CT Bankruptcy Beat
Legal Developments in Restructuring and Creditors' Rights

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Can a Lease Terminated Under State Law be Revived in the Tenant's Bankruptcy?

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by Irve J. Goldman

In these troubled times when lease and other contract defaults, as well as bankruptcies, abound, it may be useful to reexamine what happens to a lease of commercial real estate when it has been terminated in accordance with state law and the tenant thereafter files for bankruptcy protection before the eviction process is started or completed. This question is made even more topical by the Connecticut Supreme Court's recent decision in *Boccanfuso v. Daghoghi*¸ 2020 WL 5823337 (Sept. 30, 2020), which undertakes a review and clarifies certain elements of the doctrine of equitable nonforfeiture under Connecticut law. As we will see, that doctrine plays an important role in how the lease will get treated in a tenant bankruptcy.

In general, when a commercial tenant files for bankruptcy protection under chapter 11, it will have a period of 120 days to decide whether to "assume" or "reject" "an unexpired lease of nonresidential real property," subject to limited extensions of time to make that decision, first for a period of 90 days for "cause" and thereafter only with the landlord's consent. 11 U.S.C. §365(d)(4)(A), (B). In order to assume an unexpired lease, the lessee must promptly cure all lease defaults, compensate the landlord for any damages caused thereby and provide adequate assurance of future performance under the lease. 11 U.S.C. §365(b)(1). If the lease is rejected, it will be considered to give rise to a prepetition (*i.e.* pre-bankruptcy) breach of contract claim, 11 U.S.C. §365(g)(1), which will be limited to the rent that would be due for the greater of one year or 15% of the remaining term of the lease, not to exceed three years, plus any unpaid rent of the bankruptcy filling date. 11 U.S.C. §502(b)(6).

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A separate section of the Bankruptcy Code, however, precludes a trustee or chapter 11 debtor from assuming a "lease ... of nonresidential real property [that] has been terminated under applicable nonbankruptcy law prior to the order for relief." 11 U.S.C. §365(c)(3). In Connecticut, in order to terminate a lease upon a default such as nonpayment of rent or other violation of the lease, the "'landlord must perform some unequivocal act which clearly demonstrates his intent to terminate lease'." *Lyons v. Citron*¸ 182 Conn. App. 725, 732, 191 A.3d 239, 245 (2018) (quoting *Bridgeport v. Barbour-Daniel Electronics, Inc.*, 16 Conn. App. 574, 583, 548 A.2d 744 n. 8 (1988). "Service of a notice to quit is typically a landlord's unequivocal act notifying the tenant of the termination of the lease," and it is also a prerequisite to instituting a summary process action to evict the tenant. *Centrix Management Co. LLC v. Valencia,* 132 Conn. App. 582, 587, 33 A.3d 802 (2011). Importantly, in order for the notice to have its intended effect, the landlord must provide any pre-termination notices of default, or rights to cure, which the lease might require. *See Thomas E. Golden Realty v. Society for Savings*¸ 31 Conn. App. 575, 580, 626 A.2d 788 (1993); *Windsor Properties Inc. v. The Great Atlantic and Pacific Tea Company*, 35 Conn. Supp. 297, 302 408 A.2d 936 (1979).

In the late 1980s, Judge Shiff of the Connecticut Bankruptcy Court issued a series of decisions adopting a two-part test for determining whether a lease that is purportedly terminated prior to a bankruptcy filing can be "assumed" by the debtor in its bankruptcy case. The first part asks whether the lease was terminated prepetition under state law and the second step requires a determination of "whether the termination would be reversed under the state's nonforfeiture doctrine." *In re Masterworks*¸ 94 B.R. 262, 265 (Bankr. D. Conn. 1988). *See also In re M & R Apparel, Inc.*, 92 B.R. 565, 569 (Bankr. D. Conn. 1988); *In re Oyster Club of Greenwich Ltd. Partnership*¸ 98 B.R. 654, 656 (Bankr. D. Conn. 1989). If it is determined that a lease was properly terminated and would not be able to be revived under the state's nonforfeiture doctrine, the landlord would be granted relief from the automatic stay to proceed with eviction. *Masterworks*, 94 B.R. at 268.

This brings us to the Connecticut Supreme Court's recent decision in *Boccanfuso v. Daghoghi*¸ 2020 WL 5823337 (Sept. 30, 2020). In that case, the Supreme Court explored how the deliberate withholding of rent by a tenant might disqualify it from using equitable nonforfeiture to save the lease. The tenant there withheld payment of rent to the landlord for the ostensible reason that there were environmental problems with the leased property. The landlord nonetheless served a notice to quit, and in the ensuing eviction action, the tenant sought to prevent termination based on equitable nonforfeiture. The housing court found, and the Supreme Court accepted as fact, that the tenant's claimed reason for not paying rent was not genuine, but was done as a means to stay in business and get the landlord's attention.

In reaching its conclusion, the Court reviewed the doctrine as applied "to summary process actions for nonpayment of rent," and reiterated that it may successfully be used "'if (1) the tenant's breach was not wilful [sic.] or grossly negligent; (2) upon eviction the tenant will suffer a loss wholly disproportionate to the injury to the landlord; and (3) the landlord's injury is reparable'." *Id.* at *6 (quoting *Cumberland Farms, Inc*. v. *Dairy Mart, Inc*., 225 Conn. 771, 778, 627 A.2d 386 (1993)). It further explained that a tenant's failure to

demonstrate the first requirement, that its failure to pay rent was not willful or grossly negligent, will bar any relief under the equitable nonforfeiture doctrine. *Id.*

As a further point of clarification, the Court concluded based on its prior precedent that a tenant's intentional nonpayment of rent will not necessarily require a finding that the nonpayment was willful if it "is accompanied by a good faith intent to comply with the lease or a good faith dispute over the meaning of a lease." *Id.* It held, however, that withholding rent in order to "stay in business" or draw the landlord's attention to the tenant's difficult financial circumstances was not the type of good faith required to negate a "willful" nonpayment. *Id.* at *7.

Thus, under *Boccanfuso*, a tenant cannot withhold rent as a negotiating tool for the abatement or restructuring of its rent payments and expect to save the lease from forfeiture under the nonforfeiture doctrine. However, *Boccanfuso's* underlying events occurred in 2014 – well before the COVID-19 pandemic and ensuing government orders. Therefore, it appears to be an open question as to whether nonpayment of rent will be considered "willful" where, for example, there is a government shutdown affecting the tenant's business or if there is an arguably applicable force majeure clause in the lease that might excuse performance due to the current economic and national health crisis we are now undergoing.

In a tenant bankruptcy, if the previously cited Connecticut bankruptcy decisions are followed, bankruptcy courts will essentially be performing the functions of a state housing court in determining whether a terminated lease "would be saved" under the state's nonforfeiture doctrine, with the recent decision in *Boccanfuso* to serve as a guide in making that determination. Other courts faced with this situation, however, have granted the landlord relief from the automatic bankruptcy stay so the state courts can make that decision. *See e.g. In re Sweet N Sour 7th Ave. Corp.*, 431 B.R. 63, 69-70 (granting relief from the stay to allow debtor to seek to vacate a warrant of eviction issued under New York law, but conditioning the continuation of the stay in all other respects on timely payment of postpetition rent under the lease).

While these issues are getting sorted out in a bankruptcy, what about the payment of rent? The Bankruptcy Code requires that a tenant under an "unexpired" commercial real estate lease must continue to pay rent, 11 U.S.C. §365(d)(3), but there is a legal question as to whether a lease that was terminated prior to bankruptcy is considered "unexpired." The Second Circuit Court of Appeals has held that if the tenant in bankruptcy has the power to revive a terminated lease under state law, the lease will be considered "unexpired" for purposes of possible later assumption or rejection in the bankruptcy case, but it left open the question of whether that meant that rent had to paid per the lease terms as required by 11 U.S.C. §365(d)(3). *Super Nova 330 LLC v. Gazes*, 693 F.3d 138, 143 (2d Cir. 2012). Prior to that decision, at least one bankruptcy court held that if there is a possibility under state law to reverse the termination, the lease will be considered "unexpired" and the tenant will be obligated to continue to pay the rent fixed in the lease during the bankruptcy, as Bankruptcy Code §365(d)(3) requires. *In re P.J. Clarke's Restaurant Corp.*¸ 265 B.R. 392, 398-400 (Bankr. S.D.N.Y. 2001).

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