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CHAPTER 18

Bankruptcies and Subleased Properties: An Overview of the Issues

BRIAN S. HARRIS

I. INTRODUCTION

Leases of nonresidential real property (i.e., commercial leases) have become fulcrum points in many of the recent mega Chapter 11 cases.[1] Much is at stake for landlords, tenants, and subtenants in these cases. Recent changes in the case law, compounded with the 2005 amendments to the Bankruptcy Code, require all parties to leases and subleases to be more aware about potential bankruptcy issues and to develop prebankruptcy strategies to deal with other parties in distress.

The U.S. Supreme Court, in the watershed case of *Butner v. United States*,[2] mandated that state law relating to real property rights should be observed in the bankruptcy context. However, the interplay of bankruptcy law and state law pertaining to commercial leasing is chaotic (not to mention the interpretation of the leases themselves). The resulting problems can have a profound impact on all parties touched by the bankruptcy.

II. OVERVIEW

Upon the filing of a petition by a debtor with the bankruptcy court, section 541(a) of the Bankruptcy Code (Title 11 of the U.S. Code) provides that an estate is created, which includes all of the property interests of the debtor, legal or equitable, as of the commencement of the case, and section 362(a)(3) of the Bankruptcy Code prevents a third party from obtaining possession of property from the estate of such debtor. Generally speaking, a trustee is appointed to administer the bankruptcy estate, except in Chapter 11 cases where the debtor is the lessee, in which

1. *See, e.g., In re* Borders Group, Inc., No. 11-10614 (Bankr. S.D.N.Y. 2001).
2. 440 U.S. 48 (1979).

case the debtor will be a "debtor in possession." For debtors with executory contracts and/or unexpired leases, section 365 of the Bankruptcy Code contains a series of rules that govern those documents. Understanding these rules and their relationship to state law requires a close study of section 365 of the Bankruptcy Code. After a discussion of section 365 of the Bankruptcy Code, this chapter looks at the effects that different parties' bankruptcies will have in sublease situations, and in particular, the effects of a tenant's bankruptcy.

Consistent with the Bankruptcy Code, the term "lessee" is used in most instances in this chapter to refer both to a tenant under a lease and to a subtenant under a sublease; accordingly, the term "lease" may refer to a lease between a landlord and a tenant or to a sublease. However, where the context requires, more specific terms such as "sublandlord" and "subtenant" are used.

III. SECTION 365

Section 365 of the Bankruptcy Code provides the debtor with the statutory right to assume or reject executory contracts and unexpired leases to which it is a party. The basic logic of this section is straightforward: a debtor is given a period of time to evaluate its existing executory contracts and unexpired leases and determine whether it wants to assume or reject them. However, section 365 of the Bankruptcy Code provides nondebtors under commercial leases with a very important right: the debtor under the lease must continue to fully and timely perform its obligations between the date of the petition and the date on which the lease is assumed or rejected.

Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[3] (BAPCPA), the main effect of which was to make it tougher for individuals and families to file bankruptcy under Chapter 7 of the Bankruptcy Code. The BAPCPA also included changes that affect commercial leases. For filings occurring prior to the effectiveness of the BAPCPA (i.e., prior to October 17, 2005), section 365(d)(4) of the Bankruptcy Code provided that if an unexpired lease was not assumed or rejected within 60 days after the date of the bankruptcy petition was filed, or within such additional time allowed by the court for cause, then the lease was deemed rejected and the property was to be immediately surrendered to the lessor. The courts routinely granted the requested extensions of the 60-day time period, and few debtors were ever put in a position where their leases were deemed rejected, except through their own disinterest in, or inattention to, the expiration of the assumption/rejection period. Most attempts by creditors to limit the time or number of extensions were largely unsuccessful. Accordingly, prior to the effectiveness of the BAPCPA, debtor lessees frequently practiced the art of delay, pushing aside a determination on assumption or rejection until forced to do so through a plan or conversion to Chapter 7.

However, after the enactment of the BAPCPA, this practice is no longer available. Now, section 365 of the Bankruptcy Code provides that if an unexpired lease

3. Pub. L. No. 0109-8, 119 Stat. 23.

is not assumed or rejected within 120 days after the date the bankruptcy petition is filed, subject to a single 90-day extension for cause, then the lease is deemed rejected and the property is to be immediately surrendered to the lessor. If the court grants the 90-day extension for cause, the court may grant subsequent extensions only upon the prior written consent of the lessor in each instance. While courts will typically grant the 90-day extension if cause is shown, there is now greater certainty and leverage for lessors as 210 days is the maximum amount of time a lessee has to make its determination, unless the lessor approves a further extension of the time period. Conversely, in cases where the lessee has many leases and/or subleases (e.g., large retailers), or a few large leases, the new limitation may force the lessee into a premature decision about assuming or rejecting. The leases and subleases may very well not be the most pressing issue in the lessee's analysis of its business, yet a decision is required and may turn out to be the wrong one, further weakening a troubled lessee.

A. Assume or Reject?

Whether to assume or reject a lease can be a difficult decision depending on a variety of factors, including whether the rent payable under the lease is above or below market and whether the space being leased under the lease is vital to the debtor's business reorganization. From the perspective of the lessee, the right to reject the lease is an important one, as it can free the debtor from an unfavorable lease, which has the important effect of limiting the financial burden of future rental payments, protecting the lessee from the obligation to pay all future rent under the lease.[4] Because of this protection, a debtor's right to reject a lease is "vital to the basic purposes of a Chapter 11 reorganization, because it can release the debtor's estate from burdensome obligations that can impede a successful reorganization."[5]

1. Assumption

In situations where the lessee is the debtor and the lessee assumes the lease, then the lessee is required to cure all prefiling and postfiling defaults (or provide adequate assurance that they will be cured) and to provide adequate assurance of future performance under the lease. A lessee that assumes a lease may be able to assign the lease to a third party free of restrictions on assignment set forth in the lease and over the objections of the lessor, and this may turn out to be a significant and valuable right in cases where there is a below-market lease with significant time remaining in the term of the lease.[6] A lessor may view the lease assumption favorably since assumption is intended to assure the continuance of the lease and the cure of all existing defaults. However, where there is a below-market lease, and another solvent, would-be tenant waiting in the wings, or where a debtor remains a risk, the lessor may view assumption a little less favorably. In all cases, once the

4. *See, e.g.*, 11 U.S.C. § 502(b)(6) (limiting the amount of a lessor's claim for future rent due under the lease).
5. NLRB v. Bildisco & Bildisco, 456 U.S. 513, 528 (1984).
6. *See* 11 U.S.C. § 365(f).

bankruptcy case has commenced, the lessor's primary concern will typically be to obtain a quick determination on the issue of whether the lessee is going to assume or reject. A lessor may seek prompt rejection and recovery of the premises where the lessor fears that the lessee will leave the space empty or assign the lease to a new lessee who the lessor may not want. Section 365(d)(2) of the Bankruptcy Code affords a lessor the right to file a motion to compel a lessee to assume or reject, but this is not a motion the courts frequently grant.

Typically, in a Chapter 11 bankruptcy where the debtor is the lessor, the leases are assumed, so as to allow the bankruptcy estate to continue to receive the income from the leases, and any lessees and subtenants remain unaffected. Most lessees do not want their businesses to be disrupted, so unless there are major issues (e.g., the lease is well above market or there is little likelihood that the Chapter 11 reorganization will be successful), the assumption of the lease works for all parties. By contrast, in a typical Chapter 7 case where the debtor is the lessor, the leases will be rejected, freeing the lessor from further obligations under the lease, and section 365 of the Bankruptcy Code provides the lessee with two options, which are discussed below in more detail.

2. *Rejection*

Depending on the jurisdiction, which party to the lease is the debtor, and other pertinent facts, there may be some question whether a rejection of a lease (or sublease) is a breach of the lease or results in the termination of the lease. Generally speaking, a breach of a lease by the lessee does not result in termination of the lease, and the lessee remains obligated to continue to pay rent for the remaining term of the lease. Conversely, a termination of a lease ends the leasehold estate and limits the lessor to a claim for contractual damages and not a claim for the value of the remaining rental payments. Obviously, whether the rejection is a termination or a breach is critical to all parties, particularly subtenants, as a termination of a master lease between a landlord and tenant would also extinguish any subleases. Without the existence of the tenant's estate created by a master lease, there can be no subtenant estate.

3. *Lessee Rejection: Is the Rejection Termination or a Breach?*

In cases where the debtor is the lessee and the lease is rejected or deemed to be rejected, some courts have concluded that the lease should be terminated since section 365(d)(4) of the Bankruptcy Code provides that the nonresidential real property is to be immediately surrendered to the lessor, and third-party rights connected to the lease, such as a sublease, are terminated as well.[7] In *In re 6177 Realty Associates*, the court stated: The primary reason for reaching this result is the specific statutory language in § 365(d)(4). That section provides that if the Trustee does not assume an unexpired lease within 60 days of the filing date or within

7. *See, e.g.*, *In re* 6177 Realty Assocs. Inc., 142 B.R. 1017 (Bankr. S.D. Fla. 1992); Chatlos Sys. Inc. v. Kaplan, 147 B.R. 96 (D. Del. 1992), *aff'd*, 998 F.2d 1005 (3d Cir. 1993).

> such time as the Court may have fixed, "then such lease is deemed rejected, and the Trustee shall immediately surrender such non-residential real property to the lessor." § 365(d)(4).
>
> It is this surrender language in § 365(d)(4) which renders rejection of a non-residential real property lease different from other executory contracts in which rejection may not equal termination. As explained by Judge Russell in the *Southwest Aircraft* case, "by requiring that upon rejection under § 365(d)(4), 'the Trustee shall immediately surrender such non-residential real property to the lessor,' it is clear Congress intended that rejecting a lease terminates the lease."[8]

In these cases, the termination results in the forfeiture of any interests held by third parties derivative of the lessee's interest in the lease, including the subtenant's estate as noted above.

However, other courts have determined that the rejection is merely a breach of the lease and that any third-party rights connected to the lease should be decided in accordance with state law.[9] As stated by the U.S. Court of Appeals for the Third Circuit:

> Further, Congress knew how to authorize the termination of executory contracts and leases in § 365. "Termination" is used in § 365(h), (i), and (n) as one option available respectively to the purchaser of an interest in a timeshare project, the vendee of real property, or the licensee from the debtor of a right to intellectual property *if* the trustee has rejected the executory contract. Accordingly, the trustee may reject any of these contracts, but termination does not occur except at the other party's option. The option to terminate a timeshare lease, § 365(h)(1), or a license, § 365(n)(1)(A), arises where the trustee's rejection "amounts to such a breach as would entitle the [party] to treat such lease or [contract] as terminated by virtue of its own terms, applicable nonbankruptcy law, or other agreements." 11 U.S.C. § 365(h)(1) and § 365(n)(1). In § 365(h)(1), rejection is used synonymously with "disaffirmance" for these purposes; in none of these subsections is rejection or disaffirmance equated with termination. Under an objective reading, the provisions of § 365 may be redundant and complex, but Congress was not confused in its differing usages of the terms rejection, breach and termination.[10]

It appears that the trend in more recent cases follows this line of cases: rejection of a lease is a breach of the lease and not a termination.[11] In these cases, the lessor (whether landlord or tenant) is entitled to a claim for payment from the debtor/lessee. This breach of the lease is treated as if the breach occurred

8. *In re 6177 Realty Assocs.*, 142 B.R. at 1019 (citations omitted).

9. *See, e.g.*, Eastover Bank for Sav. v. Sowashee Venture (*In re* Austin Dev. Co.), 19 F.3d 1077 (5th Cir. 1994), *cert. denied*, 513 U.S. 874 (1994); CASC Corp. v. Milner (*In re* Locke), 180 B.R. 245 (Bankr. C.D. Cal. 1995); *In re* Park, 275 B.R. 253 (Bankr. E.D. Va. 2002).

10. *In re Austin Dev. Co.*, 19 F.3d at 1082–83.

11. *See* Vivek Sankaran, *Rejection Versus Termination: A Sublessee's Rights in a Lease Rejected in a Bankruptcy Proceeding Under 11 U.S.C. § 365(d)(4)*, 99 MICH. L. REV. 853 (2001) (arguing that a lease deemed rejected by a debtor tenant does not terminate the rights of the subtenant).

immediately prior to the filing of the bankruptcy petition, which makes the lessor's claim a prepetition, unsecured claim.

4. *What Is Not a Rejection?*

Some creditors have argued, which arguments have generally failed, that a breach of a lease after bankruptcy filing should be seen as a rejection of the lease.[12] Just as mere breach of a lease is not usually treated as rejection under section 365 of the Bankruptcy Code, several courts have held that "repudiation" of an executory contract does not constitute rejection under section 365 of the Bankruptcy Code. In *Kmart Corp. v. Rubloff Development Group., Inc. (In re Kmart Corp.)*, the bankruptcy court determined that even a clear and unequivocal anticipatory repudiation of a sublease did not constitute a breach.[13] In addition to refining the point as to what rejection means, this case also gives a hint as to the financial impact a bankruptcy can have on the parties involved.

Kmart was a tenant under several long-term leases ("master leases") for its retail stores. Kmart subleased certain properties, including 13 to a real estate development company, Rubloff, through individual subleases for lower rents than Kmart was paying under the master leases. Rubloff renovated the properties and successfully sub-subleased them to other retailers.

In Kmart's subsequent Chapter 11 filing, Kmart filed a motion to reject over 300 leases and subleases, including some of the subleases and the master leases under which those subleases were derived (collectively, the "Kmart/Rubloff leases"). The motion to reject included Schedule A, which listed leases and subleases that Kmart rejected immediately, and Schedule B, which listed the leases and subleases that Kmart intended to reject at a later date. Kmart reserved the right to "not reject" the leases and subleases on Schedule B. The Kmart/Rubloff leases were initially listed on Schedule A, but Kmart later amended its petition, so that such leases were listed on Schedule B to provide Rubloff and Kmart time to negotiate an assignment of the leases.

A rejection of the master leases would cause Rubloff to default on its obligations under the sub-subleases and would expose Rubloff to sub-subtenant claims for lost profits and the considerable amounts spent renovating the stores. Despite feeling pressured, Rubloff agreed to execute an assignment agreement by which Rubloff assumed all of Kmart's obligations as tenant under certain of the master leases.

In July 2002, Rubloff filed a proof of claim, seeking approximately $28 million for the difference between the rents that were now payable by Rubloff under the newly assigned master leases and the rents that were originally payable by Rubloff under the subleases. Rubloff based its claim on breach of contract, contending that by filing the motion to reject, Kmart demonstrated, unequivocally, that it intended to reject the master leases, which was evidence of Kmart's intentions not to perform its obligations under the subleases, and as such, the motion

12. *See, e.g., In re* El Paso Refinery, L.P., 220 B.R. 37 (Bankr. W.D. Tex. 1998).
13. No. 2 B 2474, 2007 Bankr. LEXIS 4215 (Bankr. N.D. Ill. 2007).

to reject constituted an anticipatory repudiation of the subleases. Rubloff further contended that it was pressured into entering into the assignment agreement to protect the subleases and mitigate its damages.

The bankruptcy court rejected Rubloff's anticipatory repudiation theory of recovery, explaining that while under state law anticipatory repudiation relieves the nonrepudiating party from its obligations to perform and allows it to immediately sue for damages without waiting for the obligations to become due, application of that theory in the bankruptcy context would render section 365 meaningless. As the bankruptcy judge stated:

> The debtor in possession's decision to assume or reject an unexpired lease is subject to court approval after notice and hearing. 11 U.S.C. § 365(a). Rejection is not effective until court approval. Accordingly, even if the debtor in possession decides to reject an unexpired lease, until that rejection becomes effective, there is always the possibility, albeit slim, that the debtor in possession may ultimately end up "exercising the affirmance option." Indeed, that is what happened in this matter with respect to the Master Leases. As discussed, Kmart and Rubloff worked out an arrangement for Rubloff to take an assignment of Kmart's interest in the Master Leases after Kmart assumed them.
>
> That open assumption option makes it impossible to consider the debtor in possession's statements that a master lease will be rejected a repudiation of the obligations under the sublease. Until rejection of the master lease is effective, the subtenant must wait to file a claim for damages resulting from the breach. . . .
>
> Stated another way, "to conclude that the mere filing of the Rejection Motion, and/or other statements of Kmart amounted to an anticipatory repudiation of the Subleases would render section 365 meaningless."[14]

The bankruptcy court also held that because section 365 requires court approval before a rejection can become effective, "no matter how unequivocal a debtor in possession's statements are prior to the rejection becoming effective, those statements are effectively rendered equivocal." The district court affirmed the bankruptcy court's reasoning, expounding that contractual principals do not always work the way one may expect them to in the bankruptcy context:

> Rubloff fails to recognize that "general principles governing contractual benefits and burdens do not always apply in the bankruptcy context. The purpose of the Bankruptcy Code is to suspend the normal operation of rights and obligations between the debtor and his creditors." . . . [T]he debtor-in-possession is "empowered by virtue of the Bankruptcy Code to deal with its contracts and property in a manner it could not have done absent the bankruptcy filing." . . . This is one of those situations where bankruptcy law qualifies and restricts the ability of the nondebtor party to an unexpired lease to invoke general contact law and remedies.[15]

14. *Id.* at 19–21 (internal citations omitted).

15. Rubloff Dev. Group, Inc. v. Kmart Corp., 389 B.R. 555 (N.D. Ill. 2008) (internal citations omitted).

To say it another way, in the bankruptcy context, a lease is not rejected unless and until it has actually been rejected. This gives the debtor considerable negotiating power with its counterparties to leases and subleases.

IV. EFFECTS OF TENANT/SUBLANDLORD BANKRUPTCY

Where the debtor is a tenant under a lease and also a sublandlord under a sublease, and the debtor-tenant rejects the master lease, the subtenant is at risk. The term "dual rejection" is used to refer to this situation. In such a case, if the tenant/sublandlord files for bankruptcy and rejects the master lease, then the subtenant is not likely to have any continuing right to stay at the property, unless the subtenant was able to obtain protection directly from the master landlord by way of the sublease, a nondisturbance agreement, or other similar protection from the landlord or by other means pursuant to state law. The ability to obtain such protection from the landlord is certainly not a given, and often times desired by the subtenant more than the landlord, so only a subtenant with bargaining power will be able to obtain it. This "dual rejection" situation was addressed in the oft-cited case of *In re Dial-A-Tire, Inc.*[16] The court determined that if a debtor/tenant rejects a lease under section 365(d)(4) of the Bankruptcy Code, the subtenant's rights are governed by section 365(h)(1) of the Bankruptcy Code. Pursuant to that section, the nondebtor/subtenant has a right to possession of the property, if it elects to retain such possession. The court found that while the rejection ended the leasehold estate of the tenant, the issue of the subtenant's possession of the property was to be determined by state law. As stated by the court, "the application of these subsections in this case produces the anomalous result of the [tenant] being obligated to surrender the Premises, but [the subtenant] not necessarily having to. The matter is resolved by resort to forum law. Thus, the dual rejection which occurred here will leave [the landlord] and [subtenant] to vie for possession of the Premises according to New York Law."[17]

When looking to state law to determine the rights of landlord and subtenant, the courts analyze the lease documents as well as the actions of the parties. In *Chumash Hill Properties, Inc. v. Peram*,[18] a master lease was deemed rejected, but the subtenant was not notified promptly. The landlord subsequently tried to evict the subtenant and the matter was taken to court. The master lease provided that in the event of a tenant bankruptcy, the subtenant's possession and use of the premises would not be disturbed so long as the subtenant complied with the sublease provisions. The court determined that the subtenant was a third-party beneficiary of the lease and entitled to the nondisturbance protection set forth in the lease documents. The court found that the language in the lease documents was unambiguous, and that the subtenant was entitled to continued right of possession and use of the premises upon termination of the master lease, so long as the subtenant did not fail to perform its obligations under the sublease. In *Block Properties Co. v.*

16. 78 B.R. 13 (Bankr. W.D.N.Y. 1987).

17. *Id.* at 16.

18. 46 Cal. Rptr. 2d 366 (Cal. Ct. App. 1995).

American National Insurance Co.,[19] the tenant had a sublease under which the subtenant was paying the tenant full rent (and subtenant had a sub-sublease under which the sub-subtenant was paying the subtenant more than full rent). The debtor/tenant failed to timely assume or reject the master lease and sublease, so both were deemed rejected. The subtenant exercised its rights under section 365(h)(1) of the Bankruptcy Code to remain in possession of the premises, but the landlord sued to regain possession of the property from the subtenant. The court in this case agreed that the rejection of the sublease was just a breach of the lease and not a termination, and that following the rejection, neither the tenant nor the bankruptcy estate had any further interest in either the master lease or the sublease, so the rights of the landlord and subtenant were a matter of state law. The sublease did not contain any language that would cause a termination of the sublease, so general contract law principles applied. The court determined that, based on general contract law principles, the landlord did not show that the rejection of the master lease was substantial breach of lease nor did the landlord show that it was damaged. In addition to timely receiving full rent, the space had been occupied without interruption. The subtenant was allowed to remain in possession of the property.

In another case, the subtenant was not quite as lucky. In *Syufy Enterprises, L.P. v. City of Oakland*,[20] the Port of Oakland ground-leased property to a tenant, who in turn subleased a portion of the property to Syufy to build a movie theater. During the course of the lease term, the tenant defaulted under the lease, and after Syufy inquired with the Port about the default, the Port informed Syufy that the Port was not going to take any action against Syufy. The Port filed an unlawful detainer suit against the tenant and obtained a default judgment. Thereafter, the tenant filed for bankruptcy and sought to assume the lease but was denied. The tenant was ordered by the court to vacate the property, but Syufy did not receive the notice nor was there any mention of the sublease in the order.

A few months later, Syufy was notified by the Port that its sublease had been terminated by the order, although the Port agreed to let Syufy stay month-to-month on the terms of the sublease. The Port claimed to want to formalize the arrangement in a new lease with Syufy to avoid claims from the bankruptcy trustee that the sublease payments were part of the bankruptcy estate, but such lease was never prepared.

A few years later, the Port was preparing the site for a new development and gave notice to Syufy that its tenancy was terminating and that Syufy needed to vacate within 30 days. Syufy sought a declaratory judgment that its lease remained in effect, and the Port sought to evict Syufy. After acknowledging the split of authority as it relates to the meaning of rejection of a lease in bankruptcy, the court noted a trend in the lower courts of the Ninth Circuit toward treating the rejection as breach of the lease, not a termination. As a result, the court was required to look at state law, and the court found that since the subtenant's rights are dependent upon the rights of the tenant/sublessor and such rights "stand and fall" with those of the tenant/sublessor, the sublease was terminated by operation

19. 998 S.W.2d 168 (Mo. Ct. App. 1999).

20. 104 Cal. App. 4th 869, 128 Cal. Rptr. 2d 808 (2002).

of law when the lease terminated. The subtenant attempted to argue that it was a third-party beneficiary under the lease, but the court rejected those arguments, in part because the lease lacked the appropriate nondisturbance protection that was important in *Chumash*.

In *Cahaba Forests, LLC v. Mary George East Hay*,[21] the tenant was deemed to have rejected a lease and related sublease, and the rejection was determined to be a breach of the lease, not a termination. The landlord contended that it had the right of possession, and the subtenant argued that it was entitled to its possessory rights, as long as it complied with the terms of the sublease. The breached, but not terminated, master lease contained an "ipso facto" clause, which permitted the landlord to terminate the master lease in the event of the tenant's bankruptcy filing. The landlord's enforcement of its rights pursuant to this clause were stayed by the tenant's bankruptcy filing, but following the rejection of the master lease, the master lease was no longer part of the bankruptcy estate, so the court looked to the provisions of the master lease and sublease. The court determined that the landlord had the right to terminate the master lease pursuant to the ipso facto clause once the lease had been rejected.

One way for a landlord and/or a subtenant to protect itself in the event of a tenant bankruptcy is, as mentioned above, by obtaining language in the lease or sublease documents that requires a subtenant to attorn to the landlord in the event that the landlord becomes the successor to the tenant under the lease. This issue was recently analyzed in *Green Tree Servicing, LLC v. DBSI Landmark Towers*.[22] DBSI Landmark Towers acquired an office building in downtown St. Paul, Minnesota, and leased the property to its affiliate, DBSI Leaseco. DBSI Leaseco in turn subleased the property to Green Tree Servicing. Following the sublease, DBSI Landmark Towers sold fractional interests in the property to 28 tenants in common (TIC). The master lease between the TIC and DBSI Leaseco permitted DBSI Leaseco to sublease space but required that all subleases contain provisions requiring the subtenant to attorn to the TIC if the sublease was terminated for any reason. The Green Tree sublease contained a provision whereby Green Tree agreed to attorn to the TIC when the TIC (1) terminates the master lease or (2) otherwise succeeds to the interest of DBSI Leaseco under master lease.

DBSI Leaseco subsequently filed for bankruptcy, and rejected both the master lease with the TIC and the sublease with Green Tree. Green Tree responded that it intended to treat the lease as terminated under section 365(h). The TIC objected to Green Tree's response, asserting that the sublease required Green Tree to attorn to the TIC, as landlord, if the master lease was terminated.

The court found that while neither DBSI Leaseco nor Green Tree had any obligations to the other under the sublease, Green Tree undertook obligations to the TIC through the attornment provisions, and nothing in section 365(h) of the Bankruptcy Code indicated that a debtor/lessor's rejection of a lease extinguished a third party's rights and obligations under the lease. The court went on to find that the attornment provision contained promises between Green Tree and the

21. 2012 U.S. Dist. Lexis 13877 (M.D. Ala. 2012).

22. 652 F.3d 910 (8th Cir. 2011).

TIC, so the TIC could enforce the sublease since the parties are in privity of contract. However, the court also found that neither of the situations in which Green Tree agreed to attorn to the TIC had occurred, that is, the master lease was terminated by the tenant, not the TIC, and the TIC did not succeed to the interest of tenant in the sublease. The court explained:

> The TIC could not succeed to an interest in the sublease that no longer existed regardless of DBSI Leaseco's continuing obligations under the master lease or the TIC's assumption under the master lease of DBSI Leaseco's duties as landlord. The only surviving contractual interest in the sublease is the TIC's right to attornment, which unfortunately for the TIC, is triggered only when the TIC "succeeds to the interest" of DBSI Leaseco.[23]

The language of the attornment provision, which is not unusual, was strictly interpreted by the court, and the holding suggests that it may be prudent to look carefully at such provisions and to include language requiring attornment in a situation where the master lease and/or sublease is rejected in bankruptcy.

V. EFFECTS OF SUBTENANT BANKRUPTCY

Often times a tenant will enter into a sublease because it is having financial problems and/or has space that it no longer needs. In other situations, the sublease may be a financing mechanism or a way to generate revenue. In any case, a lot of time may be spent during lease negotiation determining what factors may be considered by the landlord when deciding whether to approve a sublease request and in which cases landlord's consent is not required. While the tenant is looking for flexibility, the landlord is, among other things, looking to control which tenants can lease space in its building. Where a tenant is having financial problems, a sublease may be viewed by the tenant as the preferred option. The landlord may lose some control, but the payment by a subtenant of all or a portion of the tenant's rent may prevent a default under the lease and provide the tenant with the relief it needed. However, if the subtenant fails, a monetary (and maybe a nonmonetary) default by the tenant under the lease may be just around the corner. Depending on the market conditions and the remedies available to the landlord under state law, following a default under the master lease, the landlord may want to terminate the master lease, which, as noted above, has the effect of terminating the sublease.

Such was the situation described in *48th Street Steakhouse v. Rockefeller Center, Inc.*[24] 48th Street purchased a restaurant business named Charley O's, although the lease with the landlord, Rockefeller Group, was not part of the transaction. Instead, Rockefeller Group entered into a new lease with 48th Street, and on the same day, 48th Street assigned the lease to I.S.H. Liquidating Corp., an affiliate of Charley O's. I.S.H., in turn, sublet the premises to 48th Street, and 48th Street made rent payments directly to the Rockefeller Group until 48th Street filed a

23. *Id.* at 914.

24. 61 B.R. 182 (S.D.N.Y. 1986).

Chapter 11 petition. The Rockefeller Group sent a notice of default to I.S.H., stating that if the rent was not paid within five days, Rockefeller Group would terminate the lease. This caused 48th Street to file a motion in the bankruptcy court arguing that the Rockefeller Group's attempts to terminate the master lease were violations of the automatic stay imposed by section 362(a) of the Bankruptcy Code. The bankruptcy court agreed, observing that termination of the master lease would result in the immediate termination of the 48th Street property interest in the sublease. Furthermore, the bankruptcy court concluded that 48th Street's mere possessory interest in the lease is within the ambit of property of the estate under section 541 of the Bankruptcy Code. The Court of Appeals for the Second Circuit affirmed, holding that 48th Street's interest in the lease, whether it was as a subtenant or if its interest was merely possessory, constituted property of the bankrupt estate under section 541, and therefore, the landlord's attempt to terminate the lease as to I.S.H. violated the subtenant's right to an automatic stay of "any act to obtain possessions of property of the estate."[25] The result in this case may have surprised some since there was no privity between the landlord and the subtenant, but the result is that a landlord may not take action to terminate the master lease or retake possession of the property during the pendency of a subtenant's bankruptcy without first seeking leave of court.

VI. EFFECTS OF LANDLORD BANKRUPTCY

When the debtor is the lessor and the lease is rejected, the rejection results merely in the cancellation of the covenants requiring performance in the future by the lessor, but does not terminate the lease completely so as to divest the tenant of its estate in the property. Section 365(h) of the Bankruptcy Code allows lessees to make a decision about its rights under the lease following the lessor's rejection.

If the rejection amounts to a breach that would entitle the lessee to terminate the lease pursuant to the lease terms or applicable nonbankruptcy law, then the lessee may treat the lease as terminated and seek damages from the landlord that were caused by its rejection of the lease. Alternatively, the lessee may retain all of its rights under the lease (including the rights relating to the payment of rent, use, possession, quiet enjoyment, subletting, assignment, and hypothecation) and continue to occupy the property for the remaining of the term, including any renewals or extensions of the term.[26] This concept was explained thusly in a recent case:

> A rejection of a lease does not cancel or terminate it. Despite rejection, an unexpired lease continues and may be honored repudiated by either party. The primary effect of rejection is to abandon the lease from the estate so that it reverts back to the debtor's control outside of bankruptcy. Assumption and rejection are

25. *In re* 48th St. Steakhouse, Inc., 835 F.2d 427, 430 (2d Cir. 1987) (quoting 11 U.S.C. § 362(a)(3)), *cert. denied*, 485 U.S. 1035 (1988).

26. *See* 11 U.S.C. § 365(h)(1)(A).

> bankruptcy concepts that determine whether the estate will administer the lease; rejection merely removes it from the property of the estate.[27]

Since a landlord that rejects a lease is freed from having to perform under the lease, depending on the lease provisions, the tenant may be in a position to have to provide for itself, among other things, utilities, janitorial services, and common area maintenance. However, the lessee also has the right to offset damages from the lessor's failure to perform its covenants against the lessee's obligation to pay rent.[28]

The tenant's decision whether to treat the master lease as terminated or to retain its rights under the master lease may be influenced, in part, by whether there is a subtenant and what protection, if any, the sublease provides the subtenant. In many cases, however, the subtenant will not have any protection in its sublease, and the tenant, who may have entered into the sublease because it could not previously get out of its lease with the landlord, will give little or no consideration to the subtenant's concerns. In many cases, the rent from the subtenant will not be sufficient to allow an offset of costs of the services required to be provided under the sublease. Further, subleases commonly provide that the tenant is not liable to the subtenant if the master lease is terminated, unless the termination is the result of a default under the master lease by the tenant, and the tenant's election to treat the master lease as terminated after the landlord's rejection of the lease is not likely to be a default. Maybe the rent under the master lease is above market, in which event the tenant will likely elect to treat the lease as terminated, which will terminate the sublease and the subtenant's right of possession. It often seems like the best a subtenant can do is to hope that certain factors exist (e.g., the tenant is subleasing only a small portion of its space and continues to need the non-subleased space, the subtenant's rent represents a significant premium above the rent due under the lease, and/or the landlord has few obligations under the master lease) to lead the sublandlord/tenant to conclude that taking on the landlord's obligations and not terminating the lease is a good decision.

Sometimes subtenants are able to obtain significant protection and include a "quiet enjoyment" provision in the sublease, which will provide that the subtenant will be free from interference by the tenant in all cases so long as the subtenant performs under the sublease. The sublease may even contain a provision granting the subtenant the right to control the sublessor's decision whether to terminate the lease following the rejection of the master lease or to continue the lease following such rejection. Depending on the language in the lease and sublease, the tenant may even be able to assign its interest in the lease to the subtenant, and the subtenant would then be in position to decide for itself whether to continue the lease or treat the lease as terminated.

As mentioned above, in Chapter 11 bankruptcies where the debtor is the lessor, the leases are assumed, although that is not always the case. In *Precision Industries,*

27. *In re* Gary W. Scharp, 463 B.R. 123 (Bankr. C.D. Ill. 2011) (citations omitted).
28. 11 U.S.C. § 365(h)(1)(B).

Inc. v. Qualitech Steel SBQ, LLC,[29] a landlord/debtor was able to sell its property free and clear of any interest, which, in that case, was encumbered by a tenant lease. The court had to reconcile section 363(f) of the Bankruptcy Code, which allows sales of property free and clear of any interest, with section 365(h) of the Bankruptcy Code, which, as noted above, provides a lessee protection when a lessor/debtor rejects a lease. While this case did not involve any subleases, the result was surprising to many, although the unique facts of the case, including tenant's failure to object to the sale order directing the landlord/debtor to sell its property free and clear of all liens and interests, may prove to limit the effect of this case.[30]

VII. CONCLUSION

When a sublease is involved, all parties are affected if one of the parties files for bankruptcy, and there are lessons in the case law mentioned above for each of those parties. Whether those lessons can be applied in a lease or sublease will often be determined by a party's bargaining power.

29. 327 F.3d 537 (7th Cir. 2003).

30. *See* John C. Murray, *Precision Industries, Part I: Debtor-Lessor's Property May Be Sold "Free and Clear" of Unexpired Lease*, PROB. & PROP., Mar–Apr. 2004, at 10, and John C. Murray, *Precision Industries, Part II: How Lessees and Leasehold Mortgagees Can Protect Themselves*, PROB. & PROP., Mar–Apr. 2004, at 17; Michael St. Patrick Baxter, *Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in Precisions Industries v. Qualitech Steel*, 59 BUS. LAW. 1, 475 (2004).