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Getting Ready for the Next Cycle: Strategies to Understand and Mitigate Risks to Real Property Leases, Interests and Purchase Options

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Today's Discussion

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Treatment of Real Property Leases in Bankruptcy Overview

Treatment of Leases in Bankruptcy: Overview of Assumption and Rejection

- Pursuant to 11 U.S.C. § 365, a debtor in bankruptcy has authority to **assume**, **assign**, or **reject** unexpired leases
- **Assumption** of a lease allows a debtor to retain valuable agreements, but requires the debtor to cure any existing monetary or non-monetary defaults
- **Assignment** of a lease allows a debtor to transfer valuable agreements as part of going-concern transactions, or stand-alone sales
- **Rejection** of a lease allows a debtor to terminate obligations under burdensome or nonmarket agreements

Treatment of Leases in Bankruptcy: Overview of Assumption and Rejection (cont'd)

- A debtor's decision to assume or reject a lease is subject to court approval
  - Courts apply the deferential **business judgment standard**
- If a lease is not assumed or rejected during the statutory period, the lease is automatically **deemed rejected** and the debtor may be required to **surrender** the leased property (11 U.S.C. § 365(d)(2), (d)(4))

Treatment of Leases in Bankruptcy: Assumption of Lease

- In order to **assume** a lease, a debtor must cure all defaults other than insolvency-related defaults and provide adequate assurance of future performance of lease obligations (11 U.S.C. § 365(b))
- Effect of assumption:
  - Lease continues
  - If the debtor breaches the lease after it is assumed, then the landlord can file an administrative expense claim
    - *E.g.*, *In re Klein Sleep Prods.*, 78 F.3d 18, 22-28 (2d Cir. 1996)

Treatment of Leases in Bankruptcy: Assignment of Lease

- A lessee may **assign** an unexpired lease that has been assumed even when the lease prohibits assignment (11 U.S.C. § 365(f))
- Assignee will need to provide adequate assurance of future performance (11 U.S.C. § 365(b)(1))
- Assignment may be part of a larger sale of all or a portion of the debtor's business to a third party
- Once a party take assignment of the lease, it generally has to comply with the terms of the lease; it can re-let if the lease allows

Treatment of Leases in Bankruptcy: Assignment of Lease (cont'd)

- Use restrictions in a lease may be viewed as an unenforceable anti-assignment provision (for example that the tenant can only operate a certain store in the space)
- For "**shopping center**" leases, 11 U.S.C. § 365(b)(3) enumerates heightened requirements in providing adequate assurance in order for the debtor-tenant in a shopping center to be released from its obligations and avoid breach of the lease, including adequate assurance:
  - (A) of the source of rent and other consideration due under such lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, **shall be similar to the financial condition and operating performance of the debtor and its guarantors**, if any, as of the time the debtor became the lessee under the lease;
  - (B) that any percentage rent due under such lease will not decline substantially;

  . . .

Treatment of Leases in Bankruptcy: Assignment of Lease (cont'd)

- (C) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and
- (D) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center

- Assignment is impermissible if any of the foregoing subsections of section 365(b)(3) are not met

Treatment of Leases in Bankruptcy: Assignment of Lease (cont'd)

- Note that the general requirement of providing adequate assurance of future performance in assuming and assigning an unexpired lease or contract under section 365(b) (discussed above) omits specific language as to what sufficiently satisfies the provision
- This is distinguishable from section 365(b)(3), which delineates specific requirements a debtor must satisfy in providing adequate assurance for assignments in shopping centers; the legislative history indicates that the purpose of this specific language was "to ensure that the assignee itself will not soon go into bankruptcy and will provide operating and advertising benefits to the other tenants similar to those provided by the original tenant when its lease was executed"

Treatment of Leases in Bankruptcy: Assignment of Lease (cont'd)

- The definition of "shopping center," as used in the Bankruptcy Code, is often a litigated issue, but is often defined as a group of independently owned stores contractually interrelated as to the use of store premises contiguous to a common area
  - *E.g.*, *In re Joshua Slocum Ltd.*, 922 F.2d 1081, 1086 (3d Cir. 1990) ("However, the Bankruptcy Code does not define 'shopping center.' Rather, the proper definition . . . 'is left to case-by-case interpretation.'")

Treatment of Leases in Bankruptcy: Assignment of Lease (cont'd)

- Courts look to the following factors to evaluate whether a lease is in a shopping center, including:

leases with single landlord	fixed store hours	contractual interdependence
common parking area	restrictive use provisions	percentage rent clauses
all tenants involved in commercial retail	existence of master lease	anchor tenant clauses
joint contribution to trash and maintenance needs	contiguous grouping of stores	a tenant mix
restrictive clauses	joint advertising	

- For leases other than "shopping center" leases, the court will invalidate the use restriction if the court determines that the purpose of the provision is to restrict assignability of the lease or deprive the debtor of the value of the lease

Treatment of Leases in Bankruptcy: Rejection of Lease

- Effect of **rejection** (11 U.S.C. § 365(g)):
  - **Debtor-tenant** is relieved of its obligation to perform remaining obligations under the lease
  - Landlord is left with a claim for damages against the bankruptcy estate
- Debtors often request authority to abandon certain property at a leased space they are rejecting
  - This is usually granted but the landlord has the right to assert a damage claim for the costs it incurs due to such abandonment
- If **debtor** is the **landlord** under a rejected lease, tenant has the right to retain its rights and offset damages from debtor's nonperformance against rent reserved, but has no other rights against debtor on account of damages caused by nonperformance (11 U.S.C. § 365(h))

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Residential vs. Non-Residential Real Property Leases: Overview

Non-Residential vs. Residential Lease: Overview

- Whether a real property lease constitutes a non-residential lease or residential lease will affect issues related to assumption/rejection and performance of lease obligations by a debtor-lessee in bankruptcy

	Non-Residential Lease	Residential Lease
Generally	Greater landlord rights	Fewer landlord rights
Timing to assume/reject	120 days (210 days until Dec. 27, 2022, per CAA)	Any time before plan confirmation, absent court order
Post-petition obligations	Required to timely perform	Not required to timely perform, absent court order
Rent	Contract rate	Fair rental rate

Non-Residential vs. Residential Lease: "Property" Test vs. "Lease" Test

- The Bankruptcy Code does not define the terms "residential" and "non-residential," and courts apply different tests: the "Property" Test and the "Lease" Test
  - **Property Test** (majority)
    - Examines the nature of the property leased, holding that if people reside on such property the lease constitutes a residential lease
    - Applying this test, courts generally hold that leases for skilled nursing, assisted living, and other similar facilities are residential if people reside on the property in question, regardless of whether the lease is used for commercial purposes
    - *E.g.*, *In re PNW Healthcare Holdings, LLC*, 617 B.R. 354 (Bankr. W.D. Wash. 2020) (skilled residential nursing facilities to provide housing for patients receiving residential care through debtors were in nature of "residential" leases)

Non-Residential vs. Residential Lease: "Property" Test vs. "Lease" Test (cont'd)

- **Lease Test** (minority)
  - Focuses on the nature of the lease, without regard to the ultimate use of the underlying property
  - Commercial leases, where the debtor is in the business of generating income, constitute non-residential real estate leases
  - Applies to leases for skilled nursing facilities, assisted living, convalescent homes, and mobile home parks
  - *E.g.*, *In re Passage Midland Meadows Operations, LLC*, 578 B.R. 367, 378 (Bankr. S.D. W. Va. 2017) (leases for assisted living, skilled nursing, independent living, and dementia care facilities were nonresidential)

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Lease Rejection Damages

Lease Rejection Damages: Overview

- Landlords are entitled to certain damages upon rejection:
  - Administrative expense claim for the portion of its claim attributable to post-petition, pre-rejection period
  - Unsecured pre-petition claim for amounts not paid for pre-petition and any damages arising from the debtor's future nonperformance (though future rent is subject to a cap, as described later) (11 U.S.C. § 365(g))
  - Secured claim to the extent of any deposit, and an unsecured pre-petition claim if the allowable claim exceeds any deposit

Lease Rejection Damages: Calculation

- 11 U.S.C. § 502(b)(6) caps damages under a rejected real property lease:
  - Unpaid pre-petition obligations; plus
  - The "rent reserved" under the lease for the greater of (i) one year or (ii) 15% of the remaining term of the lease, not to exceed three years, following the earlier of the petition date or the date the premises are surrendered

Lease Rejection Damages: Calculation (cont'd)

- If the 502(b)(6) cap is greater than the actual damages, the rejection claim is determined by reference to actual damages
  - Section 502(b)(6) is not a formula for calculating a landlord's claim—it is a limit on damages recoverable in the bankruptcy
  - Actual damages are determined according to state law, including any duty to mitigate, before being limited by 502(b)(6)
    - *E.g.*, *In re Highland Superstores, Inc.*, 154 F.3d 573, 579 (6th Cir. 1998) ("lessor's damages are computed in accordance with the terms of the debtor's lease and applicable state law, and then are limited by application of section 502(b)(6)")
- Section 502(b)(6) does not limit a landlord's administrative expense claim for rent accrued during the debtor's post-petition occupancy of the property
- Section 502(b)(6) does *not* limit a non-debtor guarantor's liability, *see In re Modern Textile, Inc.*, 900 F.2d 1184 (8th Cir. 1990), unless guarantor also becomes a debtor in a bankruptcy case, *see In re Interco Inc.*, 137 B.R. 1003 (Bankr. E.D. Mo. 1992)

Lease Rejection Damages: Impact of Security Deposits

- Security deposits are applied as a dollar-for-dollar reduction against the 502(b)(6) cap
  - Security deposits held by landlords are considered property of the debtor's estate (often listed as assets in the debtor's schedules)
- The law is less clear if the landlord is the beneficiary of a letter of credit because unlike security deposits, letters of credit are not considered property of the debtor's estate
  - E.g., *In re Stonebridge Techs., Inc.*, 430 F.3d 260 (5th Cir. 2005) (502(b)(6) cap did not limit amount that landlord could recover under letter of credit where landlord never filed proof of claim)

Lease Rejection Damages: Impact of Security Deposits (cont'd)

- However, courts in a number of jurisdictions have held that letters of credit are merely forms of security deposits and should be treated like security deposits, resulting in a dollar-for-dollar reduction against the 502(b)(6) cap
  - *E.g.*, *In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197 (3d Cir. 2003)
- Nonetheless, a landlord holding a letter of credit as security (rather than cash) is more likely to avoid a dollar-for-dollar reduction against the cap

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Timing for Assumption/Rejection and Interim Obligations

Timing for Assumption/Rejection: Non-Residential Real Property Leases

- **Non-residential** lease
  - A debtor has 120 days to assume or reject an unexpired non-residential real property lease (11 U.S.C. § 365(d)(4))
  - The Consolidated Appropriations Act ("CAA") extends this deadline from 120 days to 210 days
    - This amendment terminates on December 27, 2022
  - A debtor is allowed one 90-day extension for "cause," but, if granted, any subsequent extensions may only be granted with the prior written consent of the lessor (11 U.S.C. § 365(d)(4)(B)(i))

Timing for Assumption/Rejection: Residential Real Property Leases

- In contrast, for **residential** (and non-real property) lease
  - A chapter 11 debtor must assume or reject (a) a residential real property lease or (b) any non-real property lease before the confirmation of a plan of reorganization (11 U.S.C. § 365(d)(2))
  - A chapter 7 trustee has 60 days to assume or reject a lease of residential real property or of personal property, but there is no such limitation on leases of nonresidential real property (*see* 11 U.S.C. § 365(d)(1))
- The bankruptcy court, upon request of any party to such lease, may order the debtor to assume or reject such lease by an earlier date

Interim Obligations: Overview

- During period between petition date and assumption/rejection:
  - Leases continue in full force
  - A lessor cannot terminate the lease unless the bankruptcy court grants relief from the automatic stay
  - Bankruptcy/insolvency termination clauses are unenforceable
  - A debtor may obtain a court order authorizing going-out-of-business sales that might otherwise violate terms of a lease

Interim Obligations:
Rent Obligations on Non-Residential Real Property Leases

- **Non-residential** lease
  - Debtor must pay rent in full and on time (11 U.S.C. § 365(d)(3))
  - If the debtor fails to make such a payment, the landlord can file a motion to compel payment of rent and/or a motion to force the debtor to make a decision to assume or reject the lease

Interim Obligations: Rent Obligations on Non-Residential Real Property Leases (cont'd)

- Payment of "stub rent" is an important factor that should be considered for any entity with significant lease obligations
- "Stub rent" refers to the amount of rent due to a landlord corresponding to the period of occupancy between the date the debtor files for bankruptcy and the first post-petition rental payment due date under the unexpired lease
  - Under the **billing date approach** (followed in the 3rd and 8th Circuits), if the date rent becomes due and payable under the lease is prior to the petition date, then the stub rent does not need to be paid immediately (but the landlord may seek rent for the post-petition period as an administrative expense)
  - Under the **proration approach** (followed in the 2nd, 4th, and 9th Circuits), the debtor is obligated to pay stub rent on a prorated basis immediately for the period of occupancy between the petition date and the first post-petition rental payment due date, regardless of when the monthly payment was due

Interim Obligations: Rent Obligations on Non-Residential Real Property Leases (cont'd)

- Rent deferral
  - 11 U.S.C. § 365(d)(3) authorizes a court to defer post-bankruptcy lease payments for up to 60 days for "cause"
  - Due to the ongoing COVID-19 pandemic, bankruptcy courts have become more willing to grant 60-day post-petition rent deferrals, with some courts even granting extensions beyond the 60-day period in certain cases
    - As a result, filing and taking advantage of a rent deferral period have become a more common debtor tactic
  - Recent examples include the following:
    - *Pier 1 Imports* (deferring rent payments beyond 60-day period)
    - *Modell's Sporting Goods* (deferring rent payments beyond 60-day period)
    - *JC Penney* (deferring rent payments for 60 days)
    - *CEC Entertainment* (deferring rent payments for 60 days)

Interim Obligations:
Rent Obligations on Residential Real Property Leases

- **Residential** (and non-real property) lease
  - No obligation to timely perform all obligations under the lease absent a court order compelling performance (*see* 11 U.S.C. § 365(d)(3))
    - While case law addressing this issue is sparse, in determining whether to compel performance, a court may consider the impact on the bankruptcy case and the debtor's ability to pay all other postpetition administrative expenses
    - A court may grant a landlord relief from the automatic bankruptcy stay under 11 U.S.C. § 362(d)(1), which would allow the landlord to compel the debtor-tenant to perform
      - Courts justify this by reasoning that failure to pay postpetition rent leaves the landlord without adequate protection unless there is a sufficient equity cushion

Interim Obligations:
Rent Obligations on Residential Real Property Leases (cont'd)

- If a debtor does not fully perform under the lease, the landlord may be entitled to an administrative expense priority claim for the post-petition use of its property
  - Administrative expense priority claim may be limited to the "actual, necessary costs and expenses of preserving the estate"
  - *E.g.*, *In re Klein Sleep Prods.*, 78 F.3d 18, 22-28 (2d Cir. 1996)
- While the landlord's administrative expense priority claim may be limited to the fair market value of the premises, and not the contract rate of rent, "[a]bsent evidence to the contrary, there is a presumption that the lease rate is the fair market value of the premises." *In re PNW Healthcare Holdings, LLC*, 617 B.R. 354, 361 n.11 (Bankr. W.D. Wash. 2020)

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Severability of Real Property Leases in Bankruptcy

Severability: Rejection of Individual Leases under Master Lease

- Although debtors are afforded great latitude in deciding which executory contracts and unexpired leases they will assume or reject, the Bankruptcy Code requires all such assumptions or rejections to be *cum onere* or "as a whole"
  - In other words, a debtor cannot "cherry pick" the provisions of an executory contract or lease that it finds favorable and assume those, while rejecting those provisions it finds burdensome; rather, the entire executory contract or lease must either be assumed or rejected
  - *See In re FFP Operating Partners, LP*, 2004 WL 3007079, at *1 (Bankr. N.D. Tex. Aug. 12, 2004) ("A debtor is not entitled to assume those portions of a lease or contract it likes, while rejecting those portions it no longer cares for.")

Severability: Rejection of Individual Leases under Master Lease (cont'd)

- A court will allow a debtor to assume some leases under a master lease, while rejecting others, if the court determines that the master lease does not constitute a **single, integrated agreement**
  - Whether a writing is a single, integrated contract is determined by state law
  - *See In re Buffets Holdings Inc.*, 387 B.R. 115, 120, 124 (Bankr. D. Del. 2008) ("[T]here is no federal policy which requires severance of a lease condition solely because it makes a debtor's reorganization more feasible.")
  - *In re Adelphia Bus. Solutions, Inc.*, 322 B.R. 51, 55 (Bankr. S.D.N.Y. 2005) ("[M]any courts . . . allow a single contract to be separately assumed and rejected if the contract is 'divisible' or 'severable' under state law.")

Severability: Factors Considered

- Factors that a court may consider include the following:
  - **Stated intent** of the parties (i.e., whether the master lease manifests an intent that it constitute one integrated and indivisible agreement)
    - *E.g.*, *Guidance Endodontics, LLC v. Dentsply Int'l, Inc.*, 708 F. Supp. 2d 1209, 1270 (D.N.M. 2010) ("[T]he essential question is: Did the parties give a single assent to the whole transaction, or did they assent separately to several things?")
  - If multiple lessees, whether the lessees are all **jointly and severally liable**
    - *E.g.*, *In re Buffets Holdings, Inc.*, 387 B.R. 115, 128 (Bankr. D. Del. 2008) (master leases were indivisible agreements where rent obligation was joint and several among multiple lessees)

Severability: Factors Considered (cont'd)

- Ability to **sell or assign individual properties**
  - *E.g.*, *In re Convenience USA*, 2002 WL 230772, at *2 (Bankr. M.D.N.C. Feb. 12, 2002) (finding as factor supporting divisibility of lease the right of the landlord to sell or transfer any number of the leased properties)
- **Cross-default** provisions among leases
  - *E.g.*, *Liljeberg Enters., Inc. v. Lifemark Hosp. of Louisiana, Inc. (In re Liljeberg Enters., Inc.)*, 2002 WL 1978855 (5th Cir. 2002) (cross-default provision demonstrated that two agreements were so interrelated that incurable breach of one precluded assumption of the other)
- **Allocation of rent** based on individual leases
  - *E.g.*, *In re Convenience USA*, 2002 WL 230772, at *2- 4 (apportionment of rent and assignment of rent to individual properties "is strongly indicative of an intent to have a divisible contract")

Severability: Factors Considered (cont'd)

- Ability to **terminate** lease as to **individual properties**
  - *E.g.*, *In re Cafeteria Operators*, 299 B.R. 384, 391 (Bankr. N.D. Tex. 2003) ("The integration clause, coupled with the provisions allowing the landlord to terminate, re-enter and repossess or relet some, but not necessarily all, of the properties evidences the parties' intent that the Master Sublease Agreement is divisible.")
- **Accounting** for properties on an **individual** basis
  - *E.g.*, *In re FFP Operating Partners*, 2004 WL 3007079, at *5 (Bankr. N.D. Tex. Aug. 12, 2004) ("[i]t appears that FFP intended that the Lease be severable as it accounted for the properties on a property by property basis")

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Recharacterization and Avoidance

Recharacterization: True Lease vs. Disguised Financing

- A debtor may request a Bankruptcy Court to "recharacterize" a lease as a disguised financing
- Factors in determining whether a lease agreement is a "true lease" or disguised financing include:
  - The intent of the parties (including how the parties characterized the transaction in the agreement)
  - Whether the lease includes a nominal purchase option
  - Whether the lease term covers the useful life of the property
  - Whether rent is calculated at a market rate
  - Whether the tenant has obligations normally associated with ownership
- *E.g.*, *United Air Lines, Inc. v. U.S. Bank Nat'l Assoc., Inc. (In re United Air Lines, Inc.)*, 447 F.3d 504, 508 (7th Cir. 2006) (leasehold-assignment-and-leaseback arrangement was not "true lease," but disguised "security agreement")

Recharacterization: True Lease vs. Disguised Financing (cont'd)

- Consequences of recharacterization include:
  - No obligation to pay rent timely
  - Treatment as debt under chapter 11 plan (e.g., cramdown)
    - Debt may potentially be unsecured if lessor failed to record and/or file protective UCC-1
    - Debt may be undersecured if the value of the collateral is less than the amount of the debt, resulting in a bifurcated claim between a secured debt up to the value of the collateral and an unsecured claim for the deficiency

Avoidance: Pre-Petition Lease Payments

- If a tenant has not been making its rent payments on time, or makes a "catch up" payment to cover rent arrearages, landlords must consider the risk that rent payments made within 90 days of the tenant's bankruptcy can be avoided as a preferential transfer under 11 U.S.C. § 547
- Rent payments made under the timing required under the lease may give a landlord a statutory defense to any preference action based on the payments being made in the "ordinary course of business"
- Late payments by a distressed tenant/counterparty could impair "ordinary course of business" defense
  - But, you should still accept payments that might constitute a preference because ***CA$H IS KING***

Avoidance: Pre-Petition Lease Payments (cont'd)

- The CAA amends section 547 to prohibit a debtor from avoiding payments made by a debtor during the preference period for "covered rental arrearages" and "covered supplier arrearages"; to qualify for the exemption:
  - (a) the debtor and the counterparty must have entered into a lease or executory contract before the filing,
  - (b) they must have amended the lease or contract after March 13, 2020, and
  - (c) the amendment must have deferred or postponed payments otherwise due under the lease or contract. The preference exemption will **not** apply to the payment of fees, penalties, or interest imposed in the post-March 13, 2020 amendment
- This CAA amendment terminates on December 27, 2022

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Purchase Options

Purchase Options: Treatment in Bankruptcy

- When a landlord that has granted a purchase option files for bankruptcy, the optionee could potentially lose the benefit of the option
- Most courts hold that option contracts are "executory contracts" and, accordingly, allow a debtor to reject the option contract and sell the underlying property free and clear of the purchase option

Purchase Options: Treatment in Bankruptcy (cont'd)

- An "executory contract" is a contract where the obligations of the debtor and non-debtor counterparty are so far underperformed that the failure to perform by either party would constitute a material breach
  - *E.g.*, *In re RoomStore, Inc.*, 473 B.R. 107 (Bankr. E.D. Va. 2012) (denying motion for relief from stay to exercise alleged option to purchase debtor's interests in LLC on basis that debtor rejected purchase option as an executory contract)
- Other courts reject the rule that options are executory contracts and instead look to outstanding obligations at the time the bankruptcy petition is filed, concluding that an option is not an executory contract because the optionee commits no breach by doing nothing (*see,* e.g.*, In re Robert L. Helms Constr. & Dev. Co., Inc.*, 139 F.3d 702, 706 (9th Cir. 1998))
- A debtor can assume, assume and assign, or reject executory contracts

Purchase Options: Treatment in Bankruptcy (cont'd)

- <u>Rejection damages</u>
  - If an option is rejected in bankruptcy, then the tenant is generally left with a general unsecured claim in the bankruptcy for the value of the option
    - Tenant is entitled to the "benefit of the bargain"
    - Example: tenant holding an option to purchase real property that is rejected in bankruptcy may be entitled to the difference between the estimated market value of the property at the time the option becomes exercisable, less the option agreement price, plus an additional speculative premium, if any, reflecting anticipated appreciation of the value of the property at the time the option will lapse, as well as any additional loss suffered as the natural and proximate result of the breach (*In re Waldron*, 36 B.R. 633, 637 (Bankr. S.D. Fla. 1984), *rev'd on other grounds*, 785 F.2d 936 (11th Cir.), *cert. dismissed*, 478 U.S. 1028, 106 S.Ct. 3343 (1986))

Purchase Options: Treatment in Bankruptcy (cont'd)

- However, some courts have held—based on **state law**—that a purchase option related to a real property lease that is recorded constitutes a real property interest that cannot be rejected or stripped in a bankruptcy sale
  - *E.g.*, *In re Plascencia*, 354 B.R. 774, 780 (Bankr. E.D. Va. 2006) (holding that, under Virginia law, a purchase option "constitute[s] an interest in real property" that "cannot be treated simply as a contingent claim that is subject to discharge or compromise in the case")
    - Court reasoned that "an option is in the 'nature of an interest in real estate which may be recorded and by that recordation protect the optionee's interest in the real estate'"
    - Critical to the ruling were two Virginia statutes providing that (1) a memorandum of an option to purchase real estate may be recorded in lieu of recording the actual option and (2) an option or memorandum is void as to subsequent interest holders until such instrument is recorded

Purchase Options: Treatment in Bankruptcy (cont'd)

- Even in states where an option is a real property interest not subject to rejection in bankruptcy, there may be statutory conditions precedent to creation of such an interest, including:
  - The option, or memorandum thereof, must be recorded
  - The option, as recorded, has not expired
  - Any amendments modifying the exercise date should also be recorded
- Notwithstanding a bankruptcy filing by a landlord, a tenant *may* still be entitled to performance on its option if it properly exercised the option before the bankruptcy filing
  - 11 U.S.C. § 365(i): If debtor rejects a real property sale agreement under which purchaser is in possession, purchaser has the option of (a) treating the contract as terminated or (b) remaining in possession, making payments, and receiving title to property

Purchase Options: Treatment in Bankruptcy (cont'd)

- To mitigate risk of rejection, optionee should:
  - Ensure that the purchase option is part of the same agreement under which it obtains possession of the real property
  - Exercise the purchase option before any bankruptcy filing (to make it more likely that the option is construed as a sale agreement under 365(i))
  - Remain in possession of the property
- Also consider adding language specifying that the option is a covenant that runs with the land, though a court is not required to defer to such language
- In a loan scenario, the purchase option is vulnerable to rejection if it is part of a loan, given that the optionee/lender is not in possession of the property
  - Also risks being construed as a void effort to allow the lender to obtain title to its collateral without complying with applicable foreclosure rules

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Month-to-Month Leases

Month-to-Month Leases: Automatic Stay

- Pursuant to 11 U.S.C. § 362, once a bankruptcy case is commenced, all litigation and creditor enforcement actions come to a halt, including:
  - Acts to control property of the estate or recover property from the estate
  - Any effort to collect, assess, or recover claims
  - Starting or continuing lawsuits
  - Creating, perfecting, or enforcing liens
  - Exercising setoffs (with exceptions)
- A bankruptcy court may grant relief from the automatic stay:
  - For "cause," including the lack of adequate protection in an interest in property, or
  - Against property if the debtor does not have equity in the property and the property is not necessary to an effective reorganization

Month-to-Month Leases: Alternative to Termination

- Because the automatic stay can prevent a landlord from exercising remedies, terminating a lease, or otherwise evicting a tenant, one potential solution is pre-petition entry into a month-to-month lease
- In most states, a month-to-month lease does not expire every month but rather continues until terminated by the requisite notice
- However, in a minority of states, a month-to-month lease terminates every month without requiring any notice
  - In such a scenario, a landlord *may* be able to exercise remedies upon termination, without first obtaining relief from the automatic stay
  - *E.g.*, *In re Marrero*, 2018 WL 5281626, at *3 (Bankr. D.P.R. Oct. 22, 2018) (lease terminated on its own terms where Puerto Rico law expressly "provides that a month to month lease contract ceases every month without requiring any special request to so declare as the lease terminates automatically every month")

Month-to-Month Leases: Alternative to Termination (cont'd)

- Unless there is something explicit in the applicable state law providing that a month-to-month lease automatically terminates each month, there is a substantial risk that the automatic stay would prevent a landlord from terminating or pursuing eviction under a month-to-month lease
- Even under a terminated month-to-month lease where the tenant is still in possession, the landlord should still obtain a "comfort order" from the bankruptcy court authorizing landlord to obtain control of the property
- To the extent a lease is structured to terminate on its own terms on a specific date that comes after the tenant's bankruptcy filing, the automatic stay could not act to extend the term of the lease
  - *See* 11 U.S.C. § 541(b)(2) (bankruptcy estate "ceases to include any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease during the case")

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“Single Asset Real Estate” Debtors

"Single Asset Real Estate" Debtors

- The Bankruptcy Code establishes special rules and creditor protections in a single asset real estate ("SARE") case
- What is a SARE debtor?
  - A SARE is an entity whose business amounts to a single project or property; the real property generates substantially all of the debtor's income
  - A SARE may also operate a business **incidental to the real property** which produces revenue, such as a hotel, golf course, or spa; however, these businesses can be enough to prevent a debtor from being considered a SARE debtor where the business "is sufficiently active in nature to constitute a business other than the mere operation of property" (*see In re Whispering Pines Est., Inc.*, 341 B.R. 134, 136 (Bankr. D.N.H. 2006))

"Single Asset Real Estate" Debtors (cont'd)

- In a SARE chapter 11 case, secured creditors of the debtor are entitled to relief from the stay unless, within 90 days after the petition date, the debtor **either**:
  - Files a plan that has a reasonable likelihood of being confirmed; **OR**
  - Starts paying interest at non-default contract rate interest on the lesser of the debt or the fair value of the collateral
- The plan the debtor files must have a reasonable likelihood of being confirmed, so courts often decide the merits of confirmation issues in the context of motions to lift the automatic stay

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Turnarounds & Workouts named Robert Klyman to its 2016 list of Outstanding Restructuring Lawyers, honoring 12 attorneys as leaders in the bankruptcy field. In addition, Mr. Klyman has been widely and regularly recognized for both his debtor and creditor work as a leading bankruptcy and restructuring attorney by *Chambers USA* (where clients recognized him as "incredibly smart, commercial, [having] terrific business judgment, and … extremely hard-working and reachable at any time," "great in court," "a great strategist" and "incredibly technically sound"); named as one of the world's leading Insolvency and Restructuring Lawyers by *Euromoney*; recognized as one of 8 bankruptcy lawyers of the year by *IFLR1000* in 2020, listed in the K&A Restructuring Register, a leading peer review listing, as one of the top 100 restructuring professionals in the United States; named as a 'Top Bankruptcy M&A Lawyer' by *The Deal's Bankruptcy Insider*; named as one of the 12 outstanding bankruptcy lawyers in the nation under the age of 40 (in 1999, 2000, 2002 and 2004) by *Turnarounds & Workouts*; and one of '20 lawyers under 40' to watch in California by the *Daily Journal*. Mr. Klyman also has been selected regularly by his peers for inclusion in *The Best Lawyers in America©* in the field of Bankruptcy and Creditor Debtor Rights.

Mr. Klyman developed, and for 20 years co-taught, a case study for the Harvard Business School on prepackaged bankruptcies and bankruptcy valuation issues. He has also taught classes on bankruptcy dealmaking and strategy at the University of Michigan Business School, Massachusetts Institute of Technology's Sloan School of Management and UCLA Law School. Mr. Klyman is also a member of the ABA Subcommittee that drafted the ABA Model Bankruptcy Asset Purchase Agreement. He also regularly serves as a panelist presenting cutting edge issues in restructuring and bankruptcy.

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Chambers USA ranks Mr. Klein among the leading individuals practicing Real Estate Law in New York, with clients noting that he is "a total real estate genius" and a go-to person "if you have a very complex transaction that you want done correctly." He has also been included in Legal Media Group's *Expert Guide to the World's Leading Real Estate Lawyers*, *The Best Lawyers in America®*, *The Legal 500, Who's Who Legal Real Estate*, *IFLR1000* and *New York Magazine*'s "Best Lawyers."

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Ms. Schlanger's practice covers a broad range of commercial real estate transactions, including advising developers and investors in connection with the development, financing, acquisition and disposition of a variety of asset classes, including office buildings, multi-family developments, hotels and mixed-use projects throughout the United States. She has been involved in the development of many landmark buildings across the country.

Ms. Schlanger has been ranked as a top real estate attorney in Texas in *Chambers USA: America's Leading Lawyers for Business* and was named a "Woman to Watch" in commercial real estate by GlobeSt.Com. She has also been recognized by *The Best Lawyers in America©* in the area of Real Estate Law. Additionally, in 2021, the editors of GlobeSt. Real Estate Forum recognized Ms. Schlanger as a "Top Individual" for their Influencers in Senior Housing series.

Ms. Schlanger has extensive experience in the structuring and negotiation of joint venture agreements (both single-asset and "programmatic") for the purpose of commercial and residential real estate acquisition and development.

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Mr. Bouslog frequently represents debtors, creditors, and other interested parties in out-of-court and in-court restructurings, distressed acquisitions, and bankruptcy-related litigation. A significant number of Mr. Bouslog's matters have involved cross-border issues.

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Before joining the firm, Mr. Bouslog served as a judicial clerk for the Honorable Robert N. Kwan of the United States Bankruptcy Court for the Central District of California. While in law school, he served as a judicial extern for the Honorable Thomas B. Donovan of the United States Bankruptcy Court for the Central District of California and for the Honorable Stephen V. Wilson of the United States District Court for the Central District of California.

Mr. Bouslog received his Juris Doctor degree in 2011 from the UCLA School of Law, where he was elected to the *Order of the Coif* and was a member of the Moot Court Honors Program. He earned a Bachelor of Science degree *magna cum laude* in Business Management from Brigham Young University in 2007.

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Prior to joining the firm, Mr. Farag served as a judicial law clerk in the United States Bankruptcy Court for the Central District of California, first for the Honorable Martin R. Barash, then for the Honorable Robert N. Kwan.

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