This article was originally published in the April 2017 issue of New Jersey Lawyer,
a publication of the New Jersey State Bar Association, and is reprinted here with permission.

The Intersection of Commercial Real Estate and Bankruptcy Law

Know the Lease/Contract Counterparty, the Lease Terms, and How to Protect One's Rights or Face the Consequences

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Since early 2014, a spate of commercial, international and/or retail bankruptcy cases impacting New Jersey and beyond—including such notable cases as *Revel Casino*, *Dots*, *Aeropostale*, *Sports Authority*, *American Apparel* and *Quicksilver*—have left both commercial landlords and tenants scrambling to understand their rights and the impact of their tenant's or landlord's bankruptcy filing.

Moreover, as the economy becomes more intertwined in international commerce, and with the recent large Chapter 15 international bankruptcy filing of Hanjin Shipping in the U.S. Bankruptcy Court for the District of New Jersey (Newark division), parties need to understand at the outset the potential impact of who their lease counterparties (domestic company or foreign entity) are and what rights they may have in a scenario where an American court recognizes a foreign bankruptcy proceeding of a lease counterparty. Such foreign insolvency law recognition could lead to the evisceration of rights that

otherwise might be available in a Chapter 11 bankruptcy case.

This article analyzes several recent bankruptcy decisions that potentially impact the rights of landlords and/or tenants, and further provides guidance regarding situations where landlords and/or tenants must be proactive to protect their rights.

Tenant's Section 365(h) Right to Remain in Possession of Premises Under Lease, Despite Sale of Property or Rejection of Lease by Debtor-Landlord

Under Sections 363 and 365 of the Bankruptcy Code,[1] a debtor-lessor that files for Chapter 11 bankruptcy has the right, subject to court approval, to: 1) sell assets (including real property) free and clear of interests in such property; and 2) reject an unexpired lease.

In a scenario where the debtor-lessor chooses to reject a lease and thereby stop performing thereunder, Section 365(h) of the Bankruptcy Code gives the tenant-lessee a clear choice: 1) vacate the premises and assert an unsecured claim for damages (such a claim often will be worth little if anything in many bankruptcy cases); or 2) retain its rights under the lease (such as use, possession, quiet enjoyment, subletting or assignment of the leased premises) and continue to pay rent to the landlord-debtor.

However, until recently, the law was less clear in New Jersey (and, indeed, a split in the case law developed) regarding whether the protections afforded a tenant under Section 365(h) to remain in the leased premises would apply in a scenario where the debtor-landlord decides to sell the real property free and clear in a Bankruptcy Code Section 363 sale.

In 2003, the Seventh Circuit, in *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC,* held that under Section 363(f) of the Bankruptcy Code a free and clear sale order where the tenant-lessee failed to object to the sale would trump and extinguish the rights afforded to the tenant under Section 363(h) of the Bankruptcy Code.[2]

Several recent decisions have criticized the holding in *Qualitech Steel,* and have held that even where a debtor purports to sell real property free and clear of interests, Section 365(h) will continue to protect a tenant's rights to continued possession post-sale. For example, in 2014, the court in *Dishi & Sons v. Bay Condos LLC* disagreed with the Seventh Circuit and held that the tenant was entitled, even in a Section 363 sale scenario, to retain its rights under the lease pursuant to Section 365(h). While Section 365(f) of the Bankruptcy Code authorizes the debtor to sell assets free and clear, the court explained that such a sale (which causes vacation by the tenant) can only occur if the tenant receives adequate protection of its interest and "where it is improbable that lessee will receive any compensation for its interest from proceeds of the sale, and it is difficult to value the lessee's unique property interest…'adequate protection can be achieved only through continued possession of the leased premises.'"[3]

Most recently, in 2015, the New Jersey bankruptcy court weighed in in the context of the Revel Casino bankruptcy. In *In re Revel AC, Inc.*,[4] the debtor (Revel Casino) filed for Chapter 11 protection in 2014 and sought to sell the casino property free and clear of all interests, including a leasehold interest held by Idea Boardwalk LLC. Idea was a tenant of Revel's pursuant to a 10-year lease term (with a 15-year option to extend) and ran two upscale nightclubs and a beach club in the resort. The bankruptcy court initially approved the sale over the objection of Idea, finding that the validity of the leasehold interest was disputed (the debtor argued the lease was not a true lease because the rent was paid based on a percentage of profits earned by Idea) and apparently initially adopting the holding in *Qualitech Steel*. Idea succeeded in obtaining a stay of this ruling from the Third Circuit pending appeal of the sale,[5] and upon later consideration the New Jersey bankruptcy court determined that the lease was, in fact, a true lease (and thus subject to protection under Section 365(h)), and that the rights granted to the tenant by Section 365(h) of the Bankruptcy Code controlled over the Section 363 free and clear sale order.[6]

Accordingly, the bankruptcy court enjoined the purchaser, Polo North, "from interfering with IDEA's access to the premises, its infrastructure and distribution systems. IDEA must have access to utilities for operation, including electricity, hot and cold water, plumbing, gas, internet, cable and telephone service. Without these functionalities, the premises would be rendered substantially unsuitable for the purpose for which it was leased."[7] However, the court declined to expand Idea's lease rights by declining to grant certain easements Idea requested, and further noted that Polo North was not responsible for "providing services, incurring costs, or increasing its liability" beyond which would be required by Idea to utilize the premises.

In determining that the Idea lease was valid and subject to protection, both the New Jersey bankruptcy court and Third Circuit rejected arguments that the Idea lease was not a true lease, and noted that there was no authority suggesting that a percentage-lease clause disqualified a lease from being a true lease. Further, the lease at issue contained an explicit provision stating that:

> [n]othing contained in this Lease shall be deemed or construed as creating the relationship of…partnership or joint venture between the parties hereto, it being understood and agreed that neither the method of computing rent, payment of the Tenant Fees nor any other provision

> contained herein nor any acts of the parties hereto shall be deemed to create any relationship between the parties other than that of Landlord and Tenant. The provisions of this Lease relating to the Percentage Rent payable hereunder are included solely for the purpose of providing a method whereby adequate rent is to be measured and ascertained.[8]

According to the Third Circuit, such a provision "leaves no doubt that a true lease exists" and "bars any argument to the contrary."[9]

Following the determination by the bankruptcy court that Idea retained its rights to occupy the premises following the closing of the sale to Polo North, the New Jersey bankruptcy court, in Oct. 2016, then decided another issue of first impression—what rights continued to exist under the lease agreement following the lease rejection, sale of the property and Idea's election to remain in possession.

The court first explained that rejection does not constitute lease termination, and while the lessor was freed from continuing to provide certain services, the lessee (Idea) remained constrained to adhere to all of its covenants and agreements under the lease. However, the court noted that Idea could "offset against future rent any damages caused, after rejection, by the Debtors' nonperformance of the Lease terms."[10] Thus, the court ultimately concluded that, under a doctrine known as recoupment, IDEA was entitled to a credit against the rent it owed on account of certain $16 million capital contributions made by Idea due to non-performance by Polo North of certain lease obligations post-rejection.[11]

These issues are sure to arise in the future in the context of a bankruptcy filing of a resort, mall/shopping center owner, casino, or other large complex with tenants, and should also be considered in the context of parties that may be negotiating leases in complex facilities.

For parties with leases at such facilities, tenants must be careful to raise objections with the bankruptcy court to any attempt to sell the property appurtenant to their lease free and clear of their leasehold interest. Failure to timely object to a sale order, even where the order was improperly entered in violation of a tenant's Section 363(e) and 365(h) rights, could be fatal in any appeal of the sale order, as Section 363(m) of the Bankruptcy Code provides for the finality of sale orders to a good faith asset purchaser where the sale order was not stayed pending appeal and the sale is consummated. Thus, a tenant that is asleep at the wheel could lose its leasehold rights.

Furthermore, as lease agreements are negotiated in connection with complex multi-party facilities in New Jersey, such as large malls or the American Dream Meadowlands project currently under development (formerly the Xanadu project), potential tenant counterparties are advised—particularly where lessors seek to structure such agreements as quasi-investments or profit-sharing arrangements—to draft unambiguous language in the lease agreement that makes clear that the relationship is one of landlord/tenant and shall not be deemed to create a partnership or joint venture.

Think Twice Before Entering Into Lease Agreement With a Foreign Lessor or Lessee

Imagine a foreign company approaches one's client and seeks to lease: 1) to the client a floor in the foreign company's office building; or 2) from the client a floor in an office building. The foreign company then files for bankruptcy protection in a foreign jurisdiction, and commences a Chapter 15 bankruptcy proceeding in New Jersey to have the foreign proceeding recognized, stay creditor actions against the company, and recognize orders issued in the foreign bankruptcy proceeding.

In such a scenario—which is not difficult to imagine in light of the recent Hanjin Shipping bankruptcy[12] filed first as a foreign proceeding in South Korea and then as a Chapter 15 recognition proceeding in New Jersey (*i.e.,* a proceeding to recognize the rights of a foreign debtor)—the tenant of a foreign debtor and/or the landlord to a foreign debtor lessee may not be fully protected by the rights typically provided under the Bankruptcy Code in a Chapter 11 case.

For example, Section 365 is not incorporated into Chapter 15 of the Bankruptcy Code, and while arguments can be made that a bankruptcy court must protect the interests of landlords and tenants in granting relief under Chapter 15, a recent New Jersey bankruptcy court ruling might cut against this.

In the *Hanjin Shipping* case, the New Jersey bankruptcy court issued a written decision that explicitly applied the automatic stay to allow Hanjin ships to come in to port in the U.S. without allowing creditors asserting maritime liens over the ships the ability to enforce their liens, despite the liens typically being recognized under U.S. law.[13] The court deferred to the "universalist approach under chapter 15" (*i.e.,* providing aid to the foreign main bankruptcy proceeding absent plain language to the contrary or a vital United States public policy concern) and found that the creditors would be left to enforce their lien claims in the Korean bankruptcy proceeding.

A New Jersey bankruptcy court relying on such Chapter 15 precedent could apply a similar approach to lease/executory contract rights, which would mean lease counterparties with a foreign debtor party may be subject to the laws of foreign jurisdictions, which may not recognize the ability of a tenant to retain its lease following a bankruptcy filing. In such a scenario, a foreign

debtor-lessor could potentially seek to sell its property free and clear under foreign law, and then evict the tenant. At minimum, a tenant should attempt, if at all possible, to contract with a U.S.-incorporated entity that is not eligible for a foreign bankruptcy filing.

Additionally, a foreign debtor tenant may seek to utilize foreign laws that differ from U.S. bankruptcy laws regarding assumption or rejection of unexpired leases to its advantage.

There may be one saving grace under foreign insolvency law: Unlike U.S. bankruptcy law, where Section 365(e) of the Bankruptcy Code invalidates provisions (known as *ipso facto* clauses) in an agreement that permit termination due to the bankruptcy, insolvency or financial condition of a party, certain foreign insolvency regimes may permit termination based on insolvency clauses. Section 365(e) of the Bankruptcy Code does not apply by default in a Chapter 15 foreign recognition, but could be incorporated in a Chapter 15 case as part of relief granted by a U.S. bankruptcy court. Indeed such relief was recently granted in the *Hanjin* case.[14]

Thus, if a foreign lessee-debtor commences a foreign insolvency proceeding and then files for a Chapter 15 proceeding, assuming the lease agreement has an *ipso facto* clause, the landlord-lessor may seek to immediately terminate the lease (if it so desires), and the termination could be effective if it occurs prior to entry of a bankruptcy court order extending Section 365(e) protections to the foreign debtor.

Deadline for Lessee-Debtor to Assume or Reject a Non-Residential Real Property Lease Under the Bankruptcy Code and Related Going-Out-of-Business Sales

The retail debtor under Chapter 11 is provided a relatively brief period of time to decide whether to assume or reject burdensome leases, and thereby continue to operate in profitable lease locations and cancel/reduce footprint with respect to unprofitable locations.

Under Section 365(d)(4) of the Bankruptcy Code, an unexpired lease of nonresidential real property is deemed rejected if a debtor-lessee does not assume the lease within 120 days of its bankruptcy filing, which can be extended to 210 days with court permission.

However, as noted in the recent American Bankruptcy Institute Commission to Study the Reform of Chapter 11: Final Report and Recommendations (the ABI report),[15] prior to the 2005 Bankruptcy Code amendments, a debtor had an initial 60 days to review its unexpired nonresidential leases and decide whether to assume or reject them.

Despite this 60-day deadline, a debtor could obtain one or more extensions of this period, and courts (prior to 2005) were granting debtors multiple and lengthy extensions 60-day assumption/rejection period on a routine basis. This led, in 2005, to the passage of modified Section 365(d)(4), and a 210-day assumption or rejection requirement.

However, as further explained in the ABI report, the new 210-day limit for a debtor to make a decision regarding its commercial leases has put retailers in a timing pinch, particularly because going-out-of-business (GOB) sales take at least 120 days to conduct, and thus the 210-day limit puts pressure on retail debtors to decide within 90 to 120 days after filing to either quickly file a Chapter 11 plan while complying with all their lenders' requirements, or to liquidate. The 210-day deadline to assume or reject nonresidential leases has also meant, according to the ABI report, that it is nearly impossible for a middle-market retail company to do anything but conduct a GOB sale.[16]

When a GOB sale is conducted by a retail debtor on a landlord's property, landlords need to act quickly to protect their lease rights in bankruptcy court or face court orders impacting those rights. For example, in the *Dots, LLC* bankruptcy case filed in New Jersey, the bankruptcy court, in 2014, authorized GOB sales to be conducted "by the Debtors and the Agent notwithstanding any restrictive provision of any lease, sublease or other agreement relative to occupancy affecting or purporting to restrict the conduct of the Sale, the rejection of leases, abandonment of assets or 'going dark' or similar provisions."[17]

Finally, it must be noted that in one recent Delaware bankruptcy court case (*Filene's*) in connection with the lease of a nonresidential real property located in Secaucus, the court authorized a debtor to assume a lease well after the 210-day assumption period, provided that a motion to assume an unexpired lease was filed within the 210-day period but the court order was entered later.[18] Other recent cases have also allowed for this.[19] The authors believe these holdings potentially allow a retail debtor-lessee to play games with landlords by artificially moving to assume their leases and then adjourning the hearing on the request to assume the leases, and that landlord-lessors must be vigilant in arguing against such a practice and protecting the rights afforded to them by the Bankruptcy Code. ⚖

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ENDNOTES

1. 11 U.S.C. §§ 363(b) and 365(a).
2. *Precision Industries, Inc. v. Qualitich Steel SBQ, LLC*, 327 F.3rd 537 (7th Cir. 2003).
3. *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 698-99, 711-12 (S.D.N.Y. 2014).
4. *IDEA Boardwalk, LLC v. Revel Entm't Grp. (In re Revel AC, Inc.)*, 532 B.R. 216, 227-28 (Bankr. D.N.J. 2015).
5. *See In re Revel AC, Inc.*, 802 F.3d 558 (3d Cir. 2015).
6. *IDEA Boardwalk,* 532 B.R. at 227-28.
7. *Id.*
8. *Id.* at 226; *Revel AC, Inc.*, 802 F.3d at 574.
9. *Revel AC, Inc.*, 802 F.3d at 574.
10. *IDEA Boardwalk, LLC v. Polo North Country Club, Inc. (In re Revel AC, Inc.)*, Adv. No. 14-01756 (MBK), 2016 WL 6155903, at *7-*8 (Bank. D.N.J. Oct. 21, 2016).
11. *Id.* at *8-*12.
12. *In re Hanjin Shipping Co., Ltd.*, Case No. 16-27041 (JKS) (Bankr. D.N.J.).
13. *In re Hanjin Shipping Co., Ltd.*, Case No. 16-27041 (JKS), Docket No. 191, *Decision and Order on Maritime Lienholders' Motion for Reconsideration* (Bankr. D.N.J. Sept. 20, 2016).
14. *See Hanjin Shipping Co., Ltd.*, Case No. 16-27041 (JKS), Docket No. 102, *Order Granting Provisional Relief Pursuant to Sections 362, 365(e), 1519, 1520, and 105(a) of the Bankruptcy Code Pending Hearing on Petition for Recognition as a Foreign Main Proceeding* (Bankr. D.N.J. Sept. 9, 2016).
15. *See* ABI Report, pp. 130-31, available at https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h.
16. *See* ABI Report, pp. 131-32 n. 480. Due to the concerns expressed in the ABI Report, including that the 2005 changes to the Bankruptcy Code have prevented retailers from successfully reorganizing in chapter 11 cases, the American Bankruptcy Institute commissioners involved in the ABI Report recommended that the period to assume or reject nonresidential real property leases should be extended to at least one year from 210 days. *See* ABI Report, p. 129.

    However, the recent *Aeropostale* bankruptcy case has defied the odds, and the company has found a buyer consisting of a group of mall landlords, liquidators and a licensing company. The sale will keep 229 mall-based stores open, thereby avoiding a GOB sale and saving more than 7,000 jobs. *See, e.g., Retail Dive, Court Approves Aeropostale Sale, Thousands of Jobs Spared*, available at http://www.retaildive.com/news/court-approves-aeropostale-sale-thousands-of-jobs-spared/426181/.
17. *In re Dots, LLC*, Case No. 14-11016 (DHS), GOB/Agency Agreement Order, Docket No. 322 (Bankr. D.N.J. Feb. 27, 2014).
18. *In re Filene's Basement, LLC*, Case No. 11-13511 (KJC), 2014 WL 1713416, at *8-*9 (Bankr. D. Del. April 29, 2014).
19. *See In re Simbaki, Ltd.*, 520 B.R. 241 (Bankr. S.D. Tex. 2014).