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Lessor's Bankruptcy: The Draftsman's Response to the Tenant's Plight

LAWRENCE H. JACOBSON*

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Introduction

Nearly every well-drafted lease has, or should have, a clause which contemplates the potential bankruptcy of the lessee. Suggested language for such a clause can be found in any form book.[1] Few, if any, leases, however, and likewise few, if any, form books consider the consequences of a lessor's bankruptcy.[2] The cases dealing with the problem are likewise sparse.[3]

* Member, Freshman, Marantz, Comsky & Deutsoh, Beverly Hills, California.

[1] See, e.g., California Continuing Education of the Bar, *Legal Aspects of Real Estate Transactions* 472 (1958); *California Forms, Leases* 510 (1968).

[2] *Id.*

[3] 4A Collier, *Bankruptcy* 539 (1971).

As a practical matter, there has been little reason to consider such a possibility. Two factors, however, dictate such a consideration now. The first is the rising use of long-term leases, such as ground leases.[4] As a result, more and more of our clients now, and in the future, will find themselves in long-term relationships with others. With any long-term relationship, there is always the risk that one or more of the parties will incur financial reverses. Even the largest lessors, of seemingly impeccable solvency, are susceptible to financial collapse. It need only be recalled that one of the largest "landlords" in the country is the Penn Central.[5] It should also be remembered that there is usually very little in the standard lease to prevent the landlord from assigning its interest to a third party, who may or may not be as solvent.

A second factor is, of course, the always uncertain condition of the economy. The cyclical nature of the economy is an ever-present fact of financial life. The recent downward cycle in the economy (both domestic[6] and foreign[7]), has already seen the biggest bankruptcy in this nation's history, the Penn Central (with lessee creditors joining what has been called a "bitter struggle to get hold of the company's assets" [8]). Businesses, both large and small, are experiencing economic failures in unprecedented numbers.

In 1970 there were 194,399 bankruptcies filed. Of these, 115 were corporate reorganizations.[9] In 1970 alone, there were 10,748 industrial and commercial failures.[10] Based on 1970 figures, each year forty-four out of every 10,000 businesses operating will fail. This does not include railroads or real estate and financial companies.[11] Although it can reasonably be assumed that any down-

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[4] See, e.g., Grenert, *Ground Lease Practice* (1971).

[5] "The Biggest Bankruptcy Ever," Time, July 6, 1970, pp. 58-60.

[6] See, e.g., "Is the U.S. Going Broke?" Time, March 13, 1972, pp. 66-74.

[7] See, e.g., "Signs of Worldwide Business Crisis," U.S. News & World Report, Oct. 4, 1971, pp. 15-17.

[8] "Who's Hit by Biggest Bankruptcy," U.S. News & World Report, July 20, 1970, p. 26.

[9] U.S. Dep't of Commerce, *Statistical Abstract of the United States, 1971,* p. 476 (1971).

[10] *Id.*

[11] *Id.* at 475.

ward cycle will reverse itself, it is clear that over the next twenty to thirty years similar declines should be anticipated by prospective lessees.

Tenant's Remedies

Background

Where is the tenant left when the lessor goes bankrupt? The basic starting point in any bankruptcy in the leasehold area is Section 70b of the Bankruptcy Act, which provides:

> "The trustee shall assume or reject an executory contract, including an unexpired lease of real property, within sixty days after the adjudication or within thirty days after the qualification of the trustee, whichever is later, but the court may for cause shown extend or reduce the time. Any such contract or lease not assumed or rejected within that time shall be deemed to be rejected. If a trustee is not appointed, any such contract or lease shall be deemed to be rejected within thirty days after the date of the order directing that a trustee be not appointed. A trustee shall file, within sixty days after adjudication or within thirty days after he has qualified, whichever is later, unless the court for cause shown extends or reduces the time, a statement under oath showing which, if any, of the contracts of the bankrupt are executory in whole or in part, including unexpired leases of real property, and which, if any, have been rejected by the trustee. *Unless a lease of real property expressly otherwise provides, a rejection of the lease or of any covenant therein by the trustee of the lessor does not deprive the lessee of his estate.* A general covenant or condition in a lease that it shall not be assigned shall not be construed to prevent the trustee from assuming the same at his election and subsequently assigning the same; but an express covenant that an assignment by operation of law or the bankruptcy of a specified party thereto or of either party shall terminate the lease or give the other party an election to terminate the same is enforcible. A trustee who elects to assume a contract or lease of the bankrupt and who subsequently, with the approval of the court and upon such terms and conditions as the court may fix after hearing upon notice to the other party to the contract or lease, assigns the contract to a third person, is not liable for breaches occurring after the assignment." [Emphasis added.]

This provision was first added to the bankruptcy law by the Chandler Act in 1938. Prior to that time, there was neither a specific right granting the trustee the power to reject an executory

contract nor a provision protecting the tenant's leasehold in the event of a rejection, such rights being left to case law.[12]

The reason for granting the right to reject by the lessor's trustee is allow him to reject covenants to repair or build beyond the capital of an insolvent.[13]

The reason for the clause preserving the tenant's right to the estate is clear. It "is an obvious equitable safeguard for an innocent party who has based his affairs on the term provided in the lease. . . . [T]o do otherwise would be going unreasonably far in protecting the right of the bankrupt." [14] A tenant should not be required to give up a good location solely because of the failure of the lessor.[15]

Tenant's Estate

What, then, is considered a part of the tenant's estate? An "estate" is defined as "the interest which any one has in lands. . . ." [16] This definition is of little practical help. One must look to the executory obligations of the lessor. "If, prior to bankruptcy, this bankrupt as lessor made a valid lease of real property, without any covenants requiring performance in the future, the bankruptcy court would have no power to disturb the transaction, no more than it would have power to disturb a valid and completed sale of an automobile or other chattel." [17]

Thus, if your lessee-client has entered into a long-term triple net ground lease, with no obligation remaining to be performed on the part of the lessor, the lessor's bankruptcy should have little effect on the lessee. If, however, your lessee-client has leased floor space on the twentieth floor of an office building, the lessor's obligations to supply heat, electricity, air conditioning, and elevator service are of critical importance to the lessee.

Does the trustee have a right to reject these covenants, or would

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[12] 4A Collier, note 3 *supra,* at 539.

[13] Creedon & Zinman, "Landlord's Bankruptcy: Laissez Les Lessees, 26 Bus. Law. 1391, 1406 (1971).

[14] 4A Collier, note 3 *supra,* at 1540.

[15] Creedon, note 13 *supra,* at 1406.

[16] *Black's Law Dictionary* 645 (4th ed. 1951).

[17] 6 Collier, note 3 *supra,* at 596.

he be precluded because such rejection would "deprive lessee of his estate"? The authorities are sparse. Collier infers that such covenants may be rejected when he states "the fact that the lease made by the debtor as landlord, instead of being without covenants requiring future performance, contains a covenant requiring the debtor to furnish heat, should not enable the court to disturb the executed portion of the lease and divest the lessee of his estate in the property." [18]

Case law is equally meager.[19] One of the few cases to consider this problem was *American Brake Shoe & Foundry Co. v. New York Railways,*[20] decided prior to the enactment of Section 70(b). *In American Brake Shoe,* the receiver as lessor sought to curtail the furnishing of heat, electric current, etc. A special master held that the receiver may so disaffirm. The court rejected the special master's findings and held that such obligations may be disaffirmed only if they are a burden of the estate "that in carrying out its affirmative obligations the estate suffers an actual loss as distinguished from the obtaining of a more profitable rent." [21]

Term of the Tenant's Estate

A similar problem concerns the term of the estate. Does the term include option years? Two California cases, neither dealing with bankruptcy, taken separately shed some light on the subject. Taken together, however, they only cloud the picture more. In the first of these cases, *Erickson v. Boothe,*[22] defendant leased land with an option to renew from decedent. Decedent died prior to the expiration of the initial term, and defendant filed no claim in the probate proceedings asserting his option right, Plaintiff-executrix sought declaratory relief that the defendant, therefore, had forfeited his right to the renewal term. The court held for the defendant-lessee, stating that "options for renewal . . . are generally held to be in the nature of a *present* demise for the *full period including the renewal period.*" [23] This case has been cited by com-

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[18] 8 *id.* at 232.

[19] Creedon, note 13 *supra,* at 1404-1409.

[20] 278 F. 842 (S.D.N.Y. 1922).

[21] *Id.* at 844.

[22] 79 Cal. App. 2d 266 (1947).

[23] *Id.* at 272.

mentators as authority for the proposition that a renewal term is part of the lessee's estate and cannot be rejected by the trustee.[24]

A contrary result, however, was reached in *Klepper v. Hoover*.[25] In *Klepper*, plaintiff leased land from defendant for agricultural purposes for ten years, with an option to renew. At the time of execution of the lease, California Civil Code Section 717 prohibited leases of agricultural land for terms in excess of fifteen years.[26] In an action for declaratory relief, the defendant-lessor contended that the option term was a present demise creating a term of twenty years, and that the entire lease must, therefore, fall as a violation of Section 717. The plaintiff-lessee argued that both the lease and the option were valid, the option creating only a contractual right, not an interest in the land. The court adopted the plaintiff-lessee's position, holding that

> "[U]ntil such time as the option to extend is exercised, the lessee has only a contractual right to extend the lease, rather than any estate in the land beyond the original term. If the option is exercised, the assignee will then have an additional 10-year term, for a total of 20 years, valid under the 51-year limitation of Civil Code Section 717, as amended in 1963. We reject the contention that by a fictional process of relation-back to 1962, the lease must be deemed to be a 20-year lease from its inception and void under Section 717 as it then existed. *Only when the option is exercised does the lease become one for 20 years*." [27] [Emphasis added.]

The defendant-lessor had relied on *Erickson v. Boothe*[28] for the proposition that options for renewal effect a present demise for the full period, including the renewal period. The court distinguished rather than overruled *Erickson*, noting that the lessee had made substantial improvements and that the court upheld the option terms to prevent a forfeiture. "By adopting a 'present demise' theory, the court was able to reach an equitable result in accordance with the obvious intention of the parties. To apply the

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[24] Creedon, note 13 *supra*, at 1411.

[25] 21 Cal. App. 3d 460 (1971).

[26] In 1963 the California Legislature amended Section 717, effective September 21, 1963, to allow such leases for terms up to fifty-one years.

[27] 21 Cal. App. 3d at 464-465.

[28] Note 22 *supra*.

Erickson rule to the facts of our case would work an inequitable result contrary to the intention of the parties." [29]

After *Klepper,* which not only did not overrule *Erickson* but also clearly indicated that decisions would be made on a case-by-case basis, it is now more uncertain than ever in California whether an option period is part of the lessee's "estate." The conflict between the *Erickson* and *Klepper* approaches in California exists in other jurisdictions as well. Thus, while some states follow the present-demise theory,[30] others follow the contractual-right theory,[31] while still others follow both.[32] Since the bankruptcy court may turn to State law for guidance in the construction of leases,[33] we may still anticipate a series of conflicting decisions on this question.

Damages

What is the position of the tenant, when the lessor's trustee has rejected covenants to be performed by the lessor? To the extent that the tenant is injured thereby he can file a claim under Section 63(a)(9) of the Act, which provides, in part:

> "Debts of the bankrupt may be proved and allowed against his estate which are founded upon claims for anticipatory breach of contracts, executory in whole or in part, including unexpired leases of real or personal property: *Provided, however,* that the claim of a landlord for damages for injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall in no event be allowed in an amount exceeding the rent reserved by the lease, without acceleration, for the year next succeeding the date of the surrender of the premises to the landlord or the date of reentry of the landlord, whichever first occurs, whether before or after bankruptcy, plus an amount equal to the unpaid rent accrued, without acceleration, up to such date."

[29] 21 Cal. App. 3d at 465.

[30] Ackerman v. Loforese, 111 Conn. 700, 151 A. 159 (1930); Pritchett v. King, 56 Ga. App. 788, 194 S.E. 44 (1937); Kourie Bros. v. Jonakin, 222 Ky. 277, 300 S.W. 612 (1927); Willoughby v. Atkinson Furnishing Co., 93 Me. 185, 44 A. 612 (1899).

[31] Groth v. Continental Oil Co., 84 Idaho 409, 373 P.2d 548 (1962); Hindu Furnace Mfg. Co. v. MacKenzie, 403 Ill. 390, 86 N.E.2d 214 (1949); Martin v. Martin, 181 So. 63 (1938); Wolf v. Tastee Freez Corp., 172 Neb. 420, 109 N.W.2d 733 (1961); Mayer v. Layfmen, 140 N.J. Eq. 68, 53 A.2d 187 (1947).

[32] E.g., compare Best Realty Corp. v. Luftig, 234 N.Y.S.2d 462 (N.Y.C. Civ. Ct. 1962).

[33] *American Brake Shoe & Foundry Co.,* note 20 *supra,* at 843.

The difficulty of establishing the value of lost elevator service, etc., and the fact that by definition your debtor is insolvent do not make this a terribly appealing solution.

More ominous, however, is the possibility that notwithstanding the rejection by the trustee, your lessee-client may still be locked into the full performance of *his* obligations under the lease. The mere fact that the lessor is not performing his obligations does not give rise to a corresponding right of the lessee not to perform his obligations. A covenant to repair on the part of the lessor and a covenant to pay rent on the part of the lessee are usually considered independent covenants.[34]

Thus, the court in *Goldsmith v. Tub-O-Wash*[35] held that "covenants in leases are held to be mutually independent unless the lease expressly or impliedly makes them conditional." Likewise, in *Hosang v. Minor*,[36] the court stated: "A covenant to repair on the part of the lessor and a covenant to pay rent on the part of the lessee are usually considered as independent covenants, and unless the covenant to repair is expressly or impliedly made a condition precedent to the covenant to pay rent, the breach of the former does not justify the refusal on the part of the lessee to perform the latter." [37]

Rescissions

Two avenues are open at that point to your lessee-client: (1) if the breach is serious enough he could argue material breach and seek rescission of the lease; or (2) he could offset his rent and apply it to the cost of these obligations. There is only limited authority supporting the first of these approaches. The principal case appears to be *In re Civic Center Realty Co.*,[38] which held that the bankruptcy of a lessor owning an eighteen-story, heavily encumbered office building released the lessee from an executory lease of part of the premises in view of the possible inability of the trustee to perform the lessor's covenants requiring heat, light, and janitor

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[34] See 49 Am. Jur. 2d, "Landlord and Tenant" § 617.

[35] 199 Cal. App. 2d 132 (1962).

[36] 205 Cal. App. 2d 269 (1962).

[37] *Id.* at 272.

[38] 26 F. 825 (D. Md. 1928).

service. The case, however, has not been relied upon by any later decision.

California Civil Code Section 1942(a) (discussed below) is an example of a statutory provision giving a limited right to the lessee to vacate the premises. This approach, however, is of little solace if the lessee wants to retain his interest in the land.

The lessee could rely for support for the second approach on statutes like California Civil Code Section 1942, which provides that if within a reasonable time after notice to the lessor of dilapidations which he ought to repair, he neglects to do so, the lessee may repair the same himself, where the cost of such repairs does not require an expenditure greater than one month's rent of the premises, and deduct the expenses of such repairs from the rent, or the lessee may vacate the premises, in which case he shall be discharged from further payment of rent, or performance of other conditions.[39]

In California, "dilapidations which he ought to repair" are those that render the building "untentable" [40] [sic]. "Untentable" is defined by California Civil Code Section 1941.1 as the substantial lack of

> Effective waterproofing and weather protection of roof and exterior walls, including unbroken windows and doors;
> Plumbing facilities;
> A water supply approved under applicable law;
> Heating facilities;
> Electrical lighting;
> A sanitary building free from all accumulation of debris, filth, etc.;

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[39] This provision traces its origins in the original Field Code adopted by California in 1871. Official Revision Comm'n, Revised Laws of the State of California, In Four Codes: Civil Code (1871). Accordingly, similar provisions should be found in other jurisdictions which likewise adopted the Field Code. California's provisions were taken from New York's set forth in Sections 990 and 991 of the original New York Civil Code. See also Levi, Hablutzel, Rosenberg & White, *Model Residential Landlord-Tenant Code* (1969), which provided much of the substantive material of the recent California legislative changes in this area. For a discussion generally of the tenant's rights to make repairs at the landlord's expense, see Rose, *Landlords and Tenants: A Guide To The Residential Rental Relationship* § 6.33 (1972).

[40] Cal. Civ. Code § 1941.

An adequate number of appropriate receptacles for garbage and rubbish; and

Floors, stairways, and railings maintained in good repair.

Negotiating the Lease

As can readily be seen, virtually every case, absent express lease provisions, will turn on the particular facts. The consequences to the lessee of an adverse decision are too substantial to be left to a third-party interpretation. To the extent the lease can avoid these problems by anticipating them beforehand, it should be so drafted.

What action can the lawyer take in drafting or negotiating the lease to protect his lessee-client? Since each lease turns on its own particular facts, no attempt will be made to set forth model clauses. However, certain areas should be considered.

Termination on Landlord's Bankruptcy

The most obvious clause would be a lessee counterpart of the lessor's bankruptcy clause. Certainly, what is sauce for the goose should be sauce for the gander. If the lessor has the option of terminating the lease when the lessee becomes bankrupt, then the lessee should have that same option. This clause will avoid putting the lessee in the position of having to establish materiality of breach. If the lessor balks at this kind of clause, you can fall back to the position that the lessee may exercise the option to terminate only if the lessor's trustee rejects part of the lessor's obligations.

Rent Reduction

A second possible clause would provide for a reduction of rent in the event that certain services are curtailed. Care must be taken in that regard so that the clause does not cross over the line and become a forfeiture clause.[41]

Security Deposit

A third possible clause should focus on the security deposit. The present trend is to protect the security deposits posted by tenants.[42]

[41] Where the recoverable damages are determined in advance and there has been no relationship to the actual damages, they are viewed as a penalty as to the breaching party and, therefore, are not favored by the courts. 17 Am. Jur. 2d, "Contracts" § 499. See also Cal. Civ. Code §§ 3275, 3369.

[42] "Landlords have already been confronted recently by dissatisfied tenants in the form of tenant unions and coalitions of tenants' organizations intent on altering the current uncertain status of security deposits." "Legal

In this regard, California has recently added Section 1951 to the California Civil Code. This section provides, in part:

> "(a) Any payment or deposit of money the primary function of which is to secure the performance of a rental agreement or any part of such an agreement, other than a payment or deposit, including an advance payment of rent, made to secure the execution of a rental agreement, shall be governed by the provisions of this section.
> "(b) Any such payment or deposit of money shall be held by the landlord for the tenant who is party to such agreement. The claim of a tenant to such payment or deposit shall be prior to the claim of any creditor of the landlord, *except a trustee in bankruptcy*."

Other states may be expected to follow this lead.

Taking our cue from provisions of this type, the security deposit should be insulated to the extent necessary to protect it from the lessor's trustee. Strong objections, however, can be expected to such a provision since by so doing, the lessor might be deprived of his security in the event of the *lessee's* bankruptcy.

An acceptable compromise might well be to deposit the security deposit in a blocked savings account, requiring the signatures of both landlord and tenant to withdraw the funds. Another possibility would be to give the tenant a security interest in some property of the landlord to secure repayment of the security deposit.

Recognizing that Section 70b protects the lessee's "estate," the lease can be used as a means of setting forth the parties' intent as to what obligations are to be considered part of that estate and what obligations are merely executory obligations of the lessor. Keep in mind, also, that the lease is the best place to set forth the parties' intentions as to whether an option or renewal term was intended to be a present demise.[43]

Conclusion

As you can see, if you represent the lessee, it is far better to consider the consequences of the lessor's bankruptcy when negotiating the lease, instead of waiting for the lessor's trustee to notify you that he is rejecting a portion of the lease. The failure to do so could well prove costly to your lessee-client.

Problems of Landlord and Tenant," 3 U. Cal. (Davis) L. Rev. 38 (1971).

[43] The court in *Klepper v. Hoover,* note 25 supra, has indicated, as previously noted, that the question whether an option period is a present demise is one of the intentions of the parties, not a strict question of law.