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Obtaining Relief From Tenant Allowance and Build-Out Obligations When a Tenant Files for Bankruptcy

As our economy slides into what could be a long and severe recession, retail bankruptcies are expected to increase. Landlords are presented with a myriad of problems when one of their tenants files for bankruptcy. Although many of the obligations and rights of landlords are well established by current bankruptcy law, a novel question arises when a tenant files for bankruptcy while a landlord is in the process of constructing tenant improvements or is on the verge of providing a tenant allowance. Given the tenant's right to reject its lease, a landlord is faced with a difficult decision. This alert addresses the underlying law and suggests lease provisions that lessen the risk of a landlord being required to continue to build out space or provide a tenant allowance prior to the debtor-tenant deciding whether it will assume or reject its lease.

Law as to Unexpired Leases

When a debtor files for bankruptcy, enforcement and collection actions against the debtor are stayed. 11 U.S.C. § 362(a). Thus, regardless of the terms of the lease, the landlord cannot declare a default, terminate a lease, sue the tenant or take other collection actions until the stay has been lifted by the bankruptcy court. 11 U.S.C. § 362(c)(2)(C). Section 365 of the Bankruptcy Code governs unexpired leases. Section 365 provides that an unexpired non-residential lease will be deemed rejected by a debtor lessee if the trustee (or Chapter 11 debtor-in-possession) does not assume or reject the lease prior to the earlier of (a) the date that is 120 days after the date of the order of relief; or (b) the date of an order confirming the plan. The time period can be extended, however, for one 90-day period by the court upon a motion by one of the parties for cause shown. Any further extensions require prior written landlord consent. 11 U.S.C. § 365(a),(d)(4)(A), (B). Until such time as the debtor has elected to assume or reject its lease or the time period for making such decision has expired without the debtor having elected to assume the lease, the landlord is in a state of uncertainty. In particular, this is a problem for the landlord who is in the midst of building out space for the debtor tenant. In many cases, the lease imposes deadlines for the landlord to complete the build-out and imposes substantial penalties for failing to meet such deadlines.

In addition, even if the debtor is in default under the unexpired lease, the debtor has the right to assume the lease if debtor: (i) cures the default or provides "adequate assurance" that it will do so, (ii) compensates the other party or provides "adequate assurance" to the other party that it will compensate it for any pecuniary loss, and (iii) provides "adequate assurance" of future performance under the lease. 11 U.S.C. § 365(b)(1). "Adequate assurance" of future performance is a nebulous concept that includes not interrupting a tenant mix in a shopping center, demonstrating that percentage rent will not decrease, and providing assurance that rent will be paid in the future. 11 U.S.C. § 365(b)(3).

The landlord's right to terminate an unexpired lease in bankruptcy is further limited by the unenforceability of default provisions related to the debtor's financial condition and filing for bankruptcy, so-called *ipso facto* clauses. These provisions include declaring a default on account of: (i) filing for bankruptcy (or a debtor having a bankruptcy suit filed against it), (ii) having a trustee appointed, (iii) the debtor's financial

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1

condition or insolvency at any time prior to the close of the bankruptcy case, or (iv) failing to satisfy penalties related to non-monetary defaults. These defaults need not be cured. 11 U.S.C. § 365(b)(2).

The Landlord's Quandary

Given the tenant's expansive rights under the Bankruptcy Code, what can a landlord do to protect itself from being required to continue to build out space or pay an allowance while the tenant is deciding to assume or reject a lease?

Some landlords have considered including a lease provision that if the tenant files for bankruptcy, all of the landlord's construction deadlines shall be extended on a day-for-day basis for each day between the day the tenant files for bankruptcy and the date on which tenant elects to assume the lease. Similarly, in a lease providing for the payment of a tenant allowance, the payment of the allowance would be delayed pending the assumption/rejection decision. These approaches seem superficially reasonable: Why should a landlord be required to continue to spend money when the tenant has available to it the right to reject the lease? Why should a landlord not be able to delay construction or the payment of the allowance while it is waiting for the tenant to decide whether it will assume or reject the lease?

Reasonable or not, another *ipso facto* provision, Section 365(e)(1), poses a problem for this approach. Section 365(e)(1) invalidates any lease provision *modifying* the rights and obligations of the tenant by virtue of tenant's filing for bankruptcy. While there is no reported case authority addressing whether a provision extending or tolling a landlord's construction obligations while the debtor-tenant decides whether it will assume or reject the lease violates the *ipso facto* clause, we believe that a provision of this sort runs the risk of being unenforceable as modifying the debtor's rights under the lease upon bankruptcy.

Viewing Landlord's Improvement Obligations as "Financial Accommodations"

But not all is lost from the landlord's perspective as there are exceptions to the *ipso facto* clause prohibition. The invalidation of *ipso facto* clauses, in the context of both termination and modification of a debtor-tenant's lease, does not extend to contracts to "extend debt financing or financial accommodations, to or for the benefit of the debtor." 11 U.S.C. § 365(c)(2),(e)(2)(B). The best example of a contract to extend financial accommodations is an executory loan commitment. But can a lease be viewed as a contract to extend a financial accommodation to a tenant? The House and Senate Committee chairpersons, when passing the bill that included this section, provided that the "[c]haracterization of . . . financial accommodations is limited to the extension of cash or a line of credit and is not intended to embrace ordinary leases [implying that the provision could apply to some leases] or contracts to provide goods or services with payments to be made over time." 124 Cong.Rec. H11089 (daily ed. September 28, 1978) (statement of Rep. Edwards), reprinted in 1978 U.S.C.C.A.N. 5787, 6436, 6447 (1978); 124 Cong.Rec. S17406 (daily ed. October 6, 1978) (statement of Sen. DeConcini), reprinted in 1978 U.S.C.C.A.N. 6505, 6515 (1978). In addition, financial accommodations do not include "incidental financial accommodations or extensions of credit" since nearly every contract has the potential to involve some minor extension of credit. 2 Collier on Bankruptcy P 365.06[2].

Little case law exists regarding the construction of a lease as a financial accommodation. However, two cases provide some guidance. In *In re Postle Enterprises, Inc.*, 48 B.R. 721, 724 (Bankr. D. Ariz. 1985), the court first stated that an unexpired lease, in certain circumstances, could be considered a contract extending a financial accommodation. The court found that a \$150,000.00 improvement allowance to a

tenant for renovations to its premises went beyond the scope of an ordinary lease and rose to the level of a financial accommodation for several reasons. First, the landlord borrowed the money to pay the tenant, which allowed the tenant to avoid the costs it would have incurred if it had financed the transaction. Second, although the renovations remain with the building after the tenant vacates the premises and therefore in theory benefit the landlord, the renovations would probably not be worth much (if anything) to the landlord if that specific tenant did not use the space. Finally, similar to a loan, the landlord had relied on the tenant's financial strength when making the initial \$150,000.00 commitment. The court concluded that the lease provided a financial accommodation and so could not be assumed.

In contrast, in *In re United Press International, Inc.*, 55 B.R. 63, 66 (Bankr. D. D.C. 1985), the court held that a landlord's build-out of a tenant's premises to a tenant's specifications (including wall outlets and demising walls) did not rise above "an ordinary lease" and as such was not a financial accommodation. The court reasoned that Congress's intent behind the provision was to protect against a creditor having to extend cash or a line of credit (directly or indirectly) to a bankrupt debtor, and that this section "was not intended by Congress to include ordinary leases to provide space, goods or services." Further, the court argued that the tenant would not receive a "fiscal benefit similar to a loan or letter of credit" and would get finished office space only as the parties agreed in the lease. The court summarized the issue by stating that "to interpret 'financial accommodation' to include the lease contract at issue here would be to allow the exception to swallow the rule" because "any contract could be viewed as providing some financial benefit."

While *In re Postle Enterprises* involved an allowance being granted to the tenant and *In re United Press International* involved a lease where the landlord performed the improvements itself, it is doubtful that this distinction, standing alone, is dispositive. Instead, looking at these two cases, it appears that the relevant factors in determining whether an executory financial accommodation exists are the following: (i) the amount of money involved as to the improvements/allowance versus the aggregate rent payable under the lease; (ii) whether the landlord borrowed the money to meet the improvement obligation; (iii) whether the improvements made were special use improvements benefiting only the tenant that would likely have little or no value upon the termination of the lease; and (iv) whether, as with a typical loan, the landlord looked to the tenant's credit in determining whether to make the improvements or pay the allowance. Finally, although the allowance versus landlord performed work distinction should not be dispositive, one should recognize that providing an allowance, particularly if the lease provides that rent has been increased by an interest and principal amortization factor, may make it easier for a court to view the transaction as providing a financial accommodation as such structure looks more like a typical loan with the landlord lending money to build out the tenant's space.

Structuring Landlord Construction Obligations so as to Be Financial Accommodations

Given the limited number of cases and lack of statutory guidance regarding tenant allowances and build-outs in bankruptcy, a landlord's ability to modify the terms of the build-out provision by extending a landlord's construction deadlines or delaying the payment of a tenant allowance is uncertain. Nevertheless, to enhance its chances for the successful enforcement of a provision tolling its construction or payment obligations, a careful landlord may wish to insert lease language providing as follows:

- that the tenant's credit has been investigated and that in reliance on such credit, landlord is willing to make the allowance or perform the improvements in question;
- that the cost of the improvements has been amortized over the term of the lease at a stated interest rate and that the rent has increased by the amount of the payment to amortize the hypothetical loan;

- that landlord has borrowed from its lender the funds to make the improvements;
- that the improvements are special use improvements made for the express benefit of the tenant and will not have any value in the context of reletting such space; and
- while conclusory and not binding on a court, that landlord is offering the build-out as a “financial accommodation” to a tenant.

The prospects for success may actually be further enhanced by including the tenant improvement or allowance provisions in a separate document structured more like a loan agreement than a lease. We should sound a cautionary note, however, because of the sparse case law and the absence, in particular, of published rulings from key bankruptcy courts in which many retail cases are filed, e.g., in Delaware and the Southern District of New York.



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