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# Bankruptcy Act Alters Lease Rights

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THE BANKRUPTCY laws have an important effect on the relationships of landlords and their tenants.

The Bankruptcy Reform Act, which became law in 1978 and will go into effect on Oct. 1, 1979, makes substantial changes in the bankruptcy law and the way that law affects leases. It seems that the new law applies to debtors who file on or after Oct. 1, 1979, and the old law applies to debtors who file before then.

Consequently, leases executed by tenants who file, or are the subject of filings, under the bankruptcy laws before Oct. 1, will be governed by the old set of rules; and leases executed by tenants who file or are the subject of filings under the bankruptcy laws after Oct. 1 will be governed by the Bankruptcy Reform Act.

The most significant aspect of a tenant's insolvency under the pre-Reform Act law to a landlord is that the trustee or debtor in possession is in a position to reject its obligations under a lease. Tenants who file for reorganization under Chapter X of the Bankruptcy Act, or for an arrangement under Chapter XI or XII of the Act, also have the right to reject lease obligations. If a tenant rejects a lease under the old Act, the tenant is entitled to make a claim for an amount not to exceed one year's rent in liquidation proceedings or for an amount not to exceed three years' rent in rehabilitation proceedings.

The claim is likely to be of little solace to a landlord who executes a lease in the expectation of a twenty year stream of income. Under Section 365 of the new Act, the right of the trustee to reject is continued.

Thus a landlord confronted with a tenant's proceeding under the Bankruptcy Act has severely reduced expectations of receiving income from his property. In addition, a landlord who agreed to execute a lease only in reliance upon the favorable credit of the tenant finds himself involved with an insolvent under court protection. His chances of selling his property become limited, and his chances of refinancing are all but eliminated.

For these reasons, and perhaps the chance to make a windfall profit by cancelling an old lease with low rent, landlords have insisted upon lease clauses that gave them the right to cancel in the event of the tenant's insolvency.

Although bankruptcy cancellation clauses are largely meaningless under the Bankruptcy Reform Act, landlords will have much greater protection under the new Act.

Section 70(b) of the Bankruptcy Act, as amended to date, without considering the effect of the Bankruptcy Reform Act, provides that a lease clause that terminates the lease in the event of a tenant's bankruptcy is enforceable.

Courts have construed this part of Section 70(b) literally and enforced lease clauses which provided for automatic cancellation in the event of a tenant's bankruptcy or insolvency or which gave the landlord the right to cancel in the event of the tenant's bankruptcy or insolvency.

Even before Section 70(b) was enacted, bankruptcy cancellation clauses were enforced by the courts. Although Section 70(b) is concerned with ordinary bankruptcies pursuant to Section 102 of the old Bankruptcy Act, it is also applicable to Chapter XI arrangements and Chapter X reorganizations.

Nevertheless, a number of courts have refused to enforce a bankruptcy cancellation clause. Some have on the grounds that the landlord waived the right to terminate because the landlord accepted rent from the trustee or debtor.

Other courts have refused to enforce bankruptcy cancellation clauses in arrangements or reorganization proceedings on the grounds that a cancellation of the leasehold would interfere with the successful rehabilitation of the tenant or that the public interest would be impaired.

In 1974, the Court of Appeals for the Second Circuit broadened this exception to the strict application of Section 70(b). *In Queens Boulevard Wine & Liquor Corp. v. Blum, 503 F.2d 202, the* lease contained the following bankruptcy clause:

"[Article 16B]: If at the date fixed as commencement of the term of this lease or if at any time during the term thereby demised . . . Tenant makes an assignment for the benefit of creditors or petition for or enter into an arrangement this lease, at the option of the landlord, exercised within a reasonable time after notice of the happening of any one or more of such events may be cancelled or terminated . . .

"[Article 63] Notwithstanding the provisions of Article '16' hereof, in the event no relief is requested in any of the bankruptcy proceedings set forth in Article '16' hereof to disaffirm this lease, or to reform the same . . . and provided, *further, that all rent,* additional rent and other charges due from Tenant under this lease are paid promptly when due . . . this lease shall not be terminated as provided in Article '16' hereof, but shall continue in full force and effect."

Despite the risk of termination, the tenant failed to pay its rent on time. The court allowed the tenant to cure the rent default and refused to allow the landlord to cancel the lease.

Soon after the Queens Boulevard decision, the Second Circuit decided *In re D. H. Overmyer*, 510 F.2d 329 (1975). But this time the Court of Appeals held that the lease could be terminated by the landlord.

Perhaps the *Overmyer* case is distinguishable from *Queens Boulevard* in that the leasehold interest in question was not the sole asset of the debtor in possession and there was no possibility of rehabilitating *D. H. Overmyer*.

The *Queens Boulevard* doctrine was affirmed in *Goldwurm v. Walter Reade Organization*, 77-B-42 (S.D.N.Y.). The lease in question contained the following bankruptcy clause:

"If at the date fixed as the commencement of the term of this lease or if at any time during the term hereby demised there shall be filed by or against tenant in any court pursuant to any statute either of the United States or of any state a petition in bankruptcy or insolvency or for reorganization or for the appointment of a receiver or trustee for all or a portion of tenant's property, and within sixty days thereof tenant fails to secure a discharge thereof, or if tenant makes an assignment for the benefit of creditors or petition for or enter into an arrangement this lease, at the option of landlord, exercised within a reasonable time after notice of the happening of any one or more such events, may be cancelled or terminated . . ."

Bankruptcy Judge Galgay held that the lease could not be terminated because the theater being operated at the demised premises was the third most profitable theater in the chain. The Judge felt that the termination of the lease would interfere with the possibility of successfully rehabilitating the debtor.

Judge Galgay used good sense. A store, restaurant or theater organization can not be rehabilitated if the debtor loses the leasehold interests for its stores, restaurants or theaters. Although it is feasible to move a manufacturing or warehousing business to another location sometimes, a retail location is one of the most important, if not the most important factors in the conduct of a retail business.

So, lease negotiators are faced with three conflicting views of interpreting bankruptcy clauses in leases. One is the line of cases that construe the language of Section 70(b) of the old Bankruptcy Act literally and enforce the cancellation of the lease. The second doctrine is judge-made law under which courts refuse to enforce a bankruptcy cancellation clause when the result interferes with the rehabilitation of the debtor or the public interest. The third doctrine is contained in Subsection 365(e) of the Bankruptcy Reform Act which goes into effect on Oct. 1, 1979.

Section 365 makes the value of a bankruptcy cancellation clause after Oct. 1 dubious and makes these clauses unenforceable except under special circumstances.

**Tailored Clauses**

Bankruptcy cancellation clauses in leases I've seen in recent years fall into three main patterns. One type of clause provides that the lease is cancelled automatically in case an event of insolvency occurs.

The value of this provision to a landlord is that it cuts the tie cleanly as soon as the insolvency occurs and there may be a better chance that the clause will be enforced under the old Bankruptcy Act. The trouble with the provision is that the landlord may not want the lease cancelled.

A second type of provision gives the landlord the right to cancel in case an event of insolvency occurs.

A third type of clause states that an event of insolvency constitutes a default under the lease. Then the default clause takes over and gives the landlord the option to cancel.

The next question to answer is what constitutes an event of insolvency that will give rise to a cancellation or a right to cancel. Here is a partial list of events of insolvency: bankrupty, reorganization, arrangement, composition, assignment for the benefit of creditors, trusteeship and receivership.

A bankruptcy cancellation clause should distinguish between voluntary and involuntary events of insolvency.

Voluntary proceedings include the filing of a petition by a tenant in bankruptcy, the filing of a petition by a tenant for reorganization under Chapter X of the old Bankruptcy Act, the filing of a petition by a tenant for an arrangement under Chapter XI of the old Bankruptcy Act and the filing of a petition by a tenant to a court for the appointment of a receiver or trustee.

Sometimes a tenant's creditors will file a petition to have a tenant declared bankrupt. Landlord-oriented bankruptcy clauses tailored to the old Bankruptcy Act provide that if a tenant acquiesces to such a petition, the acquiescence is treated as a filing of the petition by the tenant.

**Tenants' Views**

A petition may be filed by a creditor of a tenant without the acquiescence of the tenant, and this petition may or may not be appropriate under the circumstances. How should a lease treat the possibility that a creditor of a tenant will file a petition in bankruptcy under the old Bankruptcy Act against the tenant to which the tenant does not acquiesce?

Tenants should not agree that the filing of an involuntary petition alone will be regarded as a default because the tenant may not be insolvent and the petition might contain erroneous allegations. A tenant who would agree to such a provision leaves itself wide open for arbitrary treatment. Any creditor of the tenant could threaten to endanger the tenant's leasehold if the creditor filed a petition in bankruptcy against the tenant.

Knowledgeable tenants insist that the bankruptcy clause provide that the tenant have a period of time in which to get such a petition dismissed. Of course, the lease would go on to say that the landlord could not cancel if the petition were dismissed during that time period.

The time periods range from thirty days to one hundred twenty days. Time is counted from the date the petition is filed, and no notice from the landlord is required.

Many negotiators who have represented tenants have insisted that

a tenant's insolvency should not constitute a default and that the landlord should have no rights as a result of the tenant's insolvency. Their theory is that, if the tenant continues to pay its rent and to comply with all of its other obligations under the lease, the landlord should not be able to terminate the relationship.

In cases decided under the old Bankruptcy Act, a tenant can achieve this result by refusing to allow its lease to contain any bankruptcy clause.

Sometimes a dispute over a bankruptcy clause expected to be construed under the old Act has been settled by providing that the landlord will have the right to cancel the lease only in case of an ordinary bankruptcy.

That's because these proceedings are intended to result in the dissolution of the bankrupt and the liquidation of its assets. On the other hand, proceedings for an arrangement under Chapter XI of the old Bankruptcy Act or for reorganization under Chapter X of the old Bankruptcy Act are intended for the rehabilitation of a troubled company.

Under the compromise, the landlord would not have the right to cancel in case of a filing for an arrangement under Chapter XI or a reorganization under Chapter X of the old Act.

Another compromise that was popular in leases negotiated with the old Act in mind is that the landlord would have the right to cancel in case of an event of insolvency unless the tenant continued to pay the rent and comply with all of its other obligations under the lease.

**Two Points of View**

There's not much to say for this provision from the landlord's point of view except that it is less distasteful than having no bankruptcy clause at all. From the tenant's point of view, this clause appears to be a good idea because it gives the tenant the power to preserve its leasehold interest even if it becomes insolvent.

But look at the clause. It provides that the landlord does not have the right to cancel the lease in the case of a bankruptcy *as long as the tenant complies with its obligations under the lease.* A tenant that pays rent late isn't complying with its obligations under the lease.

A tenant who is concerned with the possibility that it will file under the old Act, and is in a good position to insist, might be better off with a clause that provides that the landlord would not have the right to cancel in the event of insolvency if the tenant is not otherwise in *default beyond the applicable cure period.*

**Draft Clause Carefully**

It's best not to draft a lease sloppily and hope that a court will come to your aid.

In negotiating a bankruptcy clause on behalf of a tenant, make sure that the landlord can't cancel the lease as a result of a bankruptcy as long as the tenant continues to comply with its obligations under the lease.

To make sure, provide that the landlord can't cancel unless the tenant is otherwise in default under the lease. Then, make sure that the default clause is organized so that a failure to comply with an obligation under the lease won't be a default unless the failure continues for a period of time after the landlord gave notice to tenant of the failure.

In the case of a failure to pay rent, the period of time would be 15 days. In the case of any other failure, the period would be 30 days.

If the tenant would be unable to cure a failure within 30 days by the exercise of reasonable diligence, the period in which the failure might be cured would be extended as long as the tenant diligently pursues the cure.

**Lease Assumption**

The Bankruptcy Reform Act makes a drastic change in the rules governing the enforceability of lease clauses in Bankruptcy Courts. You'll have to wait a while to learn just how drastic the changes are. Many provisions of the new Act are hard to understand, and it will be a long time before court decisions make them clear.

One thing that is clear under the Bankruptcy Reform Act is that the trustee has the right to decide whether to assume or to reject an unexpired lease, subject to some limitations.

If a trustee can assume a lease, the trustee becomes the owner of the tenant's leasehold interest and can assign the leasehold interest. The right to assign is subject to additional limitations. If the trustee can't assume, I presume that the lease will be rejected automatically.

Section 365 of the Bankruptcy Reform Act contains three limitations on the trustee's right to "assume" a lease. These limitations are found in Subsections 365(c) and 365(d). Limitations on the right of assignment are contained in Subsections 365(c) and 365(f).

Under Subsection 365(k) an assignment of the lease by the trustee relieves the trustee and the estate of the tenant "from any liability for any breach of such . . . lease occurring after such assignment."

Under subsection 365(b) if the tenant is in default under the lease, the trustee can't assume the lease unless the trustee takes each of the following steps:

1. The trustee must either cure the default or provide "adequate assurance" that the default will be cured promptly.

2. The trustee must compensate the landlord for any pecuniary loss that the landlord has suffered or provide "adequate assurance" that the landlord will be compensated.

3. The trustee must provide "adequate assurance of future performance under the lease."

Congress answered one question clearly. For the purposes of construing Subsection 365(b), the insolvency or financial condition of the tenant won't be regarded as a default; and the appointment of a receiver, or the "commencement of a case" under the Reform Act won't be regarded as a default.

**Adequate Assurance**

"Commencement of a case" is a phrase of art under the new Act. It means beginning any proceeding under the Act.

I'm sure that you are asking what did they mean by "adequate assurance." There's not much to go on, but Congress did set forth four rules for determining what "adequate assurances" are with respect to shopping center leases:

1. The landlord is entitled to "adequate assurance of the source of rent and other consideration due under such lease." These words aren't crystal clear, but my guess is that Congress is saying that the landlord is entitled to know that the trustee will be in a position to pay the rent due under the lease and carry out its other responsibilities under the lease.

2. The new Act also requires adequate assurances that "any percentage rent due under such lease will not decline substantially." Here Congress takes pity on a landlord who agrees to percentage rent at the rate of two percent of gross sales because the tenant is a variety store or discount store chain. Under the old Bankruptcy Act, the trustee or debtor has great flexibility if the lease itself contains no restrictions, or limited restrictions, on use.

**Forced to Accept Assumption**

Thus, if the use clause of a department store allows a tenant to use the demised premises for any legal purposes, and the lease is interpreted under the old Act, the landlord could conceivably find itself forced to accept an assumption by the trustee and an assignment to a low volume operator such as a furniture store and never see the percentage rent to which it had become accustomed. It would appear that, under application of the new law, a trustee of a high volume, low markup food supermarket chain would not be able to assume a percentage lease if the trustee intended to change the nature of the operation to a low volume, high markup, carriage trade type of food store.

3. Subsection 365(b) requires that the "adequate assurances" to which the landlord will be entitled include assurance that assumption by the trustee and assignment of the leasehold interest will not "breach substantially any provision . . . in any *other* lease, finance agreement or master agreement relating to such shopping center." The statute offers radius, location, use and exclusively provisions as examples of clauses that should not be breached "substantially."

This provision may prove to be one of the most confusing and disruptive of all of the changes wrought by the Reform Act. Suppose a department store tenant of a shopping center "commences a case" under the new law and that the lease contains no restrictions at all on what products the tenant may sell. Suppose also that the lease for a small store in the same shopping center is subordinate in lien to the department store lease, and that the small store lease prohibits the sale of toys in the shopping center. Would the trustee be prohibited from selling toys?

Suppose a lease of a small store also subordinate to the department store lease, prohibits the use of any other store in the shopping center as a department store. If that were so, could the trustee assume a lease with intention to continue the department store operation?

**Potential Conflict**

Here too lies a potential conflict between the Bankruptcy Reform Act and the antitrust laws. As the Federal Trade Commission is attempting to regulate exclusive clauses and beginning to regulate radius clauses, Congress may have given these clauses greater protection in the context of bankruptcy law.

One question on my mind is whether Congress was not confused when they included this provision in the new Act. Perhaps they did not realize that a trustee would be bound by all of the provisions of a lease except those unenforceable by law.

Thus presumably a trustee would be bound by the use clause, radius clause and other clauses in the lease without giving effect to Subsection 365(b) of the Reform Act.

4. Another form of "adequate assurance" that must be offered to shopping center landlords is "that assumption or assignment of such lease shall not disrupt any tenant mix or balance in such shopping center."

Here too the Act appears to ignore the fact that the trustee would be bound by use clauses in its leases. And here too I see a danger that courts will conclude that a trustee of a tenant will not be able to use the demised premises for uses to which the tenant would have been entitled but for the appointment of the trustee.

This subsection limits the rights of a trustee to assume a lease and to assign the leasehold interest.

Part (1) of this Subsection seems to be saying that a trustee of a tenant can't assume a lease for personal services without consent of the landlord.

Under the law of contracts it is settled that a party who is required to render personal services under a contract cannot delegate its duties. The same rule should apply to leases in unusual circumstances.

The trustee of a watch repairman who sublets space in a jewelry store on the strength of the excellence of the repairman's work should not be in a position to assign the sublease without the consent of the jewelry store operator. Is that what Congress intended? What else do these words mean?

Subsection 365(d) limits the time periods in which a lease may be assumed or rejected.

Subsection 365(f) gives a trustee the right to assign leasehold interests even if the lease contains a restriction against assignment. However, the trustee is allowed to assign a lease only if the trustee assumes the lease.

Consequently, a trustee's right of assignment is subject to the limitations on the trustee's right to assume under Subsections 365(b), (c) and (d).

**Value of Cancellation Clause**

The right to assign is subject to one additional limitation. The limitation is that the landlord is entitled to "adequate assurance of future performance by the assignee of such . . . lease . . ."

After the new law goes into effect, will it pay to have a bankruptcy provision in a lease?

As I interpret the new Act, when you take all of the provisions of Section 365 of the Bankruptcy Reform Act into account, there should be no need for a bankruptcy clause in a lease executed after Oct. 1, 1979.

Here's why.

Paragraph (1) of Subsection 365(e) states, in fact, that a lease can't be terminated solely because of a provision in a lease that provides for termination as a result of the insolvency or financial condition of the tenant, the "commencement of a case" under the Bankruptcy Reform Act or the appointment or taking possession of a trustee or custodian.

Paragraph (2) of Subsection 365(e) states that paragraph (1) doesn't apply in some situations. The principal situation in which paragraph (1) doesn't apply arises where "applicable law excuses" the landlord "from accepting performance from, or rendering performance to, the trustee or to an assignee of such . . . lease . . . ," and the landlord "does not consent to such assumption or assignment."

Paragraph (2) of Subsection 365(e) does indicate that a clause giving the landlord the right to terminate a lease in the event of a tenant's bankruptcy will be enforced under the circumstances indicated in paragraph (2).

However, the trustee's rights to assume or assign a lease under the new Act, even in the absence of a bankruptcy cancellation clause, are subject to the same limitation.

It is my impression that the new Act intends that a trustee of a tenant of a lease, under which the tenant is expected to render personal services, may not assume the lease without consent of the landlord even if the lease contains no clause which gives the landlord the right to cancel upon an event of insolvency.

Thus the limitations on the right of the trustee to assume a lease and to assign it are at least as severe as the limitations to which the trustee would be subjected if the lease did contain a bankruptcy cancellation clause.

**Who is the Tenant?**

Suppose the lease provides that the filing of a petition for an arrangement under Chapter XI of the Bankruptcy Act by the tenant is a default, and that the original tenant assigns its leasehold interest. Then suppose the original tenant files a petition for an arrangement under Chapter XI.

If the lease is drafted poorly, the assignee may fear that the word "tenant" might be interpreted as a reference to the original tenant, and that the landlord might have the right to cancel the lease even if the assignee were solvent and had assumed all of the original tenant's obligations under the lease.

Now suppose the original tenant assigns its leasehold interest, and the assignee files a petition for an arrangement under Chapter XI. The lease could also be interpreted so that the word "tenant" refers to the assignee.

**Tenant Assurance**

If this happens, the landlord might be able to cancel the original tenant's leasehold and hold the original tenant liable for damages without allowing the original tenant to regain possession of the demised premises.

Every tenant should be concerned about the possibility that its assignee could lose its leasehold interest as a result of the original tenant's bankruptcy. Imagine the embarrassment of losing a good deal because the buyer is afraid that it will lose what it is buying because of a potential subsequent bankruptcy.

To avoid this situation, a tenant should make sure that the lease provides that, insofar as the bankruptcy clause is concerned, the word, tenant, excludes the assignor, and refers only to the assignee.

How then can a tenant who assigns its leasehold interest make sure that it doesn't lose its leasehold interest in case of the assignee's bankruptcy?

To avoid this problem the lease should provide that, if the landlord cancels the lease as a result of the bankruptcy of the assignee, the landlord may not exercise any remedy against the assignor unless the landlord offers to enter into a new lease with the assignor under the same terms and conditions of the old lease.

If and when the new lease is executed, the landlord would redeliver the premises to the assignor (the original tenant).

If the landlord is required to offer to redeliver the demised premises to the original tenant (the assignor), the assignor would be in a position to reopen its store, to find another assignee or to sublet the premises. This way the original tenant can mitigate its losses, break even or perhaps make a modest profit.

If the lease contains no provision which enables the tenant to recapture the demised premises after it is assigned, and the assignee becomes a bankrupt, the landlord might be able to cancel the lease because of the bankruptcy of the assignee, to insist that the original tenant pay rent and damages and to refuse to allow the original tenant to resume its occupancy.

Now let's look at the problem from the landlord's point of view. The landlord enters into the lease with the original tenant on the basis of the original tenant's credit. If the original tenant assigns the leasehold interest and still later becomes a bankrupt, the landlord loses the benefit of the original credit it bargained for and is still bound by the deal it made.

Although the new tenant may not be a bankrupt, if it did not have much net worth, the landlord would have never made a deal with it in the first place.

Why then should the landlord be in a position in which it loses the credit behind the lease and have no recourse? The landlord would have a just cause to complain if he loses the credit behind the tenant.

However, to prevent the landlord from finding himself in this position, the lease must provide that the landlord can cancel the lease if the original tenant becomes a bankrupt.

And if the lease contains this clause, it will be difficult for the tenant to find someone to sell its business to. Why should anybody buy a store business if it fears that it can lose what it buys because of such a fortuitous circumstance as the bankruptcy of the seller (the original tenant)?