

ARIZONA JOURNAL OF
Real Estate & Business[®]

June 2006 • VOL. 21, NO. 6 • Circulation 86,000 • 7142 E. First Street, Scottsdale, Arizona 85251 • (480) 946-5388 • 1-800-659-8088 • Price: \$1.00

SPECIAL EDITION • JUNE EDITION

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NEW BANKRUPTCY LAW FAVORS LANDLORDS, THOUGH TENANTS DON'T WALK AWAY EMPTY HANDED

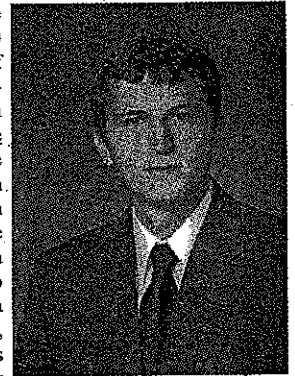
Cathy Reece and Nicolas Hoskins, Fennemore Craig, PC



The Bankruptcy Abuse, Prevention and Consumer Protection Act of 2005 (the "2005 Act") includes some significant changes that benefit landlords of commercial/non-residential real estate: (i) a commercial debtor/tenant will have to assume or reject the lease within a set time, which should help save the landlord from having the property tied up by the bankruptcy court for years on end; (ii) a commercial landlord is now guaranteed an administrative claim against the estate if a debtor/tenant assumes the lease and later defaults, though a cap has been placed on the total amount of the claim; and (iii) a shopping center landlord with a use clause in its lease is protected as to provisions such as tenant mix, financial condition

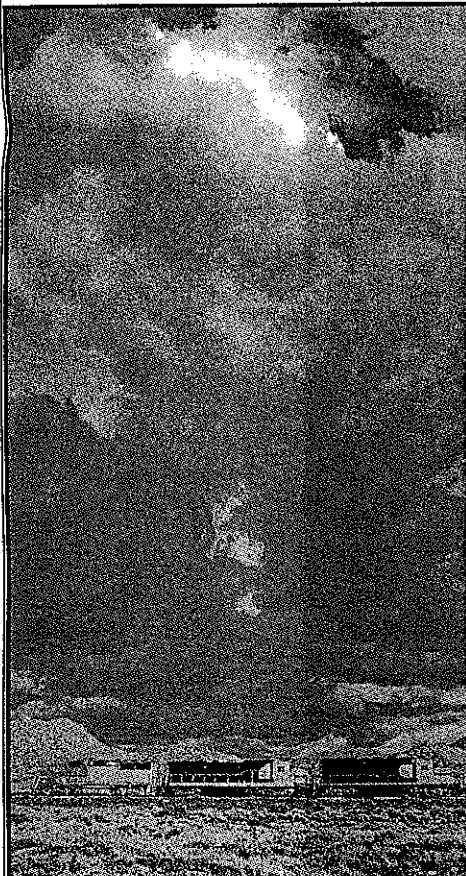
and operating performance. While the 2005 Act tilts the scales towards landlords, news for tenants is not all bad – a debtor/tenant can now assume and possibly assign the lease even if there is a historical non-monetary default, such as a temporary closure of the business pre-petition. Here are the details:

- Under the 2005 Act, a debtor must assume or reject the commercial lease within 120 days or the confirmation date of the plan of reorganization, whichever is earlier. The bankruptcy court can grant one 90 day extension "for cause," but no more extensions can be granted without the landlord's consent. The landlord can expect that the 90-day extension will be freely granted, but the landlord can take comfort that no more extensions can be granted without its consent, thus imposing a firm 210-day deadline for the debtor/tenant to assume or reject the lease. Under the old law, a debtor/tenant could tie up a property for years, because although the old initial deadline was 60 days, the deadline was extended so often by the bankruptcy court, on a limited showing from the debtor, that there effectively was no reliable deadline.



- Because the new deadline is effectively shorter than the old one, it's expected that some debtors will assume their leases before they know if they can stay current

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A HISTORY TO LEVERAGE

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post-petition on the rent or successfully find a buyer and assign the lease. It is anticipated that there may be more post-petition defaults under assumed leases and that debtor/tenants may be forced economically to reject an assumed lease. Under the old law this caused great heart burn for the debtor/tenant because of the large claim created by the rejection and the fact that in some areas of the country the claim was labeled an administrative claim which could render the debtor administratively insolvent. The 2005 Act does two things to deal with this problem: it clarifies that the landlord is definitely entitled to an administrative claim if the assumed lease is subsequently rejected, and it caps the administrative claim at 2 years' rent. While the 2-year cap reduces the total amount the landlord may recover on an administrative basis, the 2-year claim is not subject to reduction or setoff, other than monies actually received or to be received from third parties. This provision should reduce 'failure to mitigate' litigation, though landlords should not grow complacent in seeking replacement tenants, and it should make debtor/tenants more cautious about which leases are assumed.

- Shopping center landlords also received a benefit under the 2005 Act. Now, if a debtor/tenant assumes or assigns a shopping center lease, the debtor and the buyer have to comply with the lease's use clause, including provisions about tenant mix, financial condition and operating performance. This is in sharp contrast to the old law, under which bankruptcy courts routinely stripped from shopping center leases on the theory that they reduced the assignability of the lease.
- While the 2005 Act is generally harder on debtor/tenants, there is a silver lining too. The rules about

curing non-monetary defaults have been significantly relaxed. Specifically, a debtor/tenant can cure historical non-monetary defaults at and after the time of assumption in accordance with the lease. Under the 2005 Act, the debtor/tenant who at one point may have closed the location is entitled to cure that breach on assumption of the lease. Under the old case law in this part of the country, such a historical non-monetary default was impossible to cure and prevented the debtor/tenant from being able to assume the lease and assign the lease even though the debtor was currently open for business. The compromise enacted by Congress in the 2005 Act was to allow the debtor/tenant to cure the default by reopening the location and to allow the landlord to recover compensation for its actual pecuniary loss arising from that default. While it may be difficult to prove exactly what a landlord's damage may be when the tenant "goes dark" for several months, the landlord may want to anticipate this kind of damage and address it in the lease or establish a methodology.

As for **residential real estate leases**, the 2005 Act also made some changes that favored residential landlords. It is residential, not commercial landlords, that get the benefit of the following changes concerning the automatic stay and unlawful detainer actions:

- The 2005 Act makes the automatic stay inapplicable after the landlord obtains a judgment for possession pre-petition against a residential debtor/tenant. That means that if the judgment was obtained pre-petition, a writ of restitution can be obtained even after a bankruptcy filing against the residential debtor/tenant.
- The automatic stay will even be found not to apply to a *pending* the unlawful detainer action against the residential debtor/tenant if the action is based on

endangerment of the property or use of controlled substances on the property. The catch is that a landlord has to file a certificate with the bankruptcy court within the 30-day period preceding the date of the filing of the certification stating that the debtor/tenant has endangered the property or illegally used or allowed to be used a controlled substance on the property. Residential landlords will want to consult with their lawyers about this to make sure that they comply and do not run afoul of the automatic stay, which can result in significant damages.

In sum, the 2005 Act is unquestionably good news for landlords. That said, it is still too soon to tell whether these changes will fundamentally alter the balance of power between landlords and tenants. **A**

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