the root of a bankruptcy trustee’s power to assume or reject executory contracts and unexpired real property leases. Section 365(d) was amended in 1984 to add paragraphs (3) and (4), which concern, respectively, the timely performance by a trustee of duties under nonresidential real property leases and the deemed rejection of leases after the passage of 60 days with neither an assumption of the lease nor a motion to extend time to assume or reject.⁵ Section 365 was further amended in 1986, 1988, 1990, 1992, and 1994 to make other relatively minor changes.

The most significant revision in this area of law occurred just last year. Under BAPCPA, subsection (d)(4) was extensively amended to reduce the time in which a debtor may assume or reject a real property lease and to give greater rights to real property lessors in this process.

Before the 2005 Amended Act, a debtor had 60 days from the petition date to assume or reject non-residential real property leases. Under the prior law, if a nonresidential lease is not assumed within 60 days when the debtor is the lessee, then it is deemed rejected.⁶ During the period that the debtor is making the decision to assume or reject a lease, the debtor must “timely perform all obligations of the lease.”⁷ The court could extend the 60-day deadline for cause. Debtors often obtained lengthy extensions through plan confirmation to make assumption and rejection decisions.

2. Amended Law

Under BAPCPA, there is now a hard deadline for debtors to assume or reject leases. Under the 2005 Amended Act, 11 U.S.C. § 365(d)(4) provided as follows:

(4) (A) Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of—

(i) the date that is 120 days after the date of the order for relief; or

(ii) the date of the entry of an order confirming a plan.

(B) (i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days on the motion of the trustee or lessor for cause.

(ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.

The amended law provides for automatic rejection of a non-residential real estate lease if the reorganizing tenant does not assume the lease, and it imposes a strict timeline on this process. Specifically, BAPCPA amends Section 365(d)(4) to allow debtors to assume or reject unexpired leases of non-residential real estate in which the debtor is the lessee by the earlier of 120 days after the commencement of the case or the date of the confirmation of the plan. The court, for cause, may extend the 120-day period for an additional 90 days, but any extension subsequent to the additional 90 days is available *only* with the consent of the lessor. In other words, at the end of those scheduled events, the landlord is essentially given a “veto” over the tenant’s ability to expand the deadline further. The new time line is designed to focus the bankruptcy judge’s attention on the interests of the landlords and, over the course of the bankruptcy process, to increase the pressure on the tenant-debtor.

In other words, the new timeline provides the tenant reorganizing in bankruptcy with a maximum possible seven-month grace period within which to assume the lease. After four of those months or more precisely, 120 days, it must show “cause” for the extension, for example, perhaps because it must wait to see whether its business is improving. At the end of another three months (or 90 days), however, the time to assume the lease may only be extended with “the prior written consent of the lessor” who may thus stop the process. It may be that granting additional time makes sense, but at that time, it is the landlords’ prerogative to make that decision.

Although this amendment has greatly increased the leverage of commercial landlords in a debtor-tenant’s bankruptcy case, by changing the time frame for a debtor to assume or reject leases, Congress has likely created a host of unintended consequences. One of those consequences is the increasing likelihood that retailers in bankruptcy will liquidate rather than reorganize. Also, creditor committees are unlikely to be willing to take the risk of allowing a debtor to assume its leases. Rather than allowing the debtor to cure lease defaults and convert the remaining lease obligations to a higher priority claim, creditor committees will be more likely to put pressure on a tenant to reject the lease and liquidate. Further, other issues remain unresolved. For instance, what form of written consent is required? If consent to a further extension is conditioned on the payment of outstanding rent, a landlord termination option, or the like, will such agreement require Bankruptcy Court approval? Will waiver and estoppel be possible grounds to excuse the written consent requirement?

These questions will likely remain unanswered until litigation on these revised provisions winds its way through the court system.

B. Administrative Treatment for Post-Assumption, Post-Rejection Lease Claims

There is one obvious side effect to imposing a firm deadline to assume or reject leases—a debtor’s premature assumption and subsequent rejection of a commercial lease. Under BAPCPA, certain landlords may be able to force tenants to assume their leases to put themselves in a priority position that may decrease the value of the estate in a subsequent liquidation. The 2005 Amended Act attempts to deal with this reality—that the debtor may be forced into a premature assumption of the lease that is ultimately defaulted and abandoned. To ameliorate the effect on the general creditor body that would be caused by such a premature assumption followed by the later rejection, the 2005 Amended Act limits the administrative claim resulting from that circumstance.

1. Prior Law

Before BAPCPA, a debtor’s decision to assume a lease essentially gave administrative priority to all the debtor’s obligations under the lease. In other words, the result of a lease assumption was likely an administrative claim for the landlord for the full measure of damages under the lease and applicable nonbankruptcy law.⁸ This result seems warranted under the prior law because a debtor was often allowed a liberal amount of time to make its decision to assume a commercial lease, and thus, its decision should be final and obligate the debtor to perform fully under the lease. However, because the 2005 Amended Act now imposes a strict deadline for a debtor to assume a lease with limited extensions, a debtor’s lease assumption decision should have less finality.

2. Amended Law

As provided under BAPCPA, a landlord’s administrative priority claim for post-assumption, post-rejection lease claims is essentially limited to two years’ rent. 11 U.S.C. § 503(b)(7) now provides as follows:

(b) After notice and a hearing, there shall be allowed, administrative expenses, other than claims allowed under Section 502(f) of this title, including--

...

(7) with respect to a nonresidential real property lease previously assumed under section 365, and subsequently rejected, a sum equal to all monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, for the period of 2 years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor, and the claim for remaining sums due for the balance of the term of the lease shall be a claim under section 502(b)(6);

The landlord may have a priority claim of up to two years’ rent and other monetary damages after the rejection or turn over

of the leased property, whichever occurs later. This amount is to be reduced by “sums actually received or to be received” from third parties such as guarantors. The balance of the landlord’s claim will be relegated to unsecured status subject to the “cap” imposed by Section 502(b)(6) of the Bankruptcy Code.⁹

Although this amendment decreased the administrative impact of a debtor-tenant’s premature assumption of a commercial lease, by limiting the amount of the landlord’s administrative priority claim, Congress has again left certain issues unresolved. For example, what is the effect of third-party guarantees or letters of credit on assumed leases? Is collectability relevant in determining what sums are “to be received” to reduce the priority claim? Do amounts received in mitigation reduce the landlord’s priority claim? Again, these topics will likely remain unsettled until litigation of these issues generates common law answers.

C. Curing Defaults Based on Non-Monetary Obligations

Prior to assuming an unexpired commercial lease, a debtor is required to cure all defaults.¹⁰ Curing monetary defaults clearly was required. But, one of the recent and more contentious battles between landlords, tenants, and other parties to executory contracts has been fought over the need to cure *non-monetary* defaults in the assumption process.¹¹

1. Prior Law

Before BAPCPA, paragraph (1) of former Section 365(b) required an assuming trustee or debtor-in-possession to cure or provide for cure of defaults before assumption. But, subsection (b) went on to provide:

(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to--

...

(D) The satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under the executory contract or unexpired lease.

This language produced a split of interpretation by the circuits, which Congress has now attempted to resolve. To be specific, there was a split in the circuit case law on how non-monetary defaults in unexpired leases (*e.g.*, covenant defaults) are treated and whether such non-monetary defaults must be cured in order for a debtor to assume the agreement.

The circuit split arose from *In re Claremont Acquisition Corp., Inc.*, 113 F.3d 1029 (9th Cir. 1997) and *In re BankVest Corp.*, 350 F.3d 291 (1st Cir. 2004). In *Claremont* and *BankVest*, the two circuits analyzed former Section 365(b)(2)(D) and came to different conclusions about whether that language required a debtor’s non-monetary defaults be cured prior to assuming executory contracts and unexpired leases. In *Claremont*, the Ninth Circuit denied the attempted assumption of a franchise agreement for a car dealership because the debtor had ceased operations for a 14-day period pre-petition, a default on the agreement’s requirement that the operations be continuous. The Ninth Circuit held this to be an “historical” default, which the debtor could not cure. And, accord-

ing to the Ninth Circuit, all non-monetary defaults, including this “historical” default, must be cured prior to assumption regardless of whether it was possible to cure such an “historical” default.

In *BankVest*, however, the First Circuit subscribed to a directly contrary view. The court observed that the ruling in *Claremont* resulted in a harsh outcome for debtors in situations where the debtor’s ability to cure a default under an unexpired lease or executory contract was impossible. The First Circuit found the result reached in *Claremont* to be contrary to the bankruptcy principle of rehabilitating debtors, and concluded that debtors may assume executory contracts and unexpired leases without first curing *any* non-monetary defaults. Of course, this produced the disagreement between circuits on the issue of whether defaults based on non-monetary obligations must be cured prior to lease assumption.

2. Amended Law

Under BAPCPA, Congress has attempted to resolve this split of authority by codifying parts of both opinions. Under the 2005 Amended Act, a debtor need not cure non-monetary defaults of commercial real estate leases, which are “impossible” for the debtor to cure at or after the time of assumption. Under BAPCPA, 11 U.S.C. § 365(b) provides as follows:

(b) (1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph;

(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to—

...

(D) the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

Under BAPCPA, Congress has agreed with *Claremont* to the extent that Section 365(b)(2)(D) should only exempt

from the debtor's cure obligations the payment of penalty rates or penalty provisions, but that the escape clause, Section 365(b)(2)(D), does not provide a catch-all exception for non-monetary defaults. In other words, unless the non-monetary default requires some type of penalty payment, the debtor must cure the non-monetary default prior to assumption.

However, in order to reduce somewhat the harsh effects of this rule, and in agreement with *BankVest*, Congress added language to Section 365(b)(1)(A), which specifically exempts certain non-monetary cure obligations of the debtor. These exceptions, however, only apply to unexpired leases of real property—thus the results reached in *Claremont* would be the same under BAPCPA because *Claremont* dealt with a franchise agreement, not a real property lease. The 2005 Amended Act does not exempt from the debtor's cure requirements every non-monetary obligation under leases of real property. First, BAPCPA only exempts those non-monetary acts which are "impossible" for the debtor to cure at or after the time of assumption. Further, the language under new Section 365(b)(1)(A) specifically requires that, at and after the time of assumption, the debtor must perform any breach related to the failure to operate in accordance with a nonresidential real property lease. Debtors are therefore compelled to comply prospectively with all operational terms in nonresidential real property leases.

These amendments leave open some key questions, including the determination of what cure obligations are indeed impossible. Also, the distinction between operating and non-operating obligations seems to be a source for future litigation. These questions will remain unanswered until common law provides an interpretation.

D. Single Asset Real Estate Cases.

Thus far, this article has focused on bankruptcy amendments affecting real estate entities *on the creditor side*. The recent amendments, however, also had an impact on real estate entities *as debtors* in bankruptcy. Specifically, Section 362 was amended by BAPCPA to deal with the often-criticized "single asset real estate case." The purpose of Section 362(d)(3) was to address perceived abuses in single asset real estate cases, in which debtors have attempted to delay mortgage foreclosures even when there is little chance they can reorganize successfully.¹² Section 362(d)(3) attempts to abbreviate single asset real estate cases by requiring relief from stay if the debtor does not file a confirmable plan or commence payments to secured creditors relatively soon after filing for bankruptcy.

The scope of such cases has been significantly increased by BAPCPA's amendment of the definition of that phrase in 11 U.S.C. Section 101(51B). Thus, many more real estate developments, which need the protections afforded by bankruptcy as a debtor, will now be subject to these provisions.

1. Prior Law.

Before BAPCPA, the normal protections of the automatic stay enjoyed by debtors in bankruptcy were lifted in a single asset real estate case unless the debtor files a plan of reorganization within 90 days or has commenced making monthly interest payments to secured creditors at the current fair market rate. In practical terms, a single asset real estate debtor was required within 90 days of the bankruptcy petition to start paying interest on its secured debt at the current market rate in order to keep

the automatic stay in place. Alternatively, the debtor could file a plan, or obtain an extension of the 90-day deadline.¹³ While this imposition on debtors was unique to single asset real estate cases, its effect was not far reaching because the definition of single asset real estate debtors was limited to those with secured debt in the amount of \$4 million or less.¹⁴

2. Amended Law.

As a result of the recent amendments to the Bankruptcy Code, a much larger group of potential real estate development debtors may now be subject to these rules because the debt limitation was removed. Under BAPCPA, 11 U.S.C. Section 101(51B) provides as follows:

(51B) The term "single asset real estate" means real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.

In addition, the automatic stay provision applicable to single asset real estate cases, originally added by the Bankruptcy Reform Act of 1994, was amended to change the timing of the debtor's obligation to file a plan or commence payments to secured creditors, as well as the amount of the payment necessary to continue the stay in effect. Specifically, 11 U.S.C. Section 362(d)(3) provides as follows:

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

...

(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later—

(A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

(B) the debtor has commenced monthly payments that—

(i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim

is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and

(ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate;

Under BAPCPA, Congress removed the debt limitation from its definition of "single asset real estate." Single asset real estate is still defined as real property constituting a single property or project that is greater than four units, which generates substantially all of the gross income of a debtor from the business of operating the real property and activities incidental to the operation of the real property. Thus, under BAPCPA, the pivotal test will now become whether the debtor's property is a "single property or project".

As to the automatic stay, Section 362(d)(3) continues to impose a requirement in such a case that the debtor must have either (1) filed a confirmable plan; or (2) commenced monthly payments to the secured creditor in order to keep the automatic stay in effect. The timing of this obligation has been altered slightly under BAPCPA. Under the former code, this was an obligation that arose 90 days after the entry of the order for relief. However, because there was sometimes difficulty determining whether a particular case was a single asset real estate case, the 2005 Amended Act provides that the date on which the requirement commences is the end of the 90-day period or 30 days after the court determines that the debtor has "single asset real estate," whichever occurs later. Presumably, if there is some doubt, some interested party (likely the debtor) will wish to raise the issue before the running of the initial 90-day period to gain potentially more time to file a plan or start making payments. The law also now allows the debtor to make such payments from the rents or other income generated by the property.

Section 362(d)(3) was further changed as to the amount of the payment necessary to continue the stay in effect. Under the former Code, the debtor was required to pay an amount "equal to interest at a current fair market rate on the value of the creditor's interest in the real estate." As amended, in cases governed by BAPCPA, the payment must be in the amount of the "applicable non-default contract rate of interest on the value of creditor's interest in the real estate." In other words, the payments required to continue the effectiveness of the automatic stay are now at the non-default contract interest rate, rather than the then prevailing market rate of interest.¹⁵ Of course, in a rising interest rate environment, this provision may actually benefit single asset real estate debtors.

The monthly payment required under Section 362(d)(3) may be made notwithstanding the failure of the debtor to obtain consent for use of a lender's cash collateral under Section 363(c)(2), thus the payments "may, in the debtor's sole discretion, notwithstanding Section 363(c)(2), be made from rents or other income generated before, on, or after the date of commencement of the case by or from the property to each creditor whose claim is secured by such real estate."¹⁶ This language is not perfectly clear, but it appears to require a nexus between the collateral and the creditor to be paid. Stated differently, Creditor A may be paid from its rents or other income generated by its collateral. Creditor B may not be paid from the

collateral of creditor A. A definitive interpretation of this language, however, will not be reached until litigation on this point generates case law interpreting this provision.

E. Preferences

While the recent amendments to the Bankruptcy Code discussed above have a particular bearing on real estate, there is at least one additional revision which impacts creditors as a whole. Because creditors include real estate developers and owners, the attention of this article is directed to address one of these amendments—the revised ordinary course of business defense to a bankruptcy trustee's preference avoidance actions.

Bankruptcy is a topic that successful businesses normally do not need to discuss. That is, of course, unless the business is dragged into a bankruptcy case, as a creditor, after one of its clients or customers files for bankruptcy. This is a surprisingly frequent, and aggravating, situation where a bankruptcy trustee sues a business for "preferences" seeking to recapture those payments made by the debtor within the 90-day period prior to the debtor's bankruptcy petition.

However, BAPCPA has provided defendants with greater protection against a bankruptcy trustee's preference avoidance powers with one seemingly minor change—replacing the word "and" with the word "or" in the ordinary course of business defense. Under BAPCPA, this affirmative defense should be easier and less expensive to prove as only two of the prior three elements must be established.

1. Prior Law

Under Section 547(c)(2), prior to the recent amendments, a preference defendant could escape liability to the extent it could establish that a transfer was:

- a. in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
- b. made in the ordinary course of business or financial affairs of the debtor and the transferee; *and*
- c. made according to ordinary business terms.

To a great extent, the courts construed this provision to require a defendant to establish not only that the debt and payment were made in the ordinary course of business *between the parties*, but also that the transfer was ordinary or typical *in the related industry at large*.

2. Amended Law

Under the current law as amended by BAPCPA, a defendant is no longer required to establish that the transfer was ordinary in the industry. As amended, the ordinary course of business defense shields a defendant from preference liability to the extent that such transfer was:

- a. in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; and

- b. made in the ordinary course of business or financial affairs of the debtor and the transferee; *or*
- c. made according to ordinary business terms.

This “new and improved” defense will allow preference defendants more opportunities to assert it, as a defendant need only prove that the transfer was ordinary as between the parties. The revised defense should also reduce the cost of defending a preference action, since it is no longer necessary to produce expert testimony regarding ordinary industry standards. Moreover, the debate over whether expert testimony is even required to prove industry standards will not materialize so long as a defendant can show that the transfer was made in the ordinary course of business of the debtor and the transferee.

F. The “Cap” on a Landlord’s Claim for Lease Termination Damages and Treatment of Security Deposits and Letters of Credit

In addition to the recent changes to the Bankruptcy Code, there have been other developments relevant to real estate practitioners who must deal with the topic of bankruptcy. One of these developments concerns the “cap” on a landlord’s claim for lease termination damages under section 502(b)(6) of the Bankruptcy Code and the treatment of security deposits and letters of credit in calculating such a “capped” claim.

For over 70 years, the claim of a landlord for lease termination damages in the bankruptcy proceeding of a debtor-tenant has been treated differently from other general claims under the Bankruptcy Code and prior law. As originally enacted, there was no provision in the Bankruptcy Act of 1898 for a landlord’s claim for future rent damages. In 1934, Congress enacted amendments to recognize a landlord’s claim for damages for lease termination. However, at the same time, a ceiling or “cap” on the measure of a landlord’s claim was imposed as a compromise to limit the disproportionately large impact of a long-term lessor’s claim on the general unsecured creditor class. The comments of the House Judiciary Committee in 1978 make clear that the section was:

[d]esigned to compensate the landlord for his [or her] loss while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering a dividend from the estate.¹⁷

While the calculation of the “claim cap” was subsequently amended in 1984, as presently constituted, the “claim cap” under 502(b)(6) of the Bankruptcy Code limits a landlord’s damages resulting from the termination of a real property lease to:

[t]he rent reserved by such lease, without acceleration, for the greater of one year, or 15%, not to exceed three years, of the remaining term of such lease ...¹⁸

The “cap” is calculated from the earlier of the petition filing date or “the date on which [the] lessor repossessed or the lessee surrendered, the leased property.”¹⁹ The landlord also retains a claim for any unpaid rent due under such lease prior to the earlier of those dates.²⁰

In calculating the landlord’s allowable claim, Section 502(b)(6) does not address whether a security deposit held by the

landlord reduces the “capped” claim. However, the comments of the Judiciary Committees of the House of Representatives and the Senate confirm that the amount of security held by the landlord is deducted from the allowable claim:

[The landlord] will not be permitted to offset his [or her] actual damages against his [or her] security deposit and then claim for the balance under this paragraph. Rather, his [or her] security deposit will be applied in satisfaction of the claim that is allowed under this paragraph.²¹

This view of deducting security deposits from a landlord’s allowable claim applied to common situations where a debtor-tenant directly paid the security deposit to the landlord. In the last 10 years or so, it has been an increasingly frequent circumstance not to have the security deposit paid in cash by the debtor, but rather to have a third party provide the security for the tenant’s performance in the form of a letter of credit.²² Recently however, the Third Circuit in *In re PPI Enters. (U.S.), Inc.* has expanded the concept of a security deposit to include the proceeds of a letter of credit despite the “independence principle” underlying this commercial credit.²³ In deciding to permit the debtor-tenant to deduct the letter of credit proceeds from the landlord’s “capped” claim, the Third Circuit in *PPI* relied specifically on the intent of the parties for “the letter of credit to operate as a security deposit” based on the express language of the lease.²⁴ As a result, parties to a similar lease situation should note that their letter of credit will likely be treated in bankruptcy just as any other security deposit and be deducted from the landlord’s claim after such claim is “capped”.

III. CONCLUSION

While bankruptcy may not be a current “hot” topic for real estate practitioners and business persons, the real estate industry and practitioners in this area of law should become familiar with these recent amendments to the Bankruptcy Code as well as other related developments in the event there is a downturn in the economic cycle.



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ENDNOTES

- ¹ 11 U.S.C. §§ 101, et seq.
- ² *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 687, 690 (Bankr. S.D.N.Y. 1992) (quoting Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. Colo. L. Rev. 1, 1 (1991)).

- ³ *Drexel Burnham*, 138 B.R. at 690 (quoting Westbrook, *A Functional Analysis of Executory Contracts*, 74 Minn. L. Rev. 227, 228 (1989)).
- ⁴ See *Sunflower Oil Co. v. Wilson*, 142 U.S. 313 (1891).
- ⁵ Pub. L. No. 98-353, § 362(a).
- ⁶ See 11 U.S.C. § 365(d)(4), amended by 11 U.S.C. § 365(d)(4) (2005); *In re Lonepine Corp.*, 184 B.R. 370, 375 (Bankr. D. Colo. 1995) (filing motion to assume within 60 days is sufficient, court may approve after 60 days has expired); *In re Golden Triangle Film Labs, Inc.*, 176 B.R. 608, 610 (Bankr. M.D. Fla. 1994); *In re Food Barns Stores, Inc.*, 174 B.R. 1010, 1013-16 (Bankr. W.D. Mo. 1994) (failure to act within 60 days results in rejection of contract, but creditor may be held to have waived right to have lease deemed rejected; comprehensive discussion of waiver in this context); *In re Hunan Rose, Inc.*, 146 B.R. 313 (Bankr. D.D.C. 1992) (discussing impact of failure to act); *In re 6177 Realty Assocs.*, 142 B.R. 1017 (Bankr. S.D. Fla. 1992) (same).
- ⁷ 11 U.S.C. § 365(d)(3), amended by 11 U.S.C. § 365(d)(3) (2005); compare *In re All For A Dollar, Inc.*, 174 B.R. 358, 361 (Bankr. D. Mass. 1994) (finding debtor must pay only current, post-petition obligations) with *In re R.H. Macy & Co.*, 152 B.R. 869, 872-73 (Bankr. S.D.N.Y. 1993), *aff'd*, 1994 WL 482948 (S.D.N.Y. Feb. 23, 1994) (finding debtor must pay all post-petition obligations, even if bills cover pre-petition period), and with *In re Slim Life Weight Loss Ctrs., Corp.*, 182 B.R. 701, 705-06 (Bankr. D.N.J. 1995) (finding debtor-in-possession must pay all rents due on unexpired lease of non-residential real estate as administrative expense; creditor need not prove its right to administrative expense under § 503).
- ⁸ See, e.g., *In re Baldwin Rental Ctrs., Inc.*, 228 B.R. 504 (Bankr. S.D. Ga. 1998) (listing cases so holding).
- ⁹ Under Section 502(b)(6) of the Bankruptcy Code, a landlord's unsecured claim for lease termination damages is limited to "the rent reserved by such lease, without acceleration, for the greater of one year, or 15%, not to exceed three years, of the remaining term of such lease" 11 U.S.C. § 502(b)(6).
- ¹⁰ See 11 U.S.C. § 365(b)(1).
- ¹¹ See David G. Epstein & Lisa Normand, *Real-World and Academic Questions About Nonmonetary Obligations Under the 2005 Version of 365(b)*, 13 Am. Bankr. Inst. L. Rev. 617 (2005).
- ¹² S. Rep. No. 168, 103d Cong., 1st Sess. (1993) ("This amendment will ensure that the automatic stay provision is not abused, while giving the debtor an opportunity to create a workable plan of reorganization.").
- ¹³ See 11 U.S.C. § 362(d)(3).
- ¹⁴ See 11 U.S.C. § 101(51)(B).
- ¹⁵ See 11 U.S.C. § 362(d)(3)(B)(ii).
- ¹⁶ 11 U.S.C. § 363(d)(3)(B)(i).
- ¹⁷ H.R. Rep. No. 595, 95th Cong., 1st Sess. 353 (1977).
- ¹⁸ 11 U.S.C. § 502(b)(6)(A).
- ¹⁹ 11 U.S.C. § 502(b)(6)(A)(ii).
- ²⁰ 11 U.S.C. § 502(b)(6)(B).
- ²¹ H.R. Rep. No. 595, 95th Cong., 1st Sess. 353-54 (1977); S. Rep. No. 989, 95th Cong. 2d Sess. 63-64 (1978). Accordingly, the holding of *Oldden v. Tonto Realty Co.*, 143 F.2d 916 (2d Cir. 1944) on this point of law remains valid.
- ²² The standby letter of credit is a commercial instrument that obligates the issuer to pay the beneficiary upon presentation of certain documents, proving that the customer has defaulted on its obligation. The issuer's obligation under the letter of credit is independent of the underlying contract. See Comm. Code § 5103(d). As a result of the independence of letters of credit from their underlying contracts, neither the letter of credit nor its proceeds are property of a debtor's bankruptcy estate. See *Musika v. Arbutus Shopping Ctr. Ltd. P'ship (In re Farm Fresh Supermarkets of Md., Inc.)*, 257 B.R. 770, 772 (Bankr. D.Md. 2001).
- ²³ See *Solow v. PPI Enters. (U.S.), Inc. (In re PPI Enters. (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003). The Ninth Circuit is in agreement on this issue. See *AMB Prop., L.P. v. Official Creditors (In re AB Liquidating Corp.)*, 416 F.3d 961 (9th Cir. 2005); *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295 (9th Cir. BAP 2004).
- ²⁴ *PPI*, 324 F.3d at 210.

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