

I Lease Real Estate To Bon Ton -- Now What?

Landlords in particular are assessing rights under their respective leases. The Bankruptcy Code has special rules relating to leases, some of which benefit a landlord, but others that significantly limit a landlord's rights. In many liquidating Chapter 11 retail bankruptcies, the debtor retains a lease broker to try to maximize the value of their leased property while at the same time limiting landlord's claims arising from the breach of the lease caused by store closures. However, Bon Ton does not appear to have retained a real estate broker.

Under Bankruptcy Code section 365, a liquidating debtor has the right to assume the executory lease and assign it to a third party. To assume and assign the lease, any amounts past due under the lease must be cured by prompt payment, any other pecuniary damages must be satisfied and the assignee of the leased premises must provide the lessor with adequate assurance of the ability to perform the lease in the future. There are special rules set forth in section 365(b)(3) relating to shopping centers which require the assignee to show that the financial condition of the assignee will be similar to that of the debtor, that any percentage rent will not decline substantially, and that the new lessee will not violate any radius, location or exclusivity provision in the lease or disrupt the tenant mix.

The other alternative available to the debtor is to reject the lease. Rejection is deemed to be a breach immediately prior to the bankruptcy. The question is what are the damages arising from the lease rejection by the debtor? Because damages arising from a long term breach can swamp a bankruptcy case, Congress limited, or capped, damages arising from rejected leases. Under section 502(b)(6) of the Bankruptcy Code, a landlord's claims from damages under a lease rejected during the bankruptcy proceeding is capped at the greater of rent reserved under the lease for (a) one year; or (b) 15% of the remaining lease term, not to exceed three years. Under that calculation, a lease with a remaining term of 81 months or more would be entitled to claim greater than one year's rent.

Landlord's often take letters of credit instead of cash security deposits for leases. It is well established that a cash security deposit will be applied to the landlord's capped claim. However, the law is uncertain regarding whether the proceeds of a letter of credit must be applied to the capped portion of the claim thereby reducing the amount the landlord can recover from the bankruptcy estate, or, instead can be applied to the landlord's damages in excess of the cap, allowing

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the landlord to also recover in addition on the full capped claim allowed under Code section 502.

This issue has addressed by three Circuit Courts of Appeal. The Third Circuit in *Solow v. PPI Enterprises (US), Inc. (In re PPI Enterprises (US), Inc.)*, 324 F.3d 197 (3d Cir. 2003), and the Ninth Circuit in *AMB Property, LP v. Official Creditors ex rel. Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)*, 416 F.3d 961 (9th Cir. 2005), held that proceeds of a letter of credit must be applied to the capped claim. By contrast, the Fifth Circuit in *EOP-Colonade of Dallas Ltd. Partnership v. Faulkner (In re Stonebridge Technologies, Inc.)*, 430 F.3d 260 (5th Cir. 2005), ruled that landlord did not have to return to the bankruptcy estate proceeds of a letter of credit which exceeded the Code section 502(b)(6) capped amount. However, in that case the landlord did not file a proof of claim, making it factually different from the other two Circuit Court opinions, and leaving open the question of whether the result would have been different if a proof of claim had been filed.

In this tenuous retail market, the loss of a Bon Ton department store tenant is a significant economic jolt to a landlord. They should carefully assess their rights and discuss with their legal advisors the implications of filing a proof of claim and the impact of a letter of credit, if they were fortunate enough to procure one. Taking the appropriate steps to maximize a landlord's recovery, will make a bad situation a little less so.

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