AMERICAN BANKRUPTCY INSTITUTE

2023 Annual Spring Meeting

Non-Monetary Defaults

Hosted by the Asset Sales & Real Estate Committees

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CONCURRENT SESSION

2023

Discussion Outline

- Overview of Non-Monetary Defaults
  - Loan Defaults
  - Lease Defaults
- When Lenders Exercise Non-Monetary Defaults
- When Landlords Exercise Non-Monetary Defaults

Non-Monetary Defaults in Loans

Non-Monetary Defaults in Leases

When Lenders Exercise Non-Monetary Defaults

Caselaw regarding acceleration and foreclosure due to non-monetary defaults

- *In re 53 Stanhope LLC*, 625 B.R. 573, 584 (Bankr. S.D.N.Y. 2021) (Drain, J.)
- Canvassed NY state law and found that "New York has long recognized broader equitable exceptions to enforcing parties' contracts with respect to acceleration and non-monetary defaults"
- Required consideration of three factors:
    - (1) has the lender suffered actual damages as a result of the default;
    - (2) has the default impaired the lender's security, that is, the collateral securing the debt; and
    - (3) does the default make the future payment of principal and interest less likely?

Caselaw regarding acceleration and foreclosure due to non-monetary defaults

- *In re 975 Walton Bronx LLC*, No. 21-40487-jmm, 2022 Bankr. LEXIS 2832, at *3 (Bankr. E.D.N.Y. Oct. 6, 2022)
- Court ultimately adopted the *Stanhope* test but observed New York cases espousing a much more lender friendly test where acceleration and foreclosure permitted absent proof that lender engaged in "fraudulent, exploitive, overreaching, or unconscionable conduct"

Courts have permitted acceleration for non-monetary defaults

Non Monetary Default	Enforceable Default?
Unpermitted encumbrances on collateral	Yes. Granting of encumbrances on collateral impaired lender's security. *See 53 Stanhope* (NY, 2021).
Breach of change of control provision	Yes. Lender damaged because it was deprived of ability to get "bad acts" guarantee from new controlling party. *See 975 Walton* (NY, 2022).
Breach of debt service coverage ratio	Yes. Foreclosure permitted even where debt was fully secured and no payment defaults. *See Lakeside Inn* (Nev., 2015).

Courts have permitted acceleration for non-monetary defaults

Non Monetary Default	Enforceable Default?
Failure to complete construction by deadline	Yes. *See Nat'l Bank of Ariz. v. Thruston* (AZ, 2008)
Failure to keep up property insurance	Yes. *See Jordon v. Sharpe* (NY, 1983)
MAC as to financial condition of guarantors and breach of warranty as to necessity of additional funds	Yes. Foreclosure permitted where (1) guarantors suffered an adverse material change in their financial condition and (2) defendants breached a warranty provision that no additional funds would be required to complete shopping center. *See European Am. Bank* (NY, 1995)

Acceleration not permitted for non-monetary defaults

Non Monetary Default	Enforceable Default?
Building Code Violations	No. Violations later cured so no impairment of collateral or creation of payment risk. *See 53 Stanhope* (NY, 2021).
Misrepresentations re: borrowers' ownership structure.	No. No damage to Lender because Lender did not rely on credit of borrower's owners. *Id*.
Breach of covenant against alterations to structure without lender consent	No. Alterations "did not change the character of the building or the use to which it was put" and were "necessary and proper in order to preserve the building." *See Loughery* (NY, 1921).

When Landlords Exercise Non-Monetary Defaults

What Are The Debtor's Options With
Its Leases under Section 365 of the Bankruptcy Code?

1. Assume
2. Assume and Assign
3. Reject

Deadline to Assume or Reject Leases

120 Days (Initial Period)
+
90 Days (Extension)
=
210 Days (7 Months)

- Further extensions require prior written consent of landlords

* The initial period was changed to 210 days in response to the Covid-19 pandemic but reverted back to 120 days on December 27, 2022.

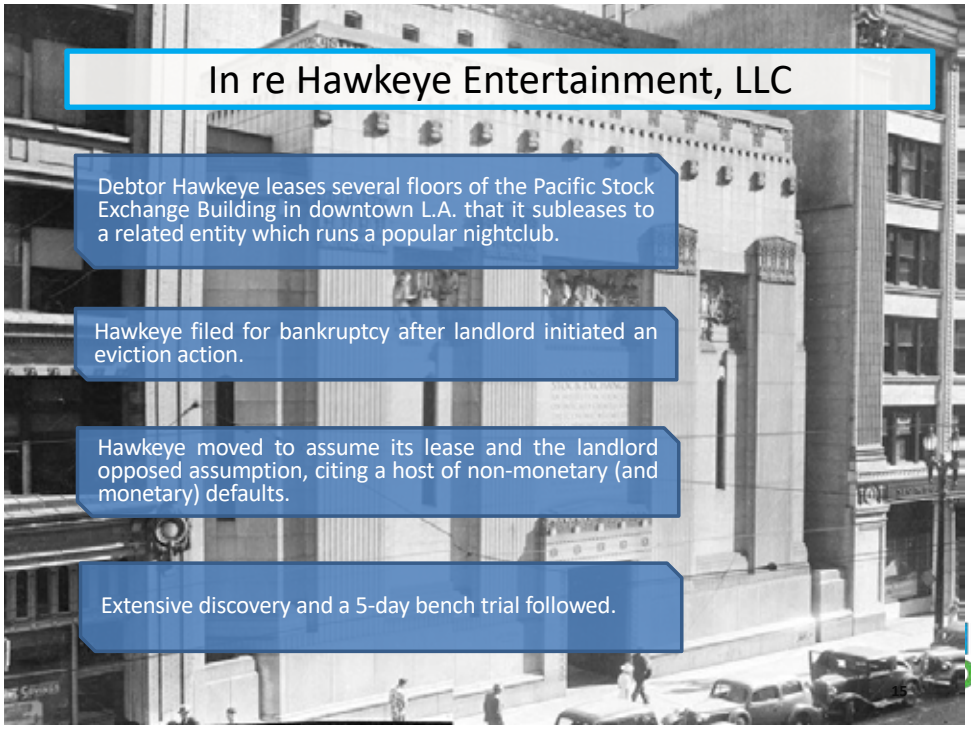
Kelley Drye

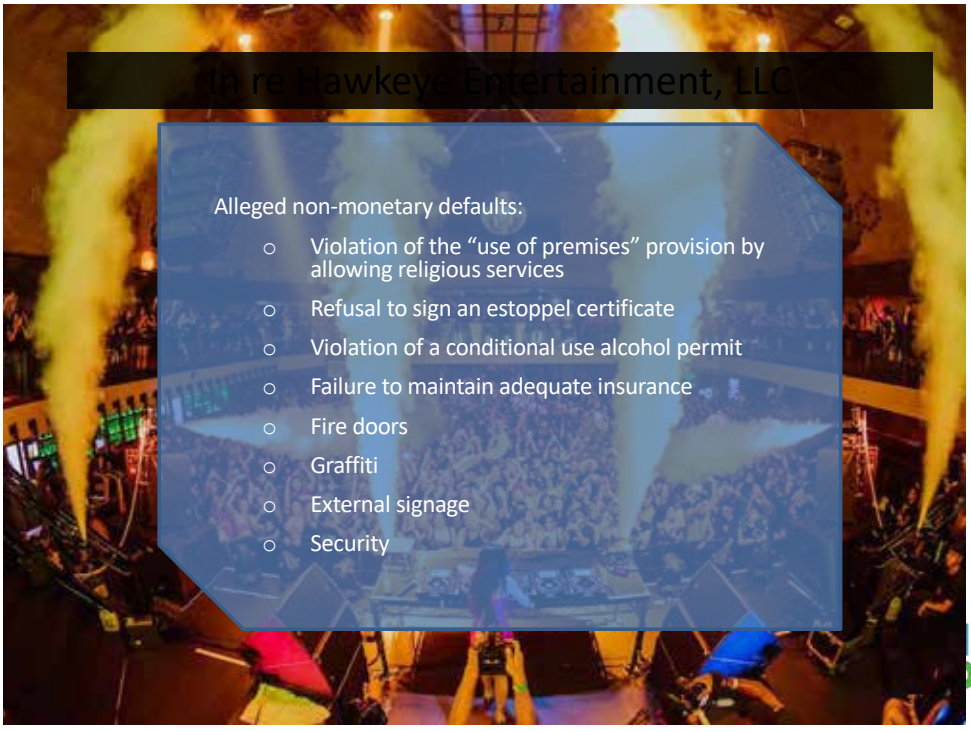
The Requirements for Assumption and Assignment

1. **Court approval**
2. **Prompt cure of all defaults**
   - Monetary v. non-monetary defaults
3. **Must compensate landlord for pecuniary loss**
   - May include attorneys' fees
4. **Must provide adequate assurance of future performance**
   - Not a guarantee

*Anti-assignment provisions are unenforceable

Kelley Drye


In re Hawkeye Entertainment, LLC
Debtor Hawkeye leases several floors of the Pacific Stock Exchange Building in downtown L.A. that it subleases to a related entity which runs a popular nightclub.
Hawkeye filed for bankruptcy after landlord initiated an eviction action.
Hawkeye moved to assume its lease and the landlord opposed assumption, citing a host of non-monetary (and monetary) defaults.
Extensive discovery and a 5-day bench trial followed.


In re Hawkeye Entertainment, LLC
Alleged non-monetary defaults:
Violation of the "use of premises" provision by allowing religious services
Refusal to sign an estoppel certificate
Violation of a conditional use alcohol permit
Failure to maintain adequate insurance
Fire doors
Graffiti
External signage
Security

ANALYZING *HAWKEYE* THROUGH AN *IPSO FACTO* LENS

THE COURTS' DIFFERING FRAMEWORKS

- Bankruptcy Court recognizes a materiality exception
  - Not in Code's language
  - Accords with state law
    - And with Code's resistance to opt-out behavior
- Ninth Circuit rejects the materiality exception
  - Plain language approach
    - Dictionary definition of "default"

IPSO FACTO GENERALLY

- 365(e)(1) invalidates ipso facto clauses
- 365(b)(2)(A), (B), and (C) except ipso facto defaults from the cure requirement
- Bankruptcy is a collective proceeding -- no one can opt out.
  - Invalidation of ipso facto clauses prevents opt-out behavior

PROTECTIONS FOR NON-DEBTOR COUNTERPARTY IN 365

- Requirements for assumption in 365(b)(1)
  - Cure
  - Compensate
  - Provide adequate assurance of future performance
- *Hawkeye* dealt with adequate assurance requirement

ANTI-IPSO FACTO SENTIMENT THROUGHOUT THE CODE

- 541 property of the estate; 363 use, sale, or lease of property ; 545 statutory liens
- De facto ipso facto clauses
  - Non-monetary defaults and the historical facts doctrine
  - Materiality exception to cure prevents forfeiture of an asset
- See Andrea Coles-Bjerre, *Ipso Facto: The Pattern of Assumable Contracts in Bankruptcy*, 40 N.M. L. Rev. 77 (2010) https://digitalrepository.unm.edu/nmlr/vol40/iss1/5/

APPLYING THE IPSO FACTO LENS TO *HAWKEYE*

- 9th Circuit adopts the result reached in bankruptcy court's ruling by finding harmless error
- 9th Circuit's language accords with ipso facto concerns:
  - "[I]t seems that requiring further assurances would serve only to assist Smart Capital in its attempts to avoid continuance of an undermarket lease. But this is not a right or benefit afforded under section 365."
  - "And while it is entitled to assurance that Hawkeye will comply with the terms of that deal, it is not entitled to use section 365(b)(1) as a means to get out of a bad deal so that it can make a better one."
- 9th Circuit's ruling also consistent with 365(b)(1)(a) rules about commercial leases
  - Permits cure of impossible-to-cure non-monetary defaults by performance in accordance with the lease at and after the time of assumption
    - Consistent with court's ruling re harmless error

APPENDIX

Courts have permitted acceleration for non-monetary defaults

Courts applying New York law have utilized a three-factor test

- In *Stanhope*, the bankruptcy court for the S.D.N.Y. observed that "New York has long recognized broader equitable exceptions to enforcing parties' contracts with respect to acceleration and non-monetary defaults" and would only permit acceleration based on nonmonetary default upon evaluation of three factors:
  - (1) has the lender suffered actual damages as a result of the default;
  - (2) has the default impaired the lender's security, that is, the collateral securing the debt; and
  - (3) does the default make the future payment of principal and interest less likely?
  - *See In re 53 Stanhope LLC*, 625 B.R. 573, 584 (Bankr. S.D.N.Y. 2021) (Drain, J.) (courts also consider whether default was inadvertent/insignificant, but usually applying the three factors).
- Defaults enforced – encumbrances in violation of loan agreements (impaired security);
- Defaults not enforced – building code violations (debtors addressed dressed violations); failure to accurately disclose Debtors' owners (discounted risk of violation of money laundering, Patriot Act rules and regulations or "know your customer" rules).

Other courts have similarly found that equitable considerations did not prevent acceleration for non-monetary defaults

- In *975 Walton Bronx LLC*, the bankruptcy court for the E.D.N.Y. found that intentional breach of a change of control covenant damaged the lender and made future payments of principal and interest less certain, justifying acceleration of the loan under New York law. *In re 975 Walton Bronx LLC*, No. 21-40487-jmm, 2022 Bankr. LEXIS 2832, at *3 (Bankr. E.D.N.Y. Oct. 6, 2022);
- The lender argued the court should have applied a different standard, contending that "the Court erred in applying the *Stanhope* legal standard and, per the *Fifty States* decision, the Lender should be permitted to accelerate the Loan unless the Debtor can prove the Lender engaged in fraudulent, exploitive, overreaching, or unconscionable conduct," although the court found the result was the same, and "which standard to apply is academic." *See id*. at *16-17;
- *Id*. at * 36-37 ("The Court agrees with Justice Cardozo that there is nothing sacrosanct about mortgages and equity can prevent a mortgagee from enforcing an acceleration clause if it 'would work a hardship approaching the oppression of a penalty,'" and "the Court agrees with Judge Drain's conclusion in *Stanhope*, that a mortgagee cannot accelerate a loan and charge default interest based on an unintentional, immaterial, nonmonetary default that does no harm to a mortgagee or its collateral," although "[t]he equitable principals articulated in *Graf* and *Stanhope*…have no application here.")

Courts also permit foreclosure for non-monetary defaults even where there is no monetary default

- ***Breach of covenants related to debt service coverage ratio (DSCR); debt to tangible net worth ratio; maintenance of cash equivalents; and loan balance to appraised collateral value (LTV) ratio –*** *See Lakeside Inn, Inc. v. Bank of the W.*, No. 3:14-cv-00473-RCJ-WGC, 2015 U.S. Dist. LEXIS 37873, at *10-14 (D. Nev. Mar. 25, 2015) (granting summary judgment in favor of bank, holding "the Bank may foreclose … based on a breach of a non-monetary covenant [even] when the debt is fully secured" and the borrower casino "never missed a payment"; "The Casino points to no Nevada law or provision of the governing documents indicating that the adequacy of the security has anything to do with the availability of the remedy.")
- ***Breach of Construction Deadline –*** *See Nat'l Bank of Ariz. v. Thruston*, 218 Ariz. 112, 120-21, 180 P.3d 977, 984-86 (Ct. App. 2008) (although bank not entitled to summary judgment for failure to meet initial burden of production, the court decided an issue "likely to be re-urged on remand," holding "although [borrower] cured the monetary default, an existing default, the non-monetary default, [i.e. failure to complete construction of property by the construction deadline according to the terms of the construction loan] remained uncured. Consequently, the Bank was entitled to pursue foreclosure of the deed of trust securing the note.");
- ***Insecurity Clause –*** *See Elizabeth Retail Props., LLC v. KeyBank Nat'l Ass'n*, No. 3:13-cv-02045-SB, 2017 U.S. Dist. LEXIS 60354, at *38-39 (D. Or. Mar. 10, 2017) (lender bank "had a good faith belief that it was insecure and, therefore, was entitled to take steps to protect its own interests" under promissory note and deed of trust, including acceleration of the indebtedness and foreclosure);
- ***Failure to Insure Property –*** *See Jordon v. Sharpe*, 92 A.D.2d 946, 946, 460 N.Y.S.2d 846, 846 (App. Div. 3rd Dept. 1983) (affirming denial of mortgagor's motion to vacate judgment in action to foreclose a mortgage finding that mortgagee was entitled to foreclose because mortgagor failed to insure the property upon due notice).
- ***Adverse Material Change & Breach Warranty as to Necessity of Additional Funds –*** *See European Am. Bank v. Vill. Square Assocs. Ltd. P'ship*, 212 A.D.2d 754, 754, 623 N.Y.S.2d 296, 297 (App. Div. 2nd Dept. 1995) (affirming summary judgment in favor of mortgagee in foreclosure action on basis of defaults under loan because (1) two of the guarantors suffered an adverse material change in their financial condition and (2) defendants breached a warranty provision that no additional funds would be required to complete a shopping center).

Courts have denied contractual rights of foreclosure based on equitable considerations including where "unconscionable."

"Whether conduct is unconscionable or oppressive depends upon the facts of each particular case." ***See Rockaway Park Series Corp. v. Hollis Auto. Corp.*****, 206 Misc. 955, 957-58, 135 N.Y.S.2d 588, 590 (Sup. Ct. 1954)**

- In *Rockaway*, the court found that "[i]t may be unconscionable…to insist upon adherence to the letter of an agreement where a mortgagee indicates by his conduct or silence that his inaction may turn to his own advantage. " *Id.*
- The court granted summary judgment in favor of the mortgagor in foreclosure action predicated on violation of an order of the municipal department of housing and buildings filed some fourteen years prior to the time of defendant's taking title, where the cumulative effect of "the delay by plaintiffs, the removal of the violations, the improvement of the property by defendants at a substantial cost…indicate that the strict enforcement of the acceleration covenant would approach in hardship oppression similar to a penalty," and "[t]o permit foreclosure under these circumstances would be unconscionable and oppressive." *Id.*

A lender's failure to identify injury or impairment to security can hamstring foreclosure action.

- In *Loughery*, a foreclosure action brought because the defendants had altered a building without the mortgagee's consent, the court declined to grant foreclosure, describing enforcement under the circumstances as "manifestly unconscionable," noting that "[t]he work complained of did not change the character of the building or the use to which it was put when the mortgage in suit and the bond secured thereby were executed and delivered," the modifications were "necessary and proper in order to preserve the building and the proper and convenient use thereof," and generally "not substantial in character; the foundation walls of the building have not been weakened and the value of the plaintiff's security has not been impaired." 117 Misc. 393, 395-97, 191 N.Y.S. 436, 438-39 (Sup. Ct. 1921).
- In contrast, courts have permitted foreclosure where unpermitted violations jeopardize the mortgagee's security. The court in *Laber v. Minassian*, distinguished *Loughery* where "the razing of the building and the removal of the gasoline tanks…changed the character of the building and the use to which it was put," "did not preserve the building," was not insubstantial in character, and did not enhance the value of the property. 134 Misc. 2d 543, 546-47, 511 N.Y.S.2d 516, 518 (Sup. Ct. 1987). "Since the building was part of the security for the mortgage, razing the building must necessarily impair that aspect of the security for the mortgage." *Id.*

In re Hawkeye Entertainment, LLC

Central District of California Bankruptcy Court Order (October 2020):

- Allowed Hawkeye to assume the lease under section 365(a) without providing cure or adequate assurance under section 365(b).
- Found none of the non-monetary defaults were actual defaults, in part because they were not "material" breaches of the lease.
  - "I just cannot read 365 to say any teeny, tiny infraction means a Debtor-In-Possession loses the very valuable asset. That would be not in keeping with state law…"
- The sole monetary default, a late April 2020 lease payment, had already been cured.

District Court Decision (October 2021):

- Affirmed and found that for the cure requirements of section 365(b) to apply "a breach of an unexpired lease agreement must be sufficiently material to warrant the lease's termination under state law."

In re Hawkeye Entertainment, LLC

Ninth Circuit Decision (September 2022):

- Affirmed outcome of lower court decisions, but reversed on the issue of a section 365 "materiality" requirement.
  - no basis in the Bankruptcy Code, California state law nor even in the lease itself to insert a materiality inquiry before applying Section 365(b).
  - Payment default in April 2020 – although remedied prior to assumption – in and of itself required the Bankruptcy Court to apply Section 365(b).
- In the end, however, the failure to apply 365(b) in this case was harmless error.

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In re Old Market Group Holdings Corp.

Southern District of New York Bankruptcy Court Decision (December 2022):

- Warehouse landlord sought cure of unfulfilled pre-assignment tenant repair obligations.
- Debtors opposed on grounds that (i) pre-assignment failure to repair had not been properly noticed was not therefore a property default under the lease, and (ii) landlord could compel the new tenant to complete the repairs and was not harmed by Debtors failure to cure.
- Relying in part on Ninth Circuit Hawkeye ruling, the bankruptcy court found that Debtors did have an obligation to cure triggered because a "default" under section 365(b)(1) is "any failure to perform contractually-required obligations." Landlord failure to provide prior notice under the lease was irrelevant.
- Whether the repairs could be performed by the new tenant also irrelevant. "[a] debtor's obligation under Section 365(b) is absolute, not contingent on a showing that its counterparty has suffered actual pecuniary loss."
- 365(b)(1) has three separate obligations (1) cure defaults; (2) compensate for pecuniary loss caused by the defaults; (3) provide adequate assurance of future performance.

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Faculty

Prof. Andrea Coles-Bjerre is associate professor of law and faculty director of the Business Law Program at the University of Oregon School of Law in Eugene, where she teaches and writes in the fields of bankruptcy and civil procedure, often using insights from cognitive linguistics to critique legal rules and the process of judicial decisionmaking. She received the Orlando J. Hollis Award for Excellence in Teaching. After finishing law school, Prof. Coles-Bjerre clerked for two years for U.S. Bankruptcy Judge Jerome Feller of the Eastern District of New York and practiced for six years with the law firm of Milbank, Tweed, Hadley & McCloy in New York, where she was the lead associate in a variety of complex chapter 11 and other insolvency matters, including the representation of an investor group that acquired New York City's Rockefeller Center, and the institutional noteholders in the reorganization of the Phar-Mor chain of drugstores (one of history's more notorious bankruptcy fraud cases). She has been a member of the Oregon faculty since 1996. Prof. Coles-Bjerre is a peer reviewer for the *American Bankruptcy Law Journal* and has been a visiting faculty member at Brooklyn Law School. She is a member of the Executive Committee of the AALS Section on Law and Interpretation. Prof. Coles-Bjerre received her B.A. *magna cum laude* from Barnard College in 1984 and her J.D. from Brooklyn Law School in 1987.

William Hao is counsel in Alston & Bird LLP's Financial Restructuring & Reorganization Group in New York. He is experienced in a wide range of bankruptcy, litigation and out-of-court restructuring matters. Mr. Hao represents secured creditors, hedge funds, trade creditors, lessors and lessees, and other parties-in-interest in distressed situations and in all aspects of bankruptcy proceedings such as avoidance actions, claims litigation, and the assumption and rejection of contracts and leases. He also has extensive experience representing parties in securitizations and other structured finance products in distressed situations and in commercial litigation, and he regularly advises clients on bankruptcy issues in connection with finance and M&A transactions. Mr. Hao is the treasurer of the Asian American Bar Association of New York and a co-chair of its Commercial Bankruptcy and Restructuring Committee. He also serves as a co-chair of the Bankruptcy, Restructuring, and Creditors'/Debtors' Rights Committee of the National Asian Pacific American Bar Association. Mr. Hao is a member of ABI, the Turnaround Management Association and the New York City Bar Association. He received his B.A. in 2001 from the University of Michigan, and his J.D. in 2005 and his LL.M. in 2007 from St. John's University School of Law.

Jane Kim is a partner at Keller Benvenutti Kim LLP, a San Francisco-based corporate bankruptcy and restructuring boutique law firm, where she represents debtors in possession, distressed companies and other parties in both in-court and out-of-court situations. Her recent engagements include representing In-Shape Health Clubs, LLC, a premium regional fitness club chain in California, and Ravn Air Group, Inc., a regional airline in Alaska, in each of their chapter 11 cases filed in Delaware. She also serves as bankruptcy co-counsel for Pacific Gas & Electric Company in its chapter 11 cases. Before moving to California and joining Keller Benvenutti Kim in 2014, Ms. Kim practiced in New York at Cleary Gottlieb for over a decade. She is a Fellow in the American College of Bankruptcy and has been recognized as a leading lawyer by publications and organizations including *Chambers USA*, *Super Lawyers*, *Benchmark Litigation California*, and *Lawdragon*'s inaugural list of the 500 Leading U.S. Bankruptcy and Restructuring Lawyers. She also was selected to serve as a lawyer representa-

tive for the Northern District of California. Ms. Kim received her B.A. from Columbia College at Columbia University in 1999 and her J.D. from Harvard Law School in 2002.

Robert L. LeHane is a partner with Kelley Drye & Warren LLP in New York. For more than 20 years, he has been representing secured and unsecured creditors, landlords, asset-purchasers, vendors, intellectual property licensors, creditors' committees, lenders and trustees in all aspects of restructuring, bankruptcy and corporate reorganization. Mr. LeHane's experience includes asset sales, avoidance actions, liquidations and appeals in the retail, restaurant, real estate, telecom and energy industries. He also represents clients with private wealth, corporate formation, trust, estate and succession-planning issues. Mr. LeHane is ranked as a leading bankruptcy lawyer in *Chambers USA* and is frequently retained to counsel landlords with large portfolios of leases in retail bankruptcy cases across the country. His team takes a lead role protecting landlord rights, working with his clients to ensure debtor compliance with leases and the Bankruptcy Code in connection with debtor-in-possession financing, lease auctions and chapter 11 reorganization plans. Mr. LeHane frequently participates in the unsecured creditors' committee process on behalf of landlord clients, and he has successfully defended unwanted lease assignments and claim objections, terminated leases, acquired designation rights and spearheaded unique complex joint venture retail acquisitions. He also chairs Kelley Drye's Client Service and Innovation Committee, which considers innovative solutions to address client demands and challenges. Mr. LeHane received his B.A. in 1990 in social studies and history from the State University of New York at Albany and his J.D. in 1998 from the University at Buffalo School of Law.