

Landlords Beware: Bankruptcy Court Litigation Could Come at a Cost

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Those who lease commercial property may find themselves unwilling participants in complex proceedings before the U.S. bankruptcy courts when a tenant files bankruptcy. Meanwhile, the lease becomes an asset among the "property of the estate" of the debtor, and the automatic stay imposed by U.S. Bankruptcy Code¹ serves to halt all collection and eviction activity in their tracks.

In light of the fast-pace of many Chapter 11 reorganizations, often involving going-concern sales, it is imperative that a landlord be vigilant in monitoring the case and asserting lease and Bankruptcy Code-provided rights timely and effectively. In any Chapter 11 case, the debtor must make the decision to either reject or assume each of its executory contracts and unexpired leases, with notice and opportunity to be heard.² If a debtor rejects a contract deemed burdensome, the debtor will be relieved of its obligation to perform, and the non-debtor party is left with a pre-petition claim for damages for breach of contract.³ In the alternative, the debtor can seek to assume an executory contract or lease and affirmatively elect to be bound by its terms, burdens and benefits.⁴ The debtor cannot assume a contract, however, without first meeting certain statutory conditions delineated in Section 365 of the Bankruptcy Code. The debtor must, among other things, "cure" outstanding defaults under the contract or "provide adequate assurance" that it will do so; and

"provide adequate assurance of future performance" after the contract is assumed.⁵

Since assumption may represent the only mechanism for a creditor to recover the prepetition arrearage owed under a contract, assumption is generally favored over rejection in ordinary market conditions.⁶ There may be circumstances, however, when the landlord has determined that it prefers instead that the tenancy terminate. In that instance, the landlord could file an objection to the debtor's motion to assume the lease, arguing, for instance, that the debtor's proposed "cure" payment is not sufficient or that other statutory requirements for assumption are not met.

A recent decision from the U.S. Bankruptcy Court for the Central District of California in the *In re Hawkeye Entertainment LLC (Hawkeye)* bankruptcy case⁷ is a good reminder to review the subject lease terms and factual record carefully to assess if the cost of achieving the desired result outweighs any corresponding benefit.

The *In re Hawkeye Entertainment LLC* Decision

When litigation is initiated in the United States, it is well-settled that each party must typically bear the cost of hiring legal counsel, even in victory, under a principle not coincidentally referred to as the American Rule.⁸ However, the American Rule has exceptions.⁹ For instance, if the dispute centers around a contract, a party that prevails in litigation *may* be entitled to recover its attorneys' fees from the losing opponent if 1) the parties have entered into a contract that shifts attorney's fees to a prevailing party or 2) a statute provides for fee shifting.¹⁰ These same concepts govern the allocation of attorneys' fees in disputes that find their way to the U.S. bankruptcy

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1 11 U.S.C. § 101, *et. seq.*

2 11 U.S.C. § 365(b)(1). With certain exceptions, in a Chapter 11 reorganization, the debtor may assume or reject an executory contract or unexpired lease at any time prior to the confirmation of a plan of reorganization, or pursuant to a plan. 11 U.S.C. § 365(d)(1).

3 11 U.S.C. § 365(g).

4 11 U.S.C. § 365(a).

5 11 U.S.C. § 365(b).

6 Once the debtor has satisfied the Bankruptcy Code provisions relating to assumption and obtained authority of the bankruptcy court to assume a contract or a lease, the debtor may seek to assign that contract for value to a third-party. To accomplish assignment, a debtor must demonstrate to the non-debtor party adequate assurance of future performance under the contract by the potential assignee. A debtor may take these steps even though a provision of the contract purports to limit or restrict such assignment. 11 U.S.C. § 365(f).

7 See *In re Hawkeye Entm't, LLC*, No. 1:19-bk-12102-MT, 2021 WL 665734 (Bankr. C.D. Cal. Feb. 19, 2021).

8 See *Baker Botts L.L.P. v. Asarco LLC*, 576 U.S. 121, 135 S. Ct. 2158, 2164, 192 L.Ed.2d 208 (2015) (quoting *Hardt v. Reliance Standard Life Ins. Co.*, 560 U.S. 242, 252-53, 130 S.Ct. 2149, 176 L.Ed.2d 998 (2010)).

9 For instance, a presiding trial court has the ability to award attorneys' fees to one party as a sanction for unscrupulous behavior or for advancing frivolous claims. See, e.g., Fed. R. Bankr. P. 9011 (court may award sanctions if claims or defenses presented by a party are, for instance, presented for an "improper purposes, such as harassment or delay" or "lack evidentiary support."); *Chambers v. NASCO, Inc.*, 501 U.S. 32, 45-56 (1991); Fed. R. Bankr. P. 8020 (court may award damages and costs to appellee in connection with frivolous appeal).

10 See, e.g. *In re Kittel See Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 247, 257-59, 95 S.Ct. 1612, 44 L.Ed.2d 141 (1975); *Bennett v. Coors Brewing Co.*, 189 F.3d 1221, 1237-38 (10th Cir. 1999).

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courts, albeit, again, with nuances and exceptions.¹¹ While a party involved in a dispute before a bankruptcy court does not hold a general right to recover attorneys' fees incurred in litigating purely bankruptcy law issues, a bankruptcy court may award fees and costs where there is a specific statutory¹² or contractual basis to do so.¹³

Against this general backdrop, the bankruptcy court had the opportunity in the *Hawkeye* bankruptcy to consider whether to award attorneys' fees to a debtor as the "prevailing party" in a contested matter under California fee-shifting statutes. *Hawkeye Entertainment LLC* (Debtor), had leased commercial space in Los Angeles from Smart Capital LLC, as landlord (Lessor), pursuant to a written lease agreement (Lease). The Debtor also had entered into a sublease for the leased premises (Sublease). By the time the *Hawkeye* Chapter 11 case was filed in 2019, the Debtor had already expended a substantial sum to preserve its tenancy through an earlier Chapter 11 bankruptcy case filed to prevent forfeiture of the Lease. Those disputes were ultimately resolved and the Lease was assumed, although the relationship remained contentious thereafter. After the conclusion of the first bankruptcy case, the landlord again attempted to terminate the Lease, culminating in the filing by the Debtor of a second Chapter 11 case and a motion to assume the Lease and Sublease (Assumption Motion) over objection by the landlord. After extensive discovery, the bankruptcy court conducted a five-day trial to determine if the Assumption Motion had merit, focusing in large part on whether the Debtor had defaulted under the express provisions of the Lease as the landlord had alleged. The bankruptcy court ultimately held that the record demonstrated that no events of default had occurred and entered an order granting the Assumption Motion (Assumption Order). The landlord appealed

the Assumption Order to the U.S. District Court for the Central District of California, an action that is pending.

Having prevailed before the bankruptcy court, the Debtor filed a motion pursuant to Federal Rule of Bankruptcy Procedure 7054(d)¹⁴ for an award of attorneys' fees totaling more than \$815,000 (Fee Motion) from the landlord, an effort the landlord challenged. In considering the merits of the Fee Motion, the bankruptcy court looked to California law as the Lease required to determine if an exception to the American Rule supported the Debtor's requested relief. The bankruptcy court observed that California law unequivocally provides that parties may agree to allocation of attorneys' fees between them in their agreements and that fee shifting is enforceable by the "prevailing party" under California Code of Civil Procedure (CCP) § 1021 and 1032.¹⁵ Separately, in an action "on a contract," California Civil Code (CCC) § 1717 authorizes an award of attorneys' fees and costs to a prevailing party if "the contract specifically provides that attorney's fees and costs, which are incurred to enforce that contract, shall be awarded either to one of the parties or to the prevailing party." The Lease expressly and broadly provided that if either party instituted an "action or proceeding against the other relating to the provisions of [the] Lease," the "party not prevailing" was obligated to reimburse the "prevailing party" for its attorneys' fees and costs incurred in connection with that action or proceeding.

In considering the Fee Motion, the bankruptcy court first undertook to determine if each of the disputes that had been intertwined with the Assumption Motion constituted the Lease-required "action or proceeding" under contract interpretation principles. In doing so, the bankruptcy court held that the litigation involving the Assumption Motion – a proceeding required to protect the Debtor's

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11 For instance, in *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007), the Supreme Court held that if a prepetition contract allocating attorneys' fees is enforceable under non-bankruptcy law, that contract may support a claim against a debtor to recover the value of attorneys' fees incurred by a creditor enforcing its rights during the bankruptcy case, unless the Bankruptcy Code expressly provides otherwise. Separately, Bankruptcy Code Section 506 authorizes over-secured creditors to include reasonable amounts for attorneys' fees and costs in the balance of their secured claims as provided for by the underlying loan agreement or State statute.

12 Section 523(d) mandates that the bankruptcy court award attorneys' fees and costs to a prevailing debtor if a creditor requests a determination of dischargeability under § 523(a)(2) as to consumer debt, "without substantial justification." 11 U.S.C. § 523(d). In addition, an individual injured by a willful violation of the automatic stay may recover attorneys' fees. See 11 U.S.C. § 362(h).

13 See, generally, *In re Circle Star Center Assoc., L.P.*, 147 Cal.App.4th 1203 (2007); *Ford v. Baroff (In re Baroff)*, 105 F.3d 439, 441 (9th Cir. 1997) (debtor was entitled to attorneys' fees under agreement's provision and state law after defeating Section 523(a) claim based on fraud); *In re Parsons*, 272 B.R. 735, 756 (D. Colo. 2001) (bankruptcy court may award attorneys' fees where there is statutory or contractual basis authorizing award; see also *In re Shangra-La, Inc.*, 167 F.3d 843, 847-49 (4th Cir. 1999) (under § 365(b), attorneys' fees can be part of damages paid to cure default and assume lease, if recoverable under contract and state law); *In re Crown Books Corp.*, 269 B.R. 12, 15-18 (Bankr. D.Del. 2001) (same).

14 Fed. R. Bankr. P. 9014 (c) makes Fed. R. Bankr. P. 7054(d) applicable to contested matters, and in turn, Fed. R. Civ. P. 54(d) establishes a procedure for moving to recover attorneys' fees.

15 California Code of Civil Procedure ("CCP") § 1021 allows recovery of attorney's fees by "the agreement, express or implied, of the parties." CCP § 1032(b) entitles a "prevailing party" to "recover costs" as a matter of right "in any action or proceeding." Costs may include attorney's fees when authorized by the parties in their respective contract, even when the action is not "on a contract." See CCP § 1033.5(a)(10). CCP § 1032(a)(4) defines a "prevailing party" to include (a) the party with a net monetary recovery; (b) a defendant in whose favor a dismissal is entered; (c) a defendant where neither plaintiff nor defendant obtains any relief; and (d) a defendant as against those plaintiffs who do not recover any relief against that defendant."

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contractual rights – was that action. (See *Hawkeye*, 2021 WL 665734, at *7-*8). With the contractual prerequisite to recovery of fees in place, the bankruptcy court next considered whether the Assumption Motion involved an action "on a contract" in order to invoke CCC § 1717 in favor of the Debtor (See *Id.* at *8-*9). The bankruptcy court found that since the "terms and rights of the parties under the [Lease] were central to every aspect of the Assumption Motion," the associated litigation was indeed "on a contract."¹⁶ Finally, the bankruptcy court determined the Debtor to be the "prevailing party" for purposes of CCC § 1717, since it was the party that had "recovered a greater relief in the action on the contract" (See *Id.* at *10 (citing CCC § 1717(b)(2))). With these findings in the Debtor's favor, the bankruptcy court issued its Final Order and Judgment for an Award of Attorneys' Fees (Fee Order) on March 8, 2021, awarding the Debtor attorneys' fees of nearly \$606,000 against the landlord.¹⁷ The landlord since filed a motion seeking reconsideration of the Fee Order in order to delay effectiveness of the Fee Order until the appeal has concluded. After a hearing regarding that request, the bankruptcy court determined that a slight reduction in the fee award was warranted for fees incurred in October, 2020, but denied the landlord's request for a stay. This order has also been appealed by the landlord.

Conclusion, Trends and Takeaway

Since issuance of the *Hawkeye* decision, the U.S. Bankruptcy Court for the District of Nevada ordered a debt-collection agency to pay a debtor's attorneys' fees under Nevada's fee-shifting statute¹⁸ after the debtor prevailed on an objection to several time-barred proofs of claim filed by the claimant.¹⁹ Similarly, the U.S. Bankruptcy for the Central District of California recently

awarded attorneys' fees to a debtor as plaintiff in litigation involving enforcement of a contract.²⁰ On the other hand, the U.S. Bankruptcy Court for the Eastern District of Louisiana denied a landlord's motion for an award of attorneys' fees, although it had successfully defended the debtor's action for breach, finding that the requested fee shifting was not actually permissible under the language chosen by the parties in the underlying lease.²¹

Given the seeming trend in application of state-law fee shifting statutes in bankruptcy court contract-based litigation where there is a "prevailing party," landlords are cautioned to conduct an assessment of the risk of losing a particular dispute versus the associated benefit of advancing a position, particularly when the underlying agreement includes fee shifting provisions.²² The parties' choice of law will certainly play an important role in the analysis regarding whether the American Rule should or should not apply. Apart from California and Nevada, reciprocal fee statutes applicable to contract and other disputes are in effect in Delaware, Florida, Montana, New York, Oregon, Utah and Washington.²³

In light of recent precedent, landlords may also want to revisit the language of their standard fee-shifting provisions to provide clarity or perhaps certain exceptions. Consulting with an experienced bankruptcy practitioner at every step in the lease origination and enforcement process is one way to place the landlord in the strongest position available in good financial times and in bad. This step should provide a benefit that far outweighs the cost.

16 See also *In re Mac-Go Corp.*, 541 B.R. 706, 715 (Bankr. N.D. Cal. 2015) (trustee's avoidance and Section 549 claims were "on a contract" under C.C.C. § 1717(a) as involving rights arising under guaranty). Compare *In re Davison*, 289 B.R. 716, 724 (9th Cir. 2003) (nondischargeability claim based on fraud not covered by C.C.P. § 1717 is not applicable); *In re Smith*, 605 B.R. 538 (Bankr. D. Utah 2019) (request for attorneys' fees denied in dischargeability action involving tort, as not recoverable under Utah's reciprocal fee statute); *Johnson v. Righetti*, 756 F.2d 738, 741-42 (9th Cir. 1985) (because creditor's request for relief from the automatic stay pursuant to Section 362(d) was not an "action on the contract," debtor was not entitled to attorneys' fees for defense against the request under C.C.P. § 1717).

17 Similarly, the U.S. Bankruptcy Court for the Central District of California recently awarded attorneys' fees to the debtor as plaintiff in litigation involving enforcement of a contract, but denied the debtor recovery of fees relating to the bankruptcy case itself. *In re Crescent Assoc. LLC*, Adv No: 18-01310-WB, *Memorandum of Decision* dated March 30, 2021.

18 NRS 18.010

sets forth specific parameters under which attorney's fees may be awarded to a party who has prevailed in a contested legal matter. As

19 *In re Antonia Andrade-Garcia*, U.S. Bankr. Ct. District of Nev., Case No. 17-15277-abl, *Memorandum of Decision* Dated March 31, 2021 (Docket No. 113).

20 *In re Crescent Assoc. LLC*, Adv No: 18-01310-WB, *Memorandum of Decision* dated March 30, 2021.

21 *In re Cella III, LLC*, No. 19-11528, 2021 WL 810246 (Bankr. E.D. La. Mar. 2, 2021).

22 It is important to note that if a landlord "prevails" in preventing assumption of its lease, it is not likely to recover its attorney fees in full; rather, those costs, to the extent recoverable under the lease, will likely become part of the "rejection damages" claim.

23 Fla. Stat. Ann. § 57.105(7); Mont. Code Ann. § 28-3-704; Or. Rev. Stat. Ann. § 20.096; Utah Code Ann. § 78b-5-826; Wash. Rev. Code. Ann. § 4.84.330; Del. Code Ann. Tit. 6, §§ 4344, 7613; Tex. Civ. Prac. & Rem. Code Ann. § 38.001.