

## Retail Blues

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ally up to speed, represented by counsel and ready for a fight.

As mentioned previously, due to declining inventory valuations, the flight of lenders from the retail loan market and tightened trade credit, it will be harder for distressed retailers to obtain the cash needed to fuel successful reorganizations. In addition, bankruptcy judges, trade creditors and landlords have all seen too many retail bankruptcies end up as administratively insolvent liquidation cases, where little or no value is left for creditors after paying back the DIP lender. As a result, all these groups have begun to aggressively challenge retailers going into bankruptcy, as well as the Chapter 11 process itself.

Among other things, DIP lenders no longer seem to be getting the rubber stamp approval they once enjoyed. Before a prepetition lender gets the benefit of funding a DIP facility and asserting liens in postpetition collateral, the stakeholders in the case are forcing the company to justify the cost of the DIP facility, as well as looking closely at the process by which the company came to a deal with the proposed lender. Creditors will also examine the company's budget and the assumptions on which it is based to make sure that money is not unnecessarily leaking out of the case. Early on in the bankruptcy case, unsecured creditors, landlords and lenders are demanding that a retailer show a defined path toward profitability before they are willing to support the company and its reorganization efforts.

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## IN PRACTICE

# Rethinking 'Terminated' Leases: How Bankruptcy Courts Keep Them Alive

By Adam L. Rosen and Patricia A. Rooney

It is often the case that whether a lease is considered terminated in a bankruptcy case depends on the court deciding the issue and the particular facts of the case. Some bankruptcy courts have held that a commercial lease continues to be "unexpired" until it has finally been terminated under state law and cannot be revived or reinstated pursuant to state law deadlines and procedures.

*In re P.J. Clarke's Restaurant Corp.*, 265 B.R. 392 (Bankr. S.D.N.Y. 2001), discussed herein, is one such example. Before analyzing *P.J. Clarke*, we will discuss whether the automatic stay protects the debtor with respect to a terminated lease and how bankruptcy courts keep terminated leases alive.

### Is the Automatic Stay Implicated?

Other courts have held that the automatic stay provided for by Bankruptcy Code § 362 does not apply to acts by a landlord to regain possession under a commercial lease that, before commencement of the tenant's bankruptcy case, was terminated by the expiration of the stated term of the lease. Sec. 362(b)(10) provides that the automatic stay does not apply to "any act by a lessor to the debtor under a lease of nonresidential real property that has terminated by the expiration of the stated term of the lease before the commencement of or during a case under this title to obtain possession of such property."

Sec. 362(b)(10) generally is interpreted to apply only to leases

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whose terms expire prior to the bankruptcy filing. See *In re Seven Stars Restaurant Inc.*, 122 B.R. 213 (Bankr. S.D.N.Y. 1990); see also *Kopelman v. Heljavian (In re Triangle Laboratories Inc.)*, 663 F.2d 463, 467-68 (3d Cir. 1981) (explaining that a lease terminated prior to a bankruptcy filing is not "resurrected by the filing"). The § 362(b)(10) exclusion has been interpreted expansively by some courts to apply to leases that were terminated by the landlord for nonpayment before the end of the term set forth in the lease. See, e.g., *In re Policy Realty Corp.*, 242 B.R. 121 (S.D.N.Y. 1999), *aff'd*, No. 99-5062, 2000 U.S. App. LEXIS 8846 (2d Cir. May 2, 2000) (unpublished opinion); *In re Neville*, 118 B.R. 14 (Bankr. E.D.N.Y. 1990).

### Should the Bankruptcy Court Retry the Issue?

A state court decision regarding the termination of a lease is binding on a bankruptcy court under res judicata. See, e.g., *Kelleran v. Andrijevic*, 825 F.2d 692, 695 (2d Cir. 1987) (holding that "[b]ankruptcy proceedings may not be used to re-litigate issues already resolved" in a state court action), *cert. denied*, 484 U.S. 1007 (1988); *Heckert v. Dotson (In re Heckert)*, 272 F.3d 253 (4th Cir. 2001) (finding in dischargeability action that res judicata bars bankruptcy court from altering amount of state court judgment); see also *Beaver Street Assocs. v. Lady Liberty Tavern Corp. (In re Lady Liberty Tavern Corp.)*, 94 B.R. 812 (S.D.N.Y. 1988).

It is also well settled that the bankruptcy court is not the appropriate place to challenge, retry or appeal any decisions made by a state court in a landlord-tenant case. See *id.* 814-15 (explaining that the bankruptcy court is required to give a state court judgment in a landlord-tenant case preclusive effect).



## How Bankruptcy Courts Keep Leases Alive

Some courts, however, have given debtors the opportunity to go back to state court to attempt to reinstate a lease, while holding the landlord at bay, when it is the court's belief that reinstatement is a reasonable possibility. For example, in *Brattleboro Housing Auth. v. Stoltz* (*In re Stoltz*), 197 F.3d 625 (2d Cir. 1999), the Second Circuit held that a residential lease was "unexpired" for purposes of § 365 insofar as that section deals with the assumption or rejection of unexpired leases, where the adverse state court decision could still be appealed.

In New York, courts have relied on the state court's power to vacate an eviction order in finding that a lease still is revivable. Under New York law, although the issuance of a warrant of eviction terminates the lease, the statute provides for the possible reinstatement by the state court.

The issuing of a warrant for the removal of a tenant cancels the agreement under which the person removed held the premises and annuls the relation between landlord and tenant, but nothing contained herein shall deprive the court of the power to vacate such warrant for good cause shown prior to the execution thereof. N.Y. Real. Prop. Acts. Law § 749(3) (Consol. 2001).

Some courts have allowed debtors to successfully defend § 362 lift stay motions and keep terminated leases "alive" adhering to the theory that the debtor's mere possession of the premises gives rise to the protections of the automatic stay and the state court might reinstate the lease. This line of cases is derived from a Bankruptcy Act case, *In re Lane Foods Inc.*, 213 F. Supp. 133 (S.D.N.Y. 1963).

In *Lane Foods*, a landlord commenced a summary proceeding against a tenant under a commercial lease for nonpayment of rent. Although a final order was granted in the landlord's favor and a warrant of eviction was entered, before the landlord could execute on the warrant, the tenant filed a Chapter 11 petition that stayed all eviction

proceedings. After the referee in bankruptcy granted various temporary restraining orders allowing the tenant to remain in possession, conditioned on payment for use and occupancy, the landlord moved before the referee for an order dissolving the restraining orders and dismissing the tenant's motion for an injunction against eviction. The essence of the landlord's argument was that the bankruptcy court had no jurisdiction to enter the restraining orders. The referee denied the landlord's motion. On appeal, the

## Confronting A Terminated Lease

The following issues should be considered when confronted with commercial leases that have been "terminated" prior to the commencement of a bankruptcy case. (1) Has the state court made a determination that terminates the lease? (2) Is the ground for termination based on a default under the lease or on the expiration of the stated term of the lease? (3) Can the lease be reinstated under state law and is reinstatement likely? (4) Has the debtor exhausted its appeals regarding termination of the lease or has the time to appeal expired and does § 108(b) further extend the debtor's time to file a state court appeal? (5) Is the automatic stay applicable to action by the landlord to evict the tenant?

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district court affirmed the referee's decision.

The district court explained that, since Chapter 11 contemplates the rehabilitation of the debtor's business, to allow a landlord to evict a tenant who is in possession of the premises at the time the petition is filed would defeat the purposes and intent of Chapter 11.

Finding that the most "significant fact" in the case was that at the time the petition was filed "the debtor was in possession of the premises," the *Lane Foods* court found it had jurisdiction to entertain the controversy, explaining

that "[b]ankruptcy courts have summary jurisdiction to adjudicate controversies relating to property over which they have actual or constructive possession. And the test of this jurisdiction is not title in but possession by the bankrupt at the time of the filing of the petition in bankruptcy." *Id.* at 136 (further citation omitted). Nevertheless, the district court limited the injunction to the extent that it gave the tenant "a reasonable opportunity to renegotiate with his landlord or to find new premises without interrupting the business." *Id.* at 136.

Courts have expanded on *Lane Foods'* view of bankruptcy court power and jurisdiction in protecting "terminated" leases. See, e.g., *48th Street Steakhouse Inc. v. Rockefeller Group Inc.* (*In re 48th Street Steakhouse Inc.*), 835 F.2d 427 (2d Cir. 1987) (holding that even where a debtor's legal rights have been terminated with respect to a lease, debtor retains an equitable interest based on bare possession that is protected by the automatic stay), *cert. denied*, 485 U.S. 1035 (1988); *In re W.A.S. Food Serv. Corp.*, 49 B.R. 969 (Bankr. S.D.N.Y. 1985) (holding that automatic stay continued in effect to allow debtor to pursue state court remedies and protect the debtor's "equitable interest in possession"); *Grand Hudson Corp. v. GSVC Restaurant Corp.* (*In re GSVC Restaurant Corp.*), 10 B.R. 300 (S.D.N.Y. 1980) (stating in dicta that restaurant lease that was terminated prepetition was still assumable where termination was not completed or where determination regarding termination could be reversed by state court but choosing to lift the stay, explaining that because the debtor had exhausted all possible legal means for relief in state court, to allow the stay to continue would permit a lack of "finality...to state court landlord-tenant proceedings"); see also *In re ISSA Corp.*, 142 B.R. 75 (Bankr. S.D.N.Y. 1992); *In re Ontario's Italian Restaurant Corp.*, 42 B.R. 319 (Bankr. S.D.N.Y. 1984).

But in cases where the debtor/tenant has exhausted its state court remedies through appeal or otherwise, grounds exist for immediate

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## 'Terminated' Leases

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termination of the stay. See, e.g., *Bell v. Alden Owners Inc.*, 199 B.R. 451 (S.D.N.Y. 1996) (holding stay lifted in Chapter 13 case regarding residential lease).

In cases where a debtor is no longer in possession of the leased premises, the automatic stay is not implicated. See, e.g., *Gulf Petroleum, S.A. v. Marrero (In re Marrero)*, 7 B.R. 586 (Bankr. D. P.R. 1980) (granting lessor petroleum company relief from automatic stay, explaining that debtor—former gas station operator and former tenant of lessor—was only “casually, peripherally concerned with th[e] lease” where there was no indication that debtor had recently operated or been in possession of gas station); *Bowie Venture v. Alexandria Investments Inc. (In re Alexandria Investments Inc.)*, 38 B.R. 781 (Bankr. D. Md. 1984) (granting relief from automatic stay to landlord when tenant had assigned lease without landlord’s consent in violation of the lease and state law, explaining that, although bankruptcy “modif[ies] and affect[s] the rights established by state law, ...there must be a property right in existence to be affected. Although the bankruptcy court may accomplish miraculous feats with respect to restructuring leases, the court does not have the power to produce a spontaneous generation of a lease relationship where none existed before.”).

### P.J. Clarke's

In *In re P.J. Clarke's Restaurant Corp.*, 265 B.R. 392 (Bankr. S.D.N.Y. 2001), Judge Allan L. Gropper held that a restaurant lease terminated by a state court order that was subject to appeal was still an “unexpired lease” for purposes of § 365. *Id.* at 399.

In *P.J. Clarke's*, the landlord terminated the lease pursuant to a conditional limitation clause based on the debtor's failure to pay five months' rent. The state court granted the landlord summary judgment, giving the landlord possession of the premises. Before the warrant

of eviction could be executed, the debtor filed a Chapter 11 petition.

The landlord filed a motion for a declaration that the lease had terminated prior to the filing and that, under § 541(b)(2), it was not property of the estate. Sec. 541(b)(2) provides that property of the estate does not include “any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease before the commencement of the case.”

The landlord also moved alternatively for an order modifying the automatic stay to complete the eviction. Judge Gropper denied the motion and permitted the debtor to appeal the state court's decision, recognizing that res judicata bound him regarding the state court determination with respect to the lease. *Id.* at 396 (citing *Kelleran*, 825 F. 2d 692). Apparently, the landlord did not argue that the automatic stay was inapplicable under § 362(b)(10).

The debtor then moved to modify the automatic stay to pursue its appeal, and the landlord filed a second motion seeking to modify the automatic stay and to condition the debtor's appeal on the payment of use and occupancy in an amount in excess of the rent called for under the lease. The court modified the automatic stay to permit the appeal to continue conditioned upon regular lease payments.

Judge Gropper reasoned that the debtor still had a protectable interest in the lease and that it was entitled to try to reverse the adverse state court decision because, if the lease were reinstated, it had 11 years to run and could be assumed by the debtor. *Id.* at 399. Judge Gropper explained that if the lease were to be reinstated, the debtor would have “far greater rights than a holdover with merely a naked right of possession and nothing more.”

Judge Gropper did not modify the stay to permit the landlord to continue its eviction proceedings while the debtor pursued its appeal. To do so would have forced the debtor to obtain a stay from the state court pending appeal. In effect, Judge Gropper granted

the debtor a stay pending appeal. The debtor might have obtained a similar stay from the state court. See, e.g., *Reynolds v. Division of Hous. & Community Renewal*, 199 A.D.2d 15, 604 N.Y.S.2d 567 (1st Dep't 1993) (granting injunctive relief to tenant in order to stop eviction proceedings upon a showing that eviction would cause irreparable harm to tenant and that tenant would be likely to succeed on the merits). In effect, the debtor in *P.J. Clarke's* used the automatic stay to delay the eviction while pursuing its state court appeal.

## Web Sites of Interest

As details of the Enron bankruptcy continue to pour in, practitioners interested in keeping up with the daily developments may want to consider the following web sites:

➤ [news.findlaw.com/legalnews/lit/enron/index.html](http://news.findlaw.com/legalnews/lit/enron/index.html). Findlaw has created a free online legal resource relating to the rise and fall of Enron. This is a collection of court documents, letters and e-mail messages from key Enron and Arthur Anderson figures. Also available are letters and statements relating to congressional inquiries, shareholder suits, PAC contributions and the full text of Enron's SEC filings dating back to 1990.

➤ [www.abiworld.org/headlines/todayshead.html](http://www.abiworld.org/headlines/todayshead.html). A general daily bankruptcy news service provided by the American Bankruptcy Institute (ABI).

➤ [bkinformation.com](http://bkinformation.com). This site provides links to daily bankruptcy news items, many of which require a subscription.

➤ [www.thedeal.com](http://www.thedeal.com). The Daily Deal spotlights the leading bankruptcy stories. Interested subscribers can receive bankruptcy stories in their own mailbox on a daily basis. In addition to Enron details, subscribers can receive analysis, along with information on which companies are restructuring and whose assets are up for sale.