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ARE LANDLORDS ENTITLED TO ADEQUATE PROTECTION? [1]

DOES THE DEBTOR REALLY HAVE TO CURE ALL DEFAULTS?

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Landlords, Lenders and 506(c)

There is a natural tension in every retail bankruptcy case between lenders and debtors on the one hand seeking to minimize administrative expenses, and their landlords on the other hand, insisting on payment of all post-petition rent. This tension plays out very early in most retail cases when the debtors and their lenders, as part of a debtor in possession financing or consensual cash collateral, seek a waiver the trustee's right under section 506(c) of the Bankruptcy Code to charge the lender's collateral for the administrative costs of preserving or disposing of such property. Before granting a so-called 506(c) waiver, most courts will require evidence, typically supported by a budget, that the funds being advanced by the lender, together with the consented use of cash collateral, will be sufficient to pay the reasonably foreseeable administrative expenses that will be incurred by the debtor(s) during the pendency of the chapter 11 case(s). In retail cases, a category of reasonably foreseeable administrative expenses that must be paid is post-petition rent.[2]

This requirement is sometimes referred to as the "pay to play" concept. Courts in a number of jurisdictions have adopted this "pay to play" concept.[3]

Post-petition rent obligations come in two flavors: (i) so-called "stub rent" covering the per diem post-petition rent in the month the petition is filed, and (ii) the requirement under section 365(d)(3) of the Bankruptcy Code that the Debtor timely perform all post-petition lease obligations.

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[1] The authors borrow liberally from the following pleadings filed recently in the Chapter 11 case *In re Christmas Tree Shops, LLC, et al.*, No. 23-BK-10576 (Bankr. D. Del. filed May 5, 2023): Limited Objection of Acadia Realty Limited Partnership, et al., to Debtors' Motion for Entry of Orders (I) Authorizing the Debtors to Obtain Postpetition Financing . . .; Omnibus Reply of Restore Capital . . . . .

[2] *See*, *e.g.*, *In re Sports Authority, Inc.*, No. 16-10527 (Bankr. D. Del. Apr. 26, 2016, and May 3, 2016) (denying waiver of 506(c) surcharge rights unless final financing order provided for immediate payment of stub rent).

[3] *See In re Machinery, Inc.*, 287 B.R. 755, 768 (Bankr. E.D. Mo. 2002) (citing *Underwriters Ins. v. Magna Bank* (*In re Hen House Interstate, Inc.*), 150 F.3d 868, 871-72 (8th Cir. 1998)) ("[B]oth Boatmen's and Hen House . . . require a finding that the secured creditor does in fact impliedly consent [to surcharging of its collateral] when it agrees to the debtor's continued operation of its business."), *rev'd on other grounds*, 150 F.3d 868 (8th Cir.1998) (en banc), *aff'd.*, 530 U.S. 1 (2000); *United States v. Boatmen's First Nat'l. Bank*, 5 F.3d 1157, 1159-60 (8th Cir.1993); *see also Sports Authority*, *supra*.

The issue of payment of stub rent arises in districts that have adopted the billing date approach to interpreting section 365(d)(3). The most prominent of these districts is Delaware.[4]

The billing date approach looks strictly at the due date for the lease obligation. If rent was due on the first of the month and the petition was filed on the second day (or any day thereafter) of the month, the entire month of unpaid use and occupancy would be treated as a lease obligation that arose prepetition and is not obligated to be paid timely under Section 365(d)(3) of the Bankruptcy Code. However, courts have held that the per diem rent attributable to the post-petition portion of the calendar month in which a bankruptcy case is commenced is entitled to administrative expense treatment under section 503(b) to the extent the debtor continues to use and occupy the leased premises during this time period.[5]

In districts that follow the accrual or proration method, rent for the month in which a bankruptcy case is commenced is prorated: rent for the days of the month falling before the petition date are considered prepetition either to be added to a landlord's general unsecured claim or paid as cure if the lease were assumed, and rent for the days of the month occurring on and after the petition date are considered lease obligation arising from and after the petition date payable promptly under section 365(d)(3) of the Bankruptcy Code.[6]

Unlike post-petition rent payable under section 365(d)(3) of the Bankruptcy Code in proration or accrual districts, "stub rent" in billing date districts may not have to be paid until other administrative expenses are required to be paid; namely, on or after the effective date of a confirmed plan. Courts have discretion to determine the timing of the payment of administrative

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[4] *See In re Montgomery Ward Holding Corp.*, 268 F.3d 205, 209-10 (3d Cir. 2001); *In re Goody's Fam. Clothing Inc.*, 610 F.3d 812 (3d Cir. 2010); *see also Burival v. Creditor Comm.* (*In re Burival*), 406 B.R. 548, 553 (B.A.P. 8th Cir. 2009); *BK Novi Project LLC v. Stevenson* (*In re Baby N'Kids Bedrooms, Inc.*), No. 07-1606, 2008 WL 9836333, at *2 (6th Cir. Mar. 26, 2008); *HA-LO Indus., Inc. v. CenterPoint Props. Tr.*, 342 F.3d 794, 799 (7th Cir. 2003) (billing date for rent; accrual for taxes); *Koenig Sporting Goods, Inc. v. Morse Road Co.* (*In re Koenig Sporting Goods Inc.*), 203 F.3d 986, 989-90 (6th Cir. 2000); *In re Sportsman's Warehouse, Inc.*, 436 B.R. 308, 312 (Bankr. D. Del. 2009); *In re CCI Wireless, LLC*, 279 B.R. 590, 594 (Bankr. D. Colo. 2002); *In re F&M Distribs., Inc.*, 197 B.R. 829 (Bankr. E.D. Mich. 1995); *In re Appletree Mkts., Inc.*, 139 B.R. 417, 420-21 (Bankr. S.D. Tex. 1992); *In re Krystal Co.*, 194 B.R. 161, 163-64 (Bankr. E.D. Tenn. 1996).

[5] *See, e.g.*, *In re Goody's Family Clothing Inc.*, 610 F.3d 812, 816-19 (3d Cir. 2010); *In re Garden Ridge Corp.*, 323 B.R. 136, 142-43 (Bankr. D. Del. 2005) (citing *In re ZB Co. Inc.*, 302 B.R. 316, 319 (Bankr. D. Del. 2003)) (landlords entitled to prorated rent from the Petition Date—despite the fact that the billing date occurred the day before the petition date); *In re HQ Global Holdings, Inc.*, 282 B.R. 169, 173 (Bankr. D. Del. 2002) (section 503(b)(1)(A) provided the grounds for the landlords' stub rent claim). *But see In re Oreck Corp.*, 506 B.R. 500, 509 (Bankr. M.D. Tenn. 2014) (denying administrative expense claim status to stub rent under the billing approach because the obligation did not arise postpetition).

[6] *See, e.g.*, *K-4, Inc. v. Midway Engineered Wood Prods, Inc.* (*In re Treesource Indus., Inc.*), 363 F.3d 994, 998 (9th Cir. 2004); *El Paso Props. Corp. v. Gonzales* (*In re Furr's Supermarkets, Inc.*), 283 B.R. 60, 70 (B.A.P. 10th Cir. 2002); *In re Handy Andy Home Improvement Ctrs.*, 144 F.3d 1125 (7th Cir. 1998) (proration of taxes as opposed to monthly rent); *Heathcon Holdings, LLC v. Dunn Indus., LLC* (*In re Dunn Indus., LLC*), 320 B.R. 86, 93 (Bankr. D. Md. 2005); *In re GCP CT Sch. Acquisition, LLC*, 443 B.R. 243, 255 (Bankr. D. Mass. 2010); *In re Learningsmith, Inc.*, 253 B.R. 131, 133 (Bankr. D. Mass. 2000); *In re All for a Dollar, Inc.*, 174 B.R. 358, 361-62 (Bankr. D. Mass. 1994); *In re Stone Barn Manhattan LLC*, 398 B.R. 359, 362-65 (Bankr. S.D.N.Y. 2008); *In re Ames Dep't Stores, Inc.*, 306 B.R. 43, 67-70 (Bankr. S.D.N.Y. 2004); *In re NETtel Corp., Inc.*, 289 B.R. 486 (Bankr. D.D.C. 2002); *In re Travel 2000, Inc.*, 264 B.R. 444, 447-48 (Bankr. W.D. Mich. 2001).

expenses.[7] If forced to wait for payment of the stub rent, the landlords in a retail bankruptcy case bear the risk of administrative insolvency, while the debtor and its lender(s) enjoy the benefit of continued use and occupancy in the first weeks of a chapter 11 case.

For this reason, early in the case, typically at the first- or second-day hearing, landlords will object to the granting of a 506(c) waive in favor of the secured lender(s) absent some assurance that the administrative expense stub rent claims will be paid, along with the post-petition rent for the subsequent months that are required under section 365(d)(3) to be paid timely until a lease is assumed or rejected. One of the arguments raised by landlords is that they are entitled to adequate protection of their administrative expense claims for stub rent. The argument goes as follows:

> Section 363(e), which states:
>
> > Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. . . .[8]

provides a basis to grant adequate protection to real property lessors in the form of budgeting for the payment of or reserving for the payment of post-petition rent.[9]

In addition, there is the equitable argument that saddling the landlords with the risk of administrative insolvency unfairly places landlords in a position unlike any other administrative creditor by relegating landlords to the position of an involuntary, unsecured, post-petition, interest-free lender to the debtors. Unlike other creditors, the landlords are not permitted to cease doing business with a debtor in bankruptcy and must continue to permit a debtor to use and occupy the premises until a lease is rejected (or assumed). Forcing the landlords to finance a debtor's reorganization by delaying payment of administrative rent is the very result that Section 365(d)(3) was intended to counteract.[10]

If a court were to agree that a landlord is entitled under section 363(e) to adequate protection for any post-petition rent obligations such as the first month's stub rent, it may consider

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[7] *See, e.g.*, *Garden Ridge*, 323 B.R. at 143 (citing *HQ Global*, 282 B.R. 169, 173 (Bankr. D. Del. 2002); *ZB Co.*, 302 B.R. at 320) ("In determining the time of payment, courts consider prejudice to the debtor, hardship to the claimant, and potential detriment to other creditors.").

[8] 11 U.S.C. § 363(e)

[9] *See, e.g.*, *In re P.J. Clarke's Rest. Corp.*, 265 B.R. 392, 404 (Bankr. S.D.N.Y. 2001) (providing that a "landlord's right to adequate protection seems to follow clearly from the language of Section 363(e)"); *In re Ernst Home Center, Inc.*, 209 B.R. 955, 966-67 (Bankr. W.D. Wash. 1997) (finding that adequate protection is available to real property lessors under Section 363(e)); *In re RB Furniture, Inc.*, 141 B.R. 706, 713-14 (Bankr. C.D. Cal. 1992) (adequate protection under Section 363(e) may even be broader than the rights encompassed under Section 365(d)(3), given it "is a fluid concept that reflects all the circumstances surrounding a debtor's use of property").

[10] *See In re Warehouse Club, Inc.*, 184 B.R. 316, 318 (Bankr. N.D. Ill. 1994).

various forms of protection. The form landlords most desire is actual payment.[11] In circumstances where there is a risk of administrative insolvency, it is appropriate for adequate protection to take the form of budgeting and immediate cash payments for post-petition use of the Premises.[12]

In the *Chuck E. Cheese* chapter 11 cases, the Court was faced with a situation where the debtors' DIP financing budget failed to provide sufficient funds for the payment of stub rent and other outstanding post-petition lease obligations, and the debtors and their lenders sought a 506(c) waiver without paying those amounts to landlords. There, the court fashioned a remedy of an escrow for the outstanding stub rent to provide adequate protection to landlords until the catchup payment could be made by the debtors.[13]

There is, of course, a contrary view. In opposition to a landlord's request for adequate protection, a lender can argue that the only statutory protection that Congress provided for stub rent is to be found in sections 365(d)(3) and 503(b)(1)(A) of the Bankruptcy Code, not section 363(e) or 361.[14] Section 363(e) of the Bankruptcy Code requires adequate protection of "an interest in property" when the relevant property is used, leased, or sold by the debtor's estate.[15] The lender's argument reasons that a lessor's interest is not the same as a secured lender's interest in property of the estate, which, unlike a lessor's interest in the payment of contractual lease obligations, is a direct property interest that section 363(e) was intended to protect.[16]

The issue of stub rent and payment of post-petition rent generally continues to plague retail cases even in "pay to play" districts that require foreseeable administrative expenses to be covered in exchange for a 506(c) waiver. Most recently, the post-petition lenders and landlords (including the author on behalf of two landlords) are battling over the issue of post-petition rent in *In re Christmas Tree Shops, LLC, et al.*, Case No. 23-10576 (Bankr. D. Del.).

Assumption, Assignment and Cure of Defaults

In connection with the assumption of leases, recent decisions from courts in California and New York uphold and clarify a landlord's right to cure, even where the default is immaterial, or

[11] *See, e.g.*, *ZB Co.*, 302 B.R. at 320 (holding that rent should be paid to landlords on a per diem basis during the pre-rejection period in order to avoid the potential that the landlord could be left with an allowed administrative claim against an administratively insolvent estate).

[12] *See In re Kellstrom Indus., Inc.*, 282 B.R. 787, 794 (Bankr. D. Del. 2002).

[13] Transcript of Oct. 8, 2020, Hearing at 74-75, *CEC Entertainment, Inc.*, 625 B.R. 344 (Bankr. S.D. Tex. 2020); *see also In re The Sports Authority, Inc., et al.*, No. 16-10527 (Bankr. D. Del. May 3, 2016) (Final Order Authorizing Debtors to Obtain Postpetition Financing) (requiring reserve for stub rent).

[14] *See In re Sweetwater*, 40 B.R. 733 (Bankr. D. Utah 1984) (the legislative history does not support any claim by landlords to adequate protection under section 363(e) or 361 of the Bankruptcy Code).

[15] *See Caliber N.D., LLC v. Nine Point Energy Holdings, Inc.* (*In re Nine Point Energy Holdings, Inc.*), 633 B.R. 124, 144 (D. Del. 2021) ("Section 363(e) requires adequate protection only for 'an entity that has an interest in property used, sold, or leased, or proposed to be used sold or leased.' The plain text of the statute makes clear that creditors that do not actually have an interest in property that is the subject of a proposed sale are not entitled to adequate protection.").

[16] *Sweetwater*, 40 B.R. at 737-39.

does not even rise to the level of a technically defined "Default" under the terms of the applicable lease.

A. Hawkeye

In a recent decision from the Ninth Circuit Court of Appeals, a popular nightclub in historic downtown LA will remain open notwithstanding the concerted multi-year effort by a stubborn landlord to reject the nightclub lease. The silver-lining for the stubborn landlord: the Ninth Circuit overturned a troubling Central District of California ruling, where the court held that if existing defaults are not "material," not only does the debtor-tenant not have to cure the default, it is also relieved of the obligation to provide adequate assurance to assume the lease in their bankruptcy. The District Court in *In re Hawkeye Entertainment, LLC,* affirming a bankruptcy court ruling, held that the cure and adequate assurance protections of Section 365(b) of the Bankruptcy Code only apply if the breach of the lease by the tenant is of sufficient materiality to warrant the termination of the lease under state law. On this key issue, the Ninth Circuit reversed.[17]

After their landlord initiated an eviction action, Hawkeye Entertainment, LLC - whose primary asset is a lease for several floors of the Pacific Stock Exchange Building which it subleases to an affiliate that operates a successful nightclub and entertainment venue - filed for chapter 11 protection. Shortly after filing for bankruptcy, Hawkeye moved to assume the lease and sublease under Section 365 of the Bankruptcy Code.

Section 365(a) of the Bankruptcy Code empowers a debtor to assume an unexpired lease, binding the landlord to the existing terms of the lease after the debtor emerges from bankruptcy. This can be a powerful tool, especially if the lease is below-market as in the *Hawkeye* case. However, existing defaults under the unexpired lease prevent assumption unless the tenant-debtor complies with section 365(b) of the Bankruptcy Code which requires, among other things, that the debtor cures defaults and provides adequate assurance of future performance. In the absence of a default (or if the only defaults are those carved out in Section 365(b)(2)) a landlord has no real recourse to prevent assumption unless the debtor-tenant is also seeking to assign the lease under Section 365(f).

Hawkeye's landlord objected to the assumption motion, citing a myriad of lease defaults which, absent cure, would ordinarily prevent non-consensual assumption. Specifically, the landlord alleged the following defaults, which were ultimately reviewed on appeal: (i) late April 2020 rent payment, (ii) violation of the "use of premises" provision by allowing religious services, (iii) refusal to sign an estoppel certificate, (iv) violation of a conditional use alcohol permit, and (v) failure to maintain adequate insurance. In addition, the landlord also raised issues related to fire doors, graffiti, external signage and security, among others.

Following extensive discovery and briefing of the issues, the subsequent five-day bench trial before U.S. Bankruptcy Judge Maureen Tighe did not go well for the landlord. At trial, Judge Tighe observed that an old, mostly unused office building presents challenges for tenants and landlords, but "[t]hey're the kind of issues you work out in that kind of building, if they're real issues, but I thought [landlord] was using immaterial issues, or manufacturing issues that hadn't

[17] *Smart Cap. Invs. I, LLC v. Hawkeye Ent., LLC* (*In re Hawkeye Entm't., LLC*), 49 F.4th 1232, 1237 (9th Cir. 2022).

been there, as an attempt to characterize them as a default, and the bottom line is, there was no preponderance of evidence on any of these issues to convince me there's a default."[18]

Judge Tighe found that none of the alleged on-going defaults were material enough to warrant forfeiture of the lease and explained that "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…"[19] Accordingly, Hawkeye's assumption motion was approved without the need to satisfy the requirements of Section 365(b)(1)(A), (B) and (C).

On appeal, the District Court affirmed the legal conclusion 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."[20] The District Court justified the application of California state contract law by noting other undefined terms in Section 365 – "executory contract" and "unexpired" – have previously been defined by state law standards.[21] No other bankruptcy decisions were cited in direct support.

Analysis of the materiality of a default in the context of Section 365 appears sporadically in case law in various circuits, typically in the context of whether the contract at issue is executory (*i.e.* whether a material pre-petition breach rendered the contract non-executory)[22] or whether a lease provision renders the contract not capable of assumption.[23] In *Hawkeye*, the introduction of a "materiality" standard in the Bankruptcy Court appears to have been more the result of that court's aggravation with an unsympathetic landlord and the contentious factual record, than diligent survey of bankruptcy case law. Also, by applying a materiality test in this case the Bankruptcy Court avoided having to parse the admittedly challenging language of Section 365(b) as it relates to non-monetary defaults, teeny tiny or otherwise.[24]

In any event, Hawkeye's assumption of the lease was approved and then affirmed without the need to provide the landlord with adequate assurance of future performance as required under Section 365(b)(1)(A), (B) and (C) of the Bankruptcy Code, including prompt cure of defaults and compensation for pecuniary loss resulting from such defaults. District Court Judge Fernando L. Aenlle-Rocha concluded that there was no clear error in the Bankruptcy Court's findings that the alleged defaults were not "material" or, with the exception of the late rent payment which had

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[18] Transcript of Proceedings at 100-101, *In re Hawkeye Ent., LLC*, No. 19-12102 (Bankr. C.D. Cal. Oct. 15, 2020) (No. 269).

[19] Transcript of Proceedings at 55, *In re Hawkeye Ent., LLC*, No. 19-12102 (Bankr. C.D. Cal. Oct. 16, 2020) (No. 271).

[20] *Smart Capital Invs. I, LLC v. Hawkeye Entm't, LLC* (*In re Hawkeye Entm't, LLC*), No. 19-bk-12102, 2021 U.S. Dist. LEXIS 206568, at *8 (C.D. Cal. Oct. 26, 2021).

[21] *Id.* at *8-9.

[22] *See In re Kemeta, LLC*, 470 B.R. 304 (Bankr. D. Del. 2012).

[23] *See In re Joshua Slocum Ltd.*, 922 F.2d 1081, 1092 (3d Cir. 1990).

[24] A leading bankruptcy treatise describes the effort of parsing Section 365(b)(1)(A) as leaving "the reader somewhat breathless, as well as perplexed as to what was intended." COLLIER ON BANKRUPTCY ¶ 365.06 (16th ed. 2022).

already been cured, technically, Hawkeye had not even breached the lease to begin with.[25] However, in an interpretive leap the Ninth Circuit would ultimately not be able to endorse, the District Court appeared to conflate a landlord's ability to oppose assumption of a lease by looking to the requirements of Section 365, on the one hand, with the landlord's ability to terminate that lease for a material breach under state law, on the other.[26]

Adding a materiality requirement to the application of the protections of Section 365(b) would undermine the restorative policy of Section 365(b), confusingly permit a newly assumed lease to continue with outstanding non-material defaults and would have the practical consequence of denying non-debtor contract counterparties the benefit of their bargain.

The Ninth Circuit affirmed the rulings of the lower courts, permitting the assumption of the lease, but reversed on the narrow "materiality" issue. In short, the Court of Appeals found that there was 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).[27] Moreover, regardless of the existence of "teeny tiny" defaults, the facially material payment default in April 2020 – although remedied prior to assumption of the lease – in and of itself required the Bankruptcy Court to undergo the full analysis and application of Section 365(b) and precluded assumption solely under Section 365(a).[28]

The Court of Appeals went on to rule that assumption of the lease pursuant to Section 365(a) and the failure to apply 365(b) was harmless error.[29] After all, the late April 2020 rent payment was ultimately made, and as the court noted, all of the other dubious "teeny tiny" defaults, by their very nature, do not lend themselves to any additional "adequate assurance" under Section 365(b) beyond just the simple contractual obligation to abide by the terms of the lease itself. More to the point, as the court asked during oral argument, "so what?" – so what if the Bankruptcy Court did not require additional adequate assurance, what sort of additional adequate assurance could the court reasonably have required anyway?

Unable to find in the record a sufficient explanation of harm caused by failure to require adequate assurance, the Court of Appeals concluded that while the landlord "is entitled to assurance that Hawkeye will comply with the terms of [the lease], 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."[30] So, for now, the beat goes on. Failure to apply 365(b) was a harmless error and the dance floor can remain open.

B. Old Market

Following closely on the wings of Nighthawk, with *In re Old Market Group Holdings Corp.*, Judge Philip Bentley of the Bankruptcy Court for the Southern District of New York

[25] *In re Hawkeye Entm't, LLC*, 2021 U.S. Dist. LEXIS 206568, at *10-22.

[26] *Id.* at *5-7.

[27] *In re Hawkeye Entm't., LLC*, 49 F.4th at 1238-1239.

[28] *Id.* at 1237; *see also* Bill Rochelle, *A Cured Breach Still Invokes Section 365(b)(1)'s Landlord Protections, Circuit Says*, ROCHELLE'S DAILY WIRE (September 28, 2022), abi.org/newsroom/daily-wire.

[29] *In re Hawkeye Entm't., LLC*, 49 F.4th at 1239-1241.

[30] *Id.* at 1240-1241.

harmonized this messy area of the law, clarifying that the failure to perform any obligation under a lease must be cured even when the default in question does not rise to the level of "default" as defined in a lease.[31] The debtor's lease provided that the tenant's failure to perform would not become a "default" or an "Event of Default" unless the landlord provided notice of the breaches and the tenant failed to cure them within 30 days. The debtor failed to make certain repairs to the premises as required by the lease, but the landlord did not notify the debtor of its failure to perform that obligation.

The debtor argued it did not have to cure the breach, because there had not been a default as defined in the lease, and because the Landlord suffered no "pecuniary loss." The court would not bite on either point. As the court wrote, Section 365(b)(1) requires that a debtor satisfy each of three separate conditions for assumption and assignment: "(i) cure all existing defaults; (ii) provide compensation for any actual pecuniary loss resulting from the defaults, and (iii) provide adequate assurance of future performance." Any default requiring cure was the debtor's alone. Given the statute created three separate requirements, the obligation to cure remained with the Debtor even if the Landlord could require the new tenant to make the repairs and experience no pecuniary loss. The Section 365(b)(1) obligation to cure was triggered because a "default" under Section 365(b)(1) is simply "any failure to perform contractually-required obligations."

The *Hawkeye* and *Old Market* rulings makes it clear that any sort of default, material monetary default and non-material non-monetary default alike, will require compliance with Section 365(b). However, landlords, especially those with below-market leases, need to carefully consider whether it makes commercial sense to take a tenant to court to oppose lease assumption. In light of the dim view most courts have for landlord demands for adequate assurance and the critical role leases often play in a restructuring, contesting assumption will almost always be an expensive uphill battle. Unless the landlord can point to uncured monetary defaults, relying on inconsequential defaults, adequate assurance of compensation of pecuniary loss or adequate assurance of future performance is going to come across as tone deaf.[32]

Are Shopping Centers Still Protected? Toys "R" Us Implications for Current Cases

In several years pre-Covid, decisions in the Sears and Toys R Us cases significantly undermined the protections provided to shopping center landlords by section 365(b)(3) of the Bankruptcy Code as strengthened by Shopping Center amendments in 1984 and again by BAPCPA in 2005.

First a review of the requirements for lease assignments - in addition to the curing of any default, retail and shopping center lease assignments are also conditioned upon providing the Landlord with adequate assurance of future performance.[33] Section 365(f)(2)(B) of the

[31] *In re Old Mkt. Grp. Holdings Corp.*, 647 B.R. 104 (Bankr. S.D.N.Y. 2022), *leave to appeal denied*, No. 20-10161, 2023 WL 2207667 (S.D.N.Y. Feb. 24, 2023).

[32] At oral argument, the Court of Appeals did not appear at all swayed by the landlord's argument that it had actual pecuniary losses from the unsatisfied attorney fee provisions in the underlying lease at the time of assumption. Perhaps if this argument had been more fully developed in the lower courts, and the attorney fee provision itself was properly worded, the Court of Appeals might not have found harmless error.

[33] 11 U.S.C. § 365(b)(1)(C).

Bankruptcy Code provides that a trustee or debtor-in-possession may assign an unexpired nonresidential lease only if "adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease." [34]

While adequate assurance of future performance is not defined in the Bankruptcy Code, several courts have looked to the legislative history for guidance and have concluded that "the term was intended to be given a practical, pragmatic construction" in light of the facts of each case.[35] The emphasis is on protection of the lessor, and the intention "is to afford landlord with a measure of protection from having to be saddled with a debtor that may continue to default and return to bankruptcy."[36]

By implication, Bankruptcy Code section 365 operates to remove doubts entertained by a lessor concerning the status of his lease with the bankruptcy estate.[37]

The initial burden of presentation as to adequate assurance falls upon Debtors.[38] The Sea Harvest court rejected the debtor's bald statement that it "recognizes the ongoing obligation to maintain such Leases and pay all obligations with regard thereto," stating that Sea Harvest's empty declaration does not provide the compensation and assurances required by section 365(b)(1)."[39]

"The Bankruptcy Code imposes heightened restrictions on the assumption and assignment of leases of shopping centers."[40] Accordingly, section 365(b)(3) of the Bankruptcy Code provides, in pertinent part:

[A]dequate assurance of future performance of a lease of real property in a shopping center includes 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;

(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*

[34] *See In re Sun TV and Appliances, Inc.*, 234 B.R. 356, 370 (Bankr. D. Del. 1999).

[35] *In re DBSI, Inc.*, 405 B.R. 698, 708 (Bankr. D. Del. 2009).

[36] *In re Natco Industries, Inc.*, 54 B.R. 436, 441 (Bankr. S.D.N.Y. 1985).

[37] *See In re Standard Furniture Co.*, 3 B.R. 527, 530 (Bankr. S.D. Cal. 1980).

[38] *Sea Harvest Corp. v. Riviera Land Co.*, 868 F.2d 1077, 1079 (9th Cir. 1989).

[39] *Id.* at 1080.

[40] *In re Joshua Slocum, Ltd.*, 922 F.2d at 1086.

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.

Adequate assurance requires a foundation that is nonspeculative and sufficiently substantive so as to assure that a landlord will receive the bargained-for performance.[41] Courts require a *specific factual showing* through competent evidence to determine whether adequate assurance of future performance has been provided.[42] The Debtors have the burden of establishing that the proposed use by the assignee does not contravene the benefit of Landlord's bargain with respect to exclusive use provisions, as required by section 365(b)(3)(C) of the Bankruptcy Code.[43]

In two decisions in the *Toys "R" Us* case, on the other hand, Judge Phillips (Bankr. E.D. Va) significantly undermined the requirements of Section 365(b)(3) and permitted assumption of leases that would violate use or exclusive use provisions over the landlord objections.[44] First, in a decision entered on May 30, 2018, the court approved a sale of a lease for a premises located in a shopping center over the landlord's objection that the debtor failed to provide adequate assurance of future performance by the assignee as required by §365(b) of the Bankruptcy Code. The landlord relied on Section 365(b)(3), which provides that, when a leased property is located in a shopping center, the debtor must provide adequate assurance that its assignment will be subject to all lease provisions including a use or exclusivity clause, "will not breach any such provision in any other lease…," and "will not disrupt any tenant mix or balance in such shopping center." The court interpreted this section to mean that tenant mix will only be protected when it is explicitly bargained for in the debtor's lease, noting that the Code's provisions do not "bestow upon landlords new contractual rights" that were not bargained for.[45] Because the debtor's lease did not contain a use restriction, or require compliance with any other exclusive use provisions in other leases not predating its own lease in the shopping center, the court held that assumption was appropriate, notwithstanding the violation of exclusive use provisions in other leases in the shopping center – a decision seemingly at odds with the plain language of section 365(b)(3)(C).[46]

The next day, Judge Phillips determined that a use restriction in another of the debtor's leases was invalid - because the leased property was not located in a shopping center, the protections of Section 365(b)(3) did not apply.[47] The court grounded its decision in Section 365(f) of the Bankruptcy Code, which provides that a lease may be assigned notwithstanding a provision that permits the landlord to terminate or modify the lease in the event of an assignment. However,

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[41] *In re World Skating Ctr., Inc.*, 100 B.R. 147, 148–149 (Bankr. D. Conn. 1989).

[42] *See, e.g., Matter of Haute Cuisine, Inc.*, 58 B.R. 390, 393–394 (Bankr. M.D. Fla. 1986); *see also In the Matter of CM Sys., Inc.*, 64 B.R. 363, 364–65 (Bankr. M.D. Fla. 1986).

[43] *See, e.g., In re Three A's Holdings, LLC*, 364 B.R. 550, 560 (Bankr. D. Del. 2007).

[44] *In re Toys "R" Us, Inc.*, 587 B.R. 304 (Bankr. E.D. Va. 2018).

[45] *Id*. at 310.

[46] *Id.* at 310-11.

[47] *In re Toys "R" Us, Inc.*, Case No. 17-34665-KLP (Bankr. E.D. Va. May 31, 2018).

there is a strong argument that this conclusion is faulty – although Section 365(f) nullifies provisions that permit landlords to bar lease assignments, it cannot be readily applied to use restrictions.

It remains to be seen whether these pre-Covid decisions in Toys R Us will have implications on the lease disposition process currently underway in cases pending in Delaware and New Jersey, particularly Bed, Bath & Beyond Inc. where the dust has yet to settle from a flurry of landlord objections that landed on the docket in the hours just before this writing was finalized.

Faculty

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