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Striking Balance Between Ch. 11 Retail Debtors, Landlords

Law360, New York (April 02, 2015, 10:25 AM ET) -- Recently, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 released its much-anticipated report. The nearly 400-page report is groundwork for Congress to enact legislation on bankruptcy reform. It is comprehensive and provides meaningful background, debate and compromise. A prime example is the commission's proposed rebalance of the relationship between Chapter 11 debtors (namely, Chapter 11 retailers) and commercial landlords. Some recommendations are more favorable to Chapter 11 debtors, while others favor commercial landlords. Other suggestions provide more certainty and uniformity on issues that produced divergent judicial opinions and treatment. The commission's proposals to reform the treatment of commercial real property leases in Chapter 11 include:

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- more time for Chapter 11 debtors to assume commercial real property leases (pro-debtor);
- unifying the treatment of "stub" period rent under the "accrual" method instead of the "billing" method (pro-landlord);
- inclusion of an explicit duty for commercial landlords to mitigate damages from nonpayment of rent (pro-debtor);
- clarifying a landlord's claim for unperformed obligations under Section 365(d)(3) should apply only to monetary obligations, and such post-petition claim should be an administrative expense not subject to superpriority treatment (pro-debtor); and
- "rent" under Section 502(b)(6) would include any recurring monetary obligations of the debtor under the lease, not just items labeled as "rent" under the lease. Similarly, a landlord's nonrejection-type damages under the lease (such as damage to the property) would not be subject to the Section 502(b)(6) cap on damages (pro-landlord).

Every Chapter 11 Debtor Wants a Holiday Season

The commission recommends extension of a Chapter 11 debtor's unilateral period to assume commercial real property leases. Currently, there is a 210-day deadline with a built-in checkpoint at the 120-day mark. The proposal increases this period to an entire year with no built-in interim checkpoint. The commission notes the 210-day drop-dead period currently found in 11 U.S.C. §365(d)(4) is restrictive and shifts leverage too far in the landlord's favor.

The commission's proposal is too late for such post-BAPCPA (Bankruptcy Abuse Prevention and Consumer Protection Act) Chapter 11 debtor retailers as RadioShack, Linen N' Things, Borders, Circuit City and Filene's Basement. However, if accepted by Congress, the commission's proposal would benefit future Chapter 11 retailers and other Chapter 11 debtors with leased commercial real property.

This proposal attempts to balance the relationship between Chapter 11 debtors and commercial landlords, which many deemed too pro-debtor before congressional amendments in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, but viewed the BAPCPA as an overcorrection.

Prior to the BAPCPA, the Bankruptcy Code required Chapter 11 debtors to assume or reject commercial real property leases within 60 days from the start of the case, but the court could extend this deadline "for cause." Routinely, the deadline would be extended for years in line with extensions for plan confirmation, but produced uncertainty and an unfavorable business reality for landlords. This uncertainty and unfavorable treatment proved too much for Congress and certain special interest groups, and yielded the BAPCPA's changes to Section 365(d)(4) resulting in our current system, which reduced the initial assumption/rejection period to 120 days (in line with the initial plan exclusivity period).

This initial 120-day checkpoint period may be extended once for another 90-day period for cause without the landlord's consent. Such "cause" is usually determined if the Chapter 11 debtor is current with rent payments post-petition in line with a cash collateral budget. The court is not permitted to grant further extension beyond this 210-day period without a landlord's prior written consent.

The commission noted empirical and anecdotal evidence suggested the BAPCPA's 210-day hard-stop period was at least a contributing factor to the decline in retail filings and results achieved in certain retail debtor cases since enactment of the BAPCPA. However, these statistics may be more correlation than causation. On balance, the commission determined a 210-day hard-stop period before requiring landlord consent — which many times involves payment of prepetition rent (a de facto cure) since the landlord had all the leverage — tilted the balance too far in the landlord's favor and hindered Chapter 11 efforts.

The commission's extension of the assumption period to a full year without any preset interim checkpoint is certainly more debtor-friendly, as it gives every Chapter 11 retail debtor (and their creditors) an ability to reap the benefit of the holiday season no matter when the Chapter 11 was filed. Similarly, the full-year duration provides all Chapter 11 debtors with an annual cyclical business a chance to hit their high season, while commercial landlords retain their rights to seek to compel lease rejection or to shorten the assumption period for cause.

A friendly amendment to the commission's recommendation would retain the year hard-stop period, but with preset interim checkpoints at the 120-day and 240-day periods. This would place commercial real property leases on the court's agenda at least once every trimester and perhaps reduce landlord motions to compel and for stay relief in the interim.

Stub Period Rent Gets Much-Needed Uniformity

"Stub" rent is the amount due to a landlord for the period of use and occupancy between the petition date and the first post-petition rent payment date. In a majority of circuits, the courts use a prorated or accrual method to account for stub rent obligations, with the days of the month falling prior to the petition date being an unsecured claim, and the days of the month occurring after the petition date being an administrative expense. As a result, the accrual method affects a debtor's required cash flow and liquidity entering Chapter 11.

In other circuits, such as the Third Circuit, which includes Delaware in its territory, the courts use a billing method, which ignores the actual use and occupancy of the property post-petition and looks strictly to when the bill for that given month comes due. If rent was due on the first of the month and the petition was filed on the second day of the month, the entire month of unpaid use and occupancy would be an unsecured claim as the bill for that month came due prepetition.

The commission was focused on creating a uniform, codified standard and settling the circuit split that has evaded U.S. Supreme Court review. The commission reviewed case law from various circuits as to both the accrual and billing approaches. It determined the accrual method was a fair approach, most closely aligned with the purpose of Section 365 (d)(3), and would avoid debates over billing mechanisms, delays, built-in soft extensions, etc. While the commission's proposal may affect a new Chapter 11 debtor's liquidity requirements, ultimately, courts, practitioners, Chapter 11 debtors and landlords all should welcome a uniform treatment of stub rent.

Formalizing a Landlord's Duty to Mitigate

The commission's proposal to formalize a landlord's duty to mitigate includes certain ambiguities and may need further discussion and specifics prior to a final pitch to Congress. Unlike its other proposals on commercial real property leases, the commission did not include much discussion or background on this topic. However, the commission began with a generally laudable premise that a landlord should make reasonable efforts to mitigate damages should the trustee or debtor in possession reject the lease under Section 365.

The concept that a landlord should use best efforts to limit its net rejection damages is nothing new, such as by finding a new tenant or drawing against an applicable third-party letter of credit. However, the commission takes things a step further when noting Section 365 should include a "formal duty" to mitigate damages, even in circumstances when mitigation is not required by applicable nonbankruptcy law.

Another issue is the scope of a formal duty to mitigate damages in Section 365. The commission recognizes that "any mitigation or cover received by, or security deposit held by, the landlord should reduce the landlord's prepetition claim for purposes of calculating the section 502(b)(6) claim." This comment is helpful to combat some debtors, creditor committees and courts, which have held landlords are required to apply prepetition security deposits, letters of credits and other prepetition covers against post-petition administrative rent claims.

Finally, the committee noted the duration of "[a] landlord's obligation to mitigate damages should continue through the claims objection deadline or the date of the order allowing the claim, whichever is earlier." With claims objections many times being pushed off until well after plan confirmation, this could lead to problems or ambiguities with (1) landlords voting on plans, (2) preservation of claims to enforce the duty to mitigate, (3) a post-confirmation debtor or liquidating trust's standing to enforce the duty, and (4) may create unnecessary litigation for committees, liquidating trustees and post-confirmation debtors as to mere unsecured claims as many of these "duty to mitigate" scenarios are subject to discovery and evidentiary hearings.

The 502(b)(6) cap already is a major limitation on a landlord's lost-profits damages available outside of bankruptcy. And landlords frequently have these capped bankruptcy claims treated ratably pennies on the dollar. It would not seem to make sense many times for bankruptcy estates to spend whole dollars in administrative professional fees to address a pennies-on-the-dollar issue of mitigating capped unsecured damages. This is especially true in the absence of an existing split in case law as to a landlord's use of best efforts to set off collateral source recoveries on their unsecured claims against the bankruptcy estate.

Debtor Performance Under a Lease is Refined

The commission clarified the scope of a Chapter 11 debtor's pre-assumption/rejection performance under commercial real property leases. There was debate as to whether Section 365(d)(3)'s performance obligations included monetary and nonmonetary obligations. The commission noted Section 365(d)(3) only included 365(b)(2) as a qualified exception, and did not reference 365(b)(1) and its nonmonetary obligations, which set up the debate in case law as to whether this meant a debtor in possession was required to perform all nonmonetary obligations on and after the petition date as provided in Section 365(d)(3), or whether its absence from specific mention in 365(d)(3) meant that nonmonetary obligations were not within the scope of Section 365(d)(3) at all.

After briefly reviewing the debate, the commission acknowledged its compromise function of Chapter 11 reform. The commission noted since it only recommended a "relatively modest extension of the Section 365(d)(4) deadline [one-year proposal discussed above], the commission decided to recommend limiting section 365(d)(3) to monetary obligations under the leases and to provide ordinary administrative priority (not superpriority) to any such unpaid or deferred obligations under section 365(d)(3)."

The treatment and scope of 365(d)(3)'s performance obligations may deserve more stand-alone attention to properly vet the nonmonetary obligation debate prior to submitting same to Congress, since Congress could determine not to accept the commission's 365(d)(4) recommendation or perhaps the "limited" extension period otherwise is enhanced in the negotiation process.

A Broad View of Rent and Nontermination Damages

The commission delved into the practical nature of the landlord-tenant relationship, as well as recurring monthly charges that are coterminous with the principal amount of rent, such as taxes, common area maintenance (CAM) charges, insurance and the like. Clearing up mild controversy in case law and among academics, the commission recommended the term "rent" under Section 502(b)(6) should not be based on being labeled as "rent" under the lease. Rather, the Bankruptcy Code should define "rent" as any recurring monetary obligations of the debtor under the lease.

Similarly, the commission noted a landlord's nonrejection-type damages under the lease (such as damage to the property) should not be subject to the Section 502(b)(6) cap on damages, as the cap under Section 502(b)(6) applies only to, and limits, "the claim of a lessor for damages resulting from the termination of a lease of real property."

Conclusion

The commission undertook a Herculean task to reform the landscape of Chapter 11. It addressed hundreds of issues, case law, anecdotal trends and other practical considerations in proposing changes to improve and streamline recurring disputes in the Chapter 11 process. The commission's proposals to address the relationship between Chapter 11 debtors and their commercial landlords were well done and struck an overall appropriate balance between them. Hopefully, as discussed above, the commission will continue to tweak and refine its report before taking it to Congress, in order to consider comments from

the bankruptcy bench and bar, industry groups and interested parties.

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