LESSOR UPDATE: WHAT COMMERCIAL LANDLORDS SHOULD UNDERSTAND ABOUT BANKRUPTCY

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I. INTRODUCTION

Lease agreements are subject to special treatment in bankruptcy cases that is often contrary to the terms of the lease itself or relevant non-bankruptcy law. Thus, a tenant's filing of a bankruptcy case presents myriad issues for a commercial landlord. This article discusses several of the most important matters impacting a landlord in the bankruptcy case of its tenant, including the tenant's assumption, rejection or assignment of a lease; lease obligations pending assumption, rejection or assignment; deadlines for assuming, rejecting or assigning a lease; and the treatment of claims arising from the assumption, rejection or assignment of a lease. This article focuses on bankruptcy law provisions unique to nonresidential real property leases, which are of the greatest interest to most commercial landlords.

Sections 365 and 502 of the Bankruptcy Code[1] are the primary statutes governing the treatment of leases in bankruptcy. Section 365 provides for the assumption, rejection and assignment of unexpired leases. Assumption is akin to ratification of a lease, while rejection is effectively an anticipatory repudiation of a lease. Section 365 deals with a tenant's obligations under a nonresidential real property lease pending assumption, rejection or assignment, as well as containing specific provisions for "shopping center" leases. Section 502 deals with the treatment of claims arising from the breach of a lease, including limitations on claims arising from the rejection of a lease.

II. DEBTOR'S LEASE OBLIGATIONS PENDING ASSUMPTION OR REJECTION OF A NONRESIDENTIAL REAL PROPERTY LEASE

Bankruptcy Code Section 365(d)(3) requires a debtor-tenant to continue performing its post-petition (*i.e.*, post-bankruptcy) obligations under a nonresidential real property lease until it is assumed, rejected or assigned pursuant to Section 365. Such obligations, if unpaid, give rise to an administrative expense claim (which are entitled to payment priority over virtually all other unsecured claims), generally in the amount provided in the lease, regardless of the actual value of the lease to the bankruptcy estate.[2]

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[1] All references in this article to the Bankruptcy Code refer to Title 11 of the United States Code, 11 U.S.C. §§ 101 *et seq.*

[2] *E.g., In re Cukierman*, 265 F.3d 846 (9th Cir. 2001); *In re Pacific Atlantic Trading Co.*, 27 F.3d 401 (9th Cir. 1994).

There is a split of authority regarding whether a debtor is obligated to pay all amounts arising from its post-petition lease obligations under Section 365(d)(3) where there may be insufficient funds to satisfy other administrative expense claims. The conflict centers around whether such claims should effectively receive a "super-priority" such that they are fully paid even if doing so will prevent other administrative expense claims from being paid. The cases can generally be divided into three groups. The plurality, if not the majority, of cases hold that obligations under Section 365(d)(3) effectively do not give rise to a "super-priority" administrative claim, and should not be paid until it is determined that there are sufficient funds in the bankruptcy estate to fully pay all administrative claims.[3] By contrast, a substantial minority of courts have ruled that obligations arising under Section 365(d)(3) give rise to a "super-priority" administrative claim that must be timely paid regardless of the bankruptcy estate's ability to pay other administrative claims.[4] Finally, a substantial number of cases effectively take an approach midway between those two lines of cases, holding that the bankruptcy estate should pay all obligations under Section 365(d)(3), subject to later partial disgorgement if it turns out that there are insufficient funds in the bankruptcy estate to pay all administrative claims in full (so that all allowed administrative claims end up receiving the same pro rata distribution).[5]

Section 365(d)(3) and interpretive case law establishes the scope of a debtor's post-petition lease obligations. Most courts have ruled that Section 365(d)(3) encompasses post-petition obligations for taxes, insurance, common area maintenance, utilities, repairs, clean-up costs, late charges, interest and other monetary obligations.[6] However, at least a few courts have held that a debtor's post-petition failure to comply with maintenance responsibilities and obligations to restore the premises to their pre-lease condition gives

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[3] *See, e.g., In re National Refractors & Minerals Corp.*, 297 B.R. 614 (Bankr. N.D. Cal. 2003); *In re Far West Corp. of Shasta County*, 120 B.R. 551 (Bankr. E.D. Cal. 1990); *In re Orvco, Inc.*, 95 B.R. 724 (B.A.P. 9th Cir. 1989), *overruled on other grounds by, In re Pacific Atlantic Trading Co.*, 27 F.3d 401 (9th Cir. 1994); *In re Tandem Group, Inc.*, 61 B.R. 738 (Bankr. C.D. Cal. 1986). *See also In re LPM Corp.*, 300 F.3d 1134 (9th Cir. 2002) (lessor not entitled to superpriority administrative claim for obligations accruing during Chapter 11 case if case converts to Chapter 7).

[4] *See, e.g., In re Leisure Time Sports, Inc.*, 189 B.R. 511 (Bankr. S.D. Cal. 1995).

[5] *See, e.g., In re PYXSYS Corp.*, 288 B.R. 309 (Bankr. D. Mass. 2003).

[6] *See, e.g., In re* Cukierman, 265 F.3d 846 (9th Cir. 2001) (debtor required to perform all post-petition obligations under lease, regardless of whether related to use of premises); *In re National Refractors & Minerals Corp.*, 297 B.R. 614 (Bankr. N.D. Cal. 2003) (cleanup costs incurred by lessor in removing hazardous materials from leased premises and in repairing damage caused by debtor's breach of lease obligation to maintain and return leased premises in good condition is entitled to administrative expense priority to extent occurring during post-petition, pre-rejection period); *In re Far West Corp. of Shasta County*, 120 B.R. 551 (Bankr. E.D. Cal. 1991) (interest included).

rise to an unsecured claim deemed to arise pre-petition, rather than to a post-petition administrative claim, because such obligations do not accrue until the lease is rejected.[7] Further, there is a split in the case law regarding whether Section 365(d)(3) requires a debtor to pay the attorney's fees incurred post-petition by a landlord seeking to enforce the debtor's lease obligations, with a majority permitting such recovery to the extent allowed under the lease.[8]

Certain types of post-petition lease obligations specified in Section 365(b)(2) are expressly excluded from the debtor's performance duties under Section 365(d)(3). These include penalty rates or provisions arising from the debtor's failure to perform non-monetary obligations, as well as so called "*ipso facto*" provisions that impose obligations or penalties based on the commencement of a bankruptcy case by or against the debtor, the financial condition of the debtor, or the appointment of a trustee in a bankruptcy case or a custodian prior to the commencement of a bankruptcy case.

There is a split in the case law regarding the extent of a debtor's obligations under Section 365(d)(3) where a portion of an obligation falling due post-petition accrued during the pre-petition period. Most courts hold that where obligations falling due post-petition include amounts accruing pre-petition, the debtor must pay a pro-rated amount under Section 365(d)(3) based on the proportion that the post-petition period bears to the entire period to which the payment relates.[9] Similarly, several courts have required pro-rated payment under Section 365(d)(3) of lease obligations attributable to the post-petition period even where the payment fell due (and was not made) pre-petition.[10]

By contrast, a substantial minority of courts have ruled that obligations falling due post-petition that include amounts accruing pre-petition must be fully paid under Section 365(d)(3) without pro-ration.[11] Likewise, some courts have ruled that a debtor need not pay any portion of rent falling due pre-petition even if it relates to post-petition occupancy.[12]

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[7] *See, e.g., In re TreeSource Industries, Inc.* 363 F.3d. 994 (9th Cir. 2004).

[8] *Compare, e.g., In re Midway Airlines Group*, 406 F.3d 229 (4th Cir. 2005); (finding Section 365(d)(3) obligations include attorneys' fees in enforcing lease), *with In re Pacific Arts Publishing, Inc.*, 198 B.R. 319 (Bankr. C.D. Cal. 1996) (post-petition attorneys' fees incurred in enforcing lease are not included in Section 365(d)(3) obligations because they arise from pre-petition contract).

[9] *See, e.g., In re Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125 (7th Cir. 1998); *In re National Refractors & Minerals Corp.*, 297 B.R. 614 (Bankr. N.D. Cal. 2003).

[10] *See, e.g., In re Victory Markets, Inc.*, 196 B.R. 6 (N.D.N.Y. 1996).

[11] *See, e.g., In re Montgomery Ward Holding Corp.*, 268 F.3d 205 (3d Cir. 2001); *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986 (6th Cir. 2000); *In re RB Furniture, Inc.*, 141 B.R. 706 (Bankr. C.D. Cal. 1992).

[12] *See. e.g., In re Appletree Markets, Inc.*, 139 B.R. 417 (Bankr. S.D. Tex. 1992).

III. DEADLINES TO ASSUME OR REJECT A NONRESIDENTIAL REAL PROPERTY LEASE

Pursuant to Bankruptcy Code Section 365(d)(4), a debtor's lease of nonresidential real property is deemed rejected if it is not assumed or rejected by the earlier of (i) 120 days following the debtor's bankruptcy petition, and (ii) the date of entry of an order confirming a reorganization plan, in either case unless the court extends the time for assumption or rejection before such period expires. The statute authorizes the bankruptcy court to extend the 120-day period, for cause shown, for up to an additional 90 days, but conditions any further extensions on the lessor's consent.

Although the Bankruptcy Code does not provide a standard for determining whether there is "cause" for granting an extension of the time to assume or reject a lease, courts typically consider a number of factors in determining whether to grant an extension, including the following:

1. whether the lease(s) is/are the primary asset(s) of the debtor;

2. whether the lessor continues to receive rental payments;

3. whether the case is exceptionally complex and involves a large number of leases;

4. whether the decision to assume or reject the lease(s) would be central to any plan of reorganization;

5. whether there is a reasonable possibility that the debtor will submit a plan capable of being confirmed;

6. whether the debtor has had the time necessary to appraise its financial situation and the potential value of its assets in terms of the formulation of a plan;

7. whether the lessor will be subject to damages beyond compensation available under the Bankruptcy Code due to the debtor's continued occupation;

8. whether the lessor has a reversionary interest in the building built by the debtor on the lessor's land;

9. whether the property remains vacant, thereby affecting neighboring tenants; and

10. the existence of any other facts bearing on whether the debtor has had a reasonable amount of time to decide whether to assume or reject the lease(s).[13]

Courts have adopted various procedures to protect the interests of a landlord during the extension of the time for the debtor to assume or reject a lease. These include (1) granting an extension conditioned on the debtor's continued compliance with its post-petition lease obligations under Section 365(d)(3), (2) requiring the debtor to continue operating for a certain period of time (*e.g.*, keeping a retail store open through the Christmas shopping season) even if it would otherwise elect to reject the lease sooner, and (3) requiring the debtor to continue making rental payments beyond the time when the debtor would otherwise elect to reject the lease.[14] At least one court has granted an extension under Section 365(d)(4) in order to allow a third party purchaser of the debtor's assets to determine whether to assume or reject leases.[15]

In addition, a debtor may be authorized to renew a lease pending assumption or rejection despite uncured defaults, even where the lease conditions renewal on the absence of any defaults. However, the bankruptcy court has discretion regarding whether to allow a tenant in default to exercise its renewal option, after considering the scope of the default, the causes of the default, any subsequent cure, and the significance of the lease to the tenant's ability to reorganize, and then balancing these factors against the policy of Section 365(d)(3) to provide the landlord with the right to timely post-petition payments.[16]

IV. REJECTION OF AN UNEXPIRED LEASE IN BANKRUPTCY

The "business judgment rule" is the standard that governs a bankruptcy court's approval of a debtor's decision to reject an unexpired lease. Under this rule, the debtor's determination that rejection of the lease will benefit the bankruptcy estate will be accepted by the court unless shown to be manifestly unreasonable. Generally, the potential damages to the non-debtor party resulting from rejection is not relevant to the

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[13] *See In re Ernst Home Center, Inc.*, 209 B.R. 974 (Bankr. W.D. Wash. 1997), *appeal dismissed*, 221 B.R. 243 (B.A.P. 9th Cir. 1998); *In re Victoria Station, Inc.*, 88 B.R. 231, 236, n.7 (B.A.P. 9th Cir. 1988), *aff'd on other grounds*, 875 F.2d 1380 (9th Cir. 1989).

[14] *See, e.g., In re Pacific Sea Farms, Inc.*, 134 B.R. 11 (Bankr. D. Haw. 1991).

[15] *In re Ernst Home Center, Inc.*, 209 B.R. 974 (Bankr. W.D. Wash. 1997), *appeal dismissed*, 221 B.R. 243 (B.A.P. 9th Cir. 1998).

[16] *See, e.g., In re Leisure Corp.*, 234 B.R. 916 (B.A.P. 9th Cir. 1999). *See also In re Fifth Taste Concepts Las Olas, LLC*, 325 B.R. 42 (Bankr. S.D. Fla. 2005) (requiring debtor to assume lease and cure defaults as condition to exercising renewal option).

court's analysis,[17] although the court may refuse to authorize rejection of a lease where the lessor would suffer disproportionate damage (*e.g.*, where most of the benefit of rejection would be captured by a third party rather than the bankruptcy estate).[18]

V. ASSUMPTION OF AN UNEXPIRED LEASE IN BANKRUPTCY

As with lease rejection, the business judgment rule technically is the standard that governs the bankruptcy court's approval of a debtor's decision to assume an unexpired lease. However, because a key consequence of the court's approval of assumption of a lease is that any existing monetary defaults must be cured and virtually any post-assumption breach by the debtor will give rise to administrative claims against the estate that by definition will have priority over general unsecured claims, bankruptcy courts tend to be more probing and activist in considering whether to approve an assumption (as opposed to a rejection) of a lease, particularly if key estate constituents such as a creditors' committee or other important party in interest objects to assumption.

Pursuant to Bankruptcy Code Section 365(b)(1), if there has been a default under a lease, in order to assume such lease, the debtor must:

1. cure (or provide adequate assurance of prompt cure of) pre- and post-petition defaults;

2. compensate (or provide adequate assurance of prompt compensation of) all pecuniary loss resulting from pre- and post-petition defaults; and

3. provide adequate assurance of future performance under the lease.

Generally speaking, all monetary defaults must be cured in order for a debtor-tenant to assume a lease under Section 365(b)(1). This may include a landlord's recovery of its attorney's fees in enforcing the lease. To recover attorney's fees, a lessor generally must establish that the lease specifically provides for recovery of such fees and that the attorney's fees were reasonably incurred.[19] The lease must be construed as a whole to determine the scope of the lessor's contractual right to attorney's fees. Thus, standard lease language may not encompass attorney's fees incurred by a landlord in enforcing its

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[17] *See, e.g., Borman's, Inc. v. Allied Supermarkets, Inc.*, 706 F.2d 187, 189-91 (6th Cir. 1983), *cert. den.*, 464 U.S. 908 (1983).

[18] *See In re Chi-Feng Huang*, 23 B.R. 798, 801 (B.A.P. 9th Cir. 1982) (involving executory contracts subject to same provisions in Section 365 as unexpired leases.)

[19] *See, e.g., In re Bullock*, 17 B.R. 438 (B.A.P. 9th Cir. 1982).

lease rights and participating in a tenant's bankruptcy case.[20] Lease provisions that provide for recovery of attorney's fees by the "prevailing party" with respect to a disputed matter may also be interpreted to limit a landlord's recovery of attorney's fees in connection with a landlord's objection to assumption or assignment.

Pursuant to Bankruptcy Code Section 365(b)(2), certain defaults are excluded from the defaults that must be cured by the debtor in order to assume a lease. These exceptions include defaults related to "*ipso facto*" provisions and penalty rates or provisions, consistent with the obligations excluded from a debtor's post-petition lease obligations pursuant to Bankruptcy Code Section 365(d)(3), as discussed above. In addition, the debtor need not cure nonmonetary defaults under a real property lease that are impossible to cure by performing nonmonetary acts (e.g., violation of a prohibition against "going dark"), although, to the extent such defaults arise from a failure to operate in accordance with the terms of a nonresidential real property lease, such defaults must be prospectively cured at the time of lease assumption, and the lessor must be compensated for any pecuniary loss resulting from the prior defaults.

With respect to the third prerequisite for assuming a lease — *i.e.*, adequate assurance of future performance — Bankruptcy Code Section 365(b)(3) contains special requirements for the debtor's assumption of a lease in a "shopping center," mandating that the debtor demonstrate adequate assurance:

1. of the source of rent and other consideration due under the lease;

2. that any percentage rent due under the lease will not decline substantially;

3. of compliance with all lease provisions, including those regarding radius, location, use and exclusivity, as well as compliance with such provisions in other shopping center leases, financing agreements and master agreements relating to the shopping center; and

4. of no disruption of tenant mix or balance in shopping center.

The term "shopping center" is not defined in the Bankruptcy Code and has therefore been fleshed out by case law. Although there are up to 15 different factors that courts consider in determining whether a non-residential real property lease is in a "shopping center" for purposes of Section 365, as a general principle it appears that the most important characteristics of a "shopping center" are a combination of leases on

[20] *See, e.g., In re Westside Print Works, Inc.*, 180 B.R. 557 (B.A.P. 9th Cir. 1995) (denying recovery of attorneys' fees where lease provided for attorneys' fees only in connection with recovery of premises).

contiguous spaces held by a single owner/landlord, leased to commercial distributors of goods or services, with the presence of a common parking area.

VI. ASSUMPTION AND ASSIGNMENT OF AN UNEXPIRED LEASE IN BANKRUPTCY

Pursuant to Bankruptcy Code Section 365(f)(1), a debtor may assign a lease in accordance with Section 365(f)(2) notwithstanding lease provisions that purport to prohibit, restrict or condition assignment. Assignment under Section 365(f)(2) requires assumption of the lease pursuant to Section 365(a) and a showing of adequate assurance of future performance under the lease by the proposed assignee, even if there have been no defaults under the lease. Pursuant to Section 365(l), the landlord may require a deposit or other security from the assignee comparable to what the landlord would have required upon the initial leasing to a similar tenant. The assignment of a lease, like the assumption of a lease, must be approved by bankruptcy court order.

Just as the assumption of a shopping center lease is subject to special lessor-friendly provisions as discussed in the preceding section, the assignment of a shopping center lease is subject to additional requirements pursuant to Bankruptcy Code Section 365(b)(3), including a showing of adequate assurance that the financial condition and operating performance of the assignee (and its guarantors, if any) is similar to the financial condition and operating performance of the debtor (and its guarantors, if any) as of the time the debtor became the lessee under the lease. In assessing the financial condition and operating performance of a proposed assignee without an established "track record," courts have looked at such factors as the business experience of the principals of the assignee.[21]

Pursuant to Bankruptcy Code Section 365(k), the assignment of a real property lease pursuant to Bankruptcy Code Section 365(f) relieves the bankruptcy estate of all claims resulting from a subsequent breach of the lease. Since landlords often make various year-end accounting adjustments with their tenants (*e.g.*, to reflect the difference between actual expenses for certain items and the estimated amount previously charged to tenants), it is prudent for a landlord to obtain a carve-out for certain post-assignment adjustments for a specified period in the order authorizing assignment of the lease.

VII. CLAIMS ARISING FROM REJECTION OF A LEASE IN BANKRUPTCY

A landlord's claim arising from the debtor-tenant's rejection of a lease is treated as a pre-petition unsecured claim under Bankruptcy Code Sections 365(g) and 502(g), even though the rejection actually occurs post-petition. The calculation of a claim arising from lease rejection is based on the terms of the lease and relevant non-bankruptcy law, with certain adjustments required by bankruptcy law.

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[21] *See, e.g.*, *In re Service Merchandise Co., Inc.*, 297 B.R. 675 (Bankr. M.D. Tenn. 2002).

Because lease rejection claims pertaining to long-term real property leases can be very large relative to the other unsecured claims against a bankruptcy estate, in order to mitigate the risk that one or more large lease rejection claims will dominate a bankruptcy case, Bankruptcy Code Section 502(b)(6) limits the maximum recovery for a landlord's claim arising from termination of a real property lease to (1) any unpaid rent owed under the lease, *plus* (2) a portion of the remaining future rent, equal to the rent reserved in the lease for the greater of one year or 15% (not to exceed three years) of the remaining term of the lease. There is a split of authority regarding whether the 15% should be calculated based on the *time* remaining or the *rent* remaining under the lease.[22] This cap on damages is applied after calculating the total damages arising from rejection of the lease, after taking account of any mitigation.[23] In addition, relevant case law generally requires that the landlord's total damages arising from lease rejection be discounted to present value before applying the Section 502(b)(6) cap.[24]

One of the most difficult issues in calculating Section 502(b)(6)'s cap on a lease termination claim is determining what amounts are considered as "rent reserved" under the cap formula. Some courts have established a three-factor test for ascertaining whether charges owed by a debtor-tenant under a lease constitute "rent reserved" for purposes of calculating the limitation on lease rejection damages under Section 502(b)(6):

1. the charge must (a) be designated as "rent" or "additional rent" in the lease or (b) provided as the tenant's obligation in the lease;

2. the charge must be related to the value of the property or the lease; and

3. the charge must be properly classifiable as rent because it is fixed, regular or periodic.[25]

Although the relevant case law is not uniform, it reveals certain general principles regarding the types of charges that are generally included or excluded from the

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[22] *See In re Connectix Corp.*, 372 B.R. 488 (Bankr. N.D. Cal. 2007) (collecting cases holding that the reference to 15% in Section 502(b)(6) refers to the *time* remaining on the lease and cases holding that the 15% refers to the aggregate rent due under the remainder of the lease).

[23] *See, e.g., In re Highland Superstores,, Inc.*, 154 F.3d 573 (6th Cir. 1998); *In re Iron Oak Supply Corp.*, 169 B.R. 414 (Bankr. E.D. Cal. 1994). *But see* Cal. Civ. Code § 1951.2 (lessee has burden of proving amount of rental loss that lessor could have reasonably avoided as a result of lessee's breach of lease).

[24] *See In re Merry-Go-Round Enterprises, Inc.*, 241 B.R. 124 (Bankr. D. Md. 1999).

[25] *See, e.g., In re JSJF Corporation*, 344 B.R. 94, 100 (B.A.P. 9th Cir. 2006); *In re McSheridan*, 184 B.R. 91, 99-100 (B.A.P. 9th Cir. 1995), *overruled on other grounds by, In re El Toro Materials Company, Inc.*, 504 F.3d. 978 (9th Cir. 2007).

determination of "rent reserved" pursuant to Section 502(b)(6). Charges generally treated as "rent reserved" include minimum rent, real estate taxes, insurance, common area maintenance charges and annual capital improvement fees. Charges typically excluded from "rent reserved" include utility charges, maintenance and repair expenses, remodeling and reconstruction costs, service charges, re-letting fees, attorneys' fees, janitorial expenses, liquidated damages and interest.[26] Other ancillary damages associated with breach of a lease that have been held not to be subject to the Section 502(b)(6) cap include expenses resulting from a debtor's failure to comply with its obligations to maintain the premises and to restore them to the condition they were in at commencement of the lease, and construction allowances payable by the debtor upon an event of default.[27]

Under an emerging majority view, once the Section 502(b)(6) cap is calculated, any security deposit (whether in the form of cash or a letter of credit) securing the debtor-tenant's lease obligations must be deducted in determining the landlord's maximum allowable claim for lease termination damages.[28] This means that the landlord holding a security deposit generally cannot apply such security deposit to the excess (i.e., beyond the capped) amount of its claim resulting from rejection of the lease, and instead must credit such security deposit to the capped amount, thus reducing the amount of the capped claim.[29] Note, however, that in most jurisdictions, a security deposit also may be applied against any of the landlord's other prepetition unsecured claims (*i.e.*, a pre-petition claim for rent unpaid as of the bankruptcy filing, for damage to the premises as of the bankruptcy filing, or other unsecured claims that do not arise from rejection of the lease), but not against the lessor's administrative claim for unpaid postpetition rent and

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[26] *See cases collected in In re McSheridan*, 184 B.R. 91, 97-99 (B.A.P. 9th Cir. 1995), *overruled on other grounds by In re El Toro Materials Company, Inc.*, 504 F.3d. 978 (9th Cir. 2007). *See also In re JSJF Corp.*, 344 B.R. 94, 101 (B.A.P. 9th Cir. 2006) (remanding to determine whether Section 502(b)(6) cap applied to landlord's claim for attorneys' fees and costs awarded in prepetition litigation brought by landlord for defaulted lease obligations and debtor's counterclaim for constructive eviction).

[27] *See, e.g., In re El Toro Materials Company, Inc.*, 504 F.3d. 978 (9th Cir. 2007).

[28] *See, e.g., In re AB Liquidating Corp.*, 416 F.3d. 961, 963-64 (9th Cir. 2005); *In re Mayan Networks Corp.*, 306 B.R. 295, 299 (B.A.P. 9th Cir. 2004); *In re Connectix Corp.*, 372 B.R. 488 (Bankr. N.D. Cal. 2007).

[29] There as yet is little case law on whether a third party guaranty in favor of a landlord will be treated the same as a letter of credit for purposes of determining whether any recovery on such a guaranty must be applied against the landlord's capped claim. Many bankruptcy lawyers and commentators believe that it will be difficult to distinguish a third party guaranty from a letter of credit as a form of lease deposit and/or lease credit support, and that a guaranty therefore may be subject to the same treatment as a letter of credit.

other obligations.[30] After such application, any excess proceeds from the security deposit must be refunded to the extent it exceeds the lease damages cap.[31]

In view of the foregoing array of principles regarding the requisite application of security deposits in the bankruptcy context and the still-emerging case law, it may be prudent for a landlord at the outset of the lease to seek one security deposit for potentially capped lease termination damages and one or more additional security deposits for other uncapped claims. While this does not guarantee that the landlord will be able to apply the security deposit(s) in the way most advantageous to the landlord, it may give the landlord more flexibility and more arguments, particularly in jurisdictions where the courts have not fully articulated or developed the rules regarding application of security deposits.

VIII. CLAIMS ARISING FROM BREACH OF A PREVIOUSLY ASSUMED LEASE

Under Bankruptcy Code Section 365(g)(2), the rejection of a previously assumed lease is deemed a post-petition breach of such lease (in contrast to Section 365(g)(1), which provides that the rejection of an unassumed lease is deemed to be a pre-petition breach). Generally speaking, a landlord's entire claim resulting from the debtor's breach of a previously assumed lease is entitled to administrative expense priority treatment under Section 503(b). However, pursuant to Section 503(b)(7), a landlord's administrative claim for damages resulting from the rejection of a previously assumed nonresidential real property lease is limited to all monetary obligations (excluding those arising from a failure to operate or a penalty provision) for a period of two years following the later of (i) the rejection date, or (ii) the date of turnover of the premises, without reduction or setoff, except for amounts received from a third party (e.g., a guarantor); any remaining amounts due for the balance of the lease term are treated as a general unsecured claim subject to the limitations of Section 502(b)(6) (discussed above).

IX. CONCLUSION

As is apparent from the foregoing discussion, the filing of a bankruptcy case by a tenant presents a number of challenges for a commercial landlord, based on various provisions of the Bankruptcy Code that may change the parties' otherwise applicable rights and obligations pursuant to the terms of the lease and applicable non-bankruptcy law, as well as based on the non-uniform interpretation of these provisions by the courts. Commercial landlords typically are in a better position to protect and advance their

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[30] *See, e.g., In re Far West Corp. of Shasta County*, 120 B.R. 551, 553 (Bankr. E.D. Cal. 1990).

[31] *See, e.g., In re Builders Transport, Inc*. 471 F.3d 1178, 1191 (11th Cir. 2006), *cert. den.*, 127 S.Ct. 112 (2007).

interests if they understand the bankruptcy principles that will become applicable in the event of a tenant's bankruptcy. This enables commercial landlords, to the extent possible, to craft their leases to take such principles into account, and then take any appropriate action to assert their rights following a tenant's bankruptcy filing.