A Funny Thing Happened to My Ground Lease in Bankruptcy Court

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EXECUTIVE SUMMARY

Ground leases are an important – if somewhat unusual – part of the real estate finance industry. Because they typically cover large expensive properties like Rockefeller Center and The Empire State Building, to name two, and last a long time (99 years and up to start) the likelihood of something unexpected or unintended happening is high. This likelihood increases dramatically if, as highlighted below, one or both of the lease parties' files for bankruptcy. Accordingly, real estate professionals should take note and take care when entering into any transaction involving a ground lease.

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Ground leases have been around since the Middle Ages and bankruptcy laws have existed since at least Roman Times. Given this long history, it is not a surprise that a lot of law has developed on the interplay of bankruptcy and ground leases. This is particularly so since the advent of the "modern" United States Bankruptcy Act in 1898 and the extensive changes to title 11 of the United States Code implemented to it in 1978, when Chapter 11 of the United States Bankruptcy Code (the "Code") was enacted.[1] In particular, Section 365 of the Code provides special rules for the assumption or rejection of a ground lease—as well as its potential sale and transfer by a debtor to a third party.

Knowing these rules is critical to any real-estate professional. Here are the basics:

A ground lease, sometimes referred to as a "land lease," is a distinctive mechanism for the development of commercial real estate, enjoyed by those tasked with developing the Rockefeller Center and the Empire State Building, for example. The arrangement allows for prolonged lease terms often up to 99 years (with the option of renewal) for the landowner to retain ownership of the land and collect rent while the developer, in theory, may improve upon the land to its benefit as well. Both historically and presently, this atypical relationship in the real estate space generates ample conversation weighing the structure's pros and cons, which inherently grow more complicated in the face of a ground lessor or ground lessee's bankruptcy.

According to most courts, including the Second Circuit, the threshold question in analyzing the aforementioned possibilities regarding a ground lease in bankruptcy court is whether the ground lease in question is a "true lease" for the purpose of Section 365. Section 365 applies, making the ground lease eligible for, assumption or rejection, only if it is a "true lease."[2] While what exactly constitutes a "true lease" will vary state by state, it is widely accepted that "the proper inquiry for a court in determining whether § 365[] governs an agreement fixing property rights is whether 'the parties intended to impose obligations and confer rights significantly different from those arising from the ordinary landlord/tenant relationship.'" *Intl. Trade Ad. v. Rensselaer Polytechnic*, 936 F.2d 744 (2d Cir. 1991). This "intent" is determined based upon that of the parties at the time of the lease's execution. *In re Big Buck Brewery Steakhouse*, Bkrptcy No. 04-56761-SWR, Case No. 05-CV-74866 (E.D. Mich. Mar. 9, 2006). Despite there being "a 'strong presumption that a deed and lease . . . are what they purport to be,'" the economic substance of the lease is the primary determination of whether the lease is considered "true" or not, and in some states (like California), is the only appropriate factor to weigh. *Liona Corp., N.V. v. PCH Associates (In re PCH Associates)*, 804 F.2d 193 (2d Cir. 1986) *citing Fox v. Peck Iron & Metal Co.*, 25 Bankr. 674, 688 (Bankr. S.D. Cal. 1982). Generally, the further away those "economic realities" are from the ordinary landlord/tenant relationship, the less likely a lease will be

considered a "true lease" for the purpose of Section 365. *Id.* For example, if property was purchased by the lessor specifically for the lessee's use or solely to secure tax advantages, or for a purchase price unrelated to the land's value, it is less likely to be a true lease.

If the ground lease is in fact determined to be a "true lease" (and subject to court approval), the appointed trustee or debtor-in-possession in a bankruptcy case may then either assume or reject the lease as it would any other unexpired lease held by the debtor.

However, exceptions apply. These heavily rely on a debtor's "adequate assurances" to the remaining parties to the agreements. Section 365 of the Code provides that if there has been a default on a debtor's unexpired lease, the DIP may *not* assume the aforementioned lease unless, at the time of assumption, the DIP: (i) cures or provides "adequate assurance" that they will in fact "promptly cure[] such default"; (ii) compensates or provides "adequate assurance" that they will "promptly compensate" parties to the agreements (other than the debtor) for any pecuniary loss arising from such default; and (iii) offers "adequate assurance" of their future performance under that lease. *See* 11 U.S.C. § 365(b).

Unrelated to "adequate assurance" are the exceptions that further bar assignment or assumption of leases in the event that applicable law excuses a party from accepting performance from a party other than the DIP and they opt to exercise such right, *see* 11 U.S.C. § 365(c)(1); the contract's purpose is to create a loan or financing to the debtor, *see* 11 U.S.C. § 365(c)(2); or the lease at issue is of nonresidential real property and has been terminated under other (non-bankruptcy) law prior to the order for relief, *see* 11 U.S.C. § 365 (c)(3).

If, on the other hand, a DIP does not want to assume or assign the lease, it can reject any existing unexpired agreements held by the debtor. The most generally cited provision governing rejection of a lease affected by a bankruptcy case is Section 365(d)(4), which provides:

> "If the [DIP] does not assume or reject an unexpired lease of nonresidential real property under which the debtor is the lessee within [sixty] 60 days after the date of the order for relief . . . then such lease is deemed rejected, and the [DIP] shall immediately surrender such nonresidential real property to the lessor." *See* 11 U.S.C. § 365(d)(4).[3]

Courts have recently held that this rejection "has the same consequence as a contract breach outside bankruptcy," providing the counterparty a claim for damages, "while leaving intact the rights the counterparty has received under the contract." *Mission Product Holdings, Inc. v. Tempnology, LLC*, 587 U.S. ___ (2019). While this "breach-by-rejection" (a term coined by the courts) will often lead to the contract's termination, it is important to note that rejection alone will not terminate the responsibilities imposed by the lease.

Real property is idiosyncratic, and likewise, real estate financing options are countless and change daily as the market fluctuates. Ground leases are all unique.

As can readily be recognized from the summary above, dealing with a particular ground lease in the context of a Chapter 11 bankruptcy can be legally and factually complicated. Therefore, when drafting or amending ground leases, landlords, leasehold financiers, and mortgagees should consult knowledgeable legal counsel and commercial real estate professionals who understand and can explain what can happen to a particular lease in a Chapter 11 case.

For more information, contact Christopher F. Graham, Partner at grahamc@whiteandwilliams.com or 212.714.3066; or Morgan A. Goldstein, Associate at goldsteinm@whiteandwilliams.com or 475.977.8302. Or you may reach out to another member of our Financial Restructuring and Bankruptcy Practice.

[1] "Apart from certain special provisions, the Bankruptcy Code generally leaves the determination of property rights in the assets of a bankrupt's estate to state law." *See Butner v. United States*, 440 U.S. 48 (1979).

[2] If the lease examined is not a "true lease," it will be considered a "finance lease," in which the trustee or debtor-in-possession ("DIP") owns the land and the landlord is treated as the lender.

[3] Generally, "... a debtor in possession shall have all the rights ... and powers and shall perform all the functions and duties ... of a trustee serving in a case under this chapter." *See* 11 U.S. Code § 1107(a).