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Landlords Given Reasons to Sweat: "Teeny Tiny" Non-Monetary Defaults and Assumption Requirements

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The good news for party-goers and tenants: Thanks to a recent decision from the Ninth Circuit Court of Appeals, a popular nightclub in historic downtown Los Angeles will remain open notwithstanding the concerted multi-year effort by a stubborn landlord to reject the nightclub's lease. The silver lining for stubborn landlords: The Ninth Circuit overturned a troubling Central District of California ruling that if existing defaults are not "material," your debtor/tenant does not have to cure them or provide adequate assurance to assume your lease in their bankruptcy. The district court in *In re Hawkeye Entertainment LLC*, affirming a bankruptcy court ruling, held that the cure and adequate assurance protections of § 365(b) of the Bankruptcy Code only apply if the breach of the lease by the tenant is of sufficient materiality to warrant the termination of the lease under state law. On this key issue, the Ninth Circuit reversed.[1]

After its landlord initiated an eviction action, Hawkeye Entertainment LLC — whose primary asset is a lease for several floors of the Pacific Stock Exchange Building, which it subleases to an affiliate that operates a successful nightclub and entertainment venue — filed for chapter 11 protection. Shortly after filing, Hawkeye moved to assume the lease and sublease under § 365.

Section 365(a) empowers a debtor to assume an unexpired lease, binding the landlord to the existing lease terms after the debtor emerges from bankruptcy. This can be a powerful tool, especially if the lease is below market, as it was in the *Hawkeye* case. However, existing defaults under the unexpired lease prevent assumption unless the tenant/debtor complies with § 365(b), which requires, among other things, that the debtor cure defaults and provide adequate assurance of future performance. In the absence of a default (or if the only defaults are those carved out in § 365(b)(2)), a landlord has no real recourse to prevent assumption unless the debtor/tenant is also seeking to assign the lease under § 365(f).

Hawkeye's landlord objected to the assumption motion, citing myriad lease defaults that, absent cure, would ordinarily prevent nonconsensual assumption. Specifically, the landlord alleged the following defaults, which were ultimately reviewed on appeal: (1) late April 2020 rent payment; (2) violation of the "use of premises" provision by allowing religious services; (3) refusal to sign an estoppel certificate; (4) violation of a conditional-use alcohol permit; and (5) failure to maintain adequate insurance. In addition, the landlord also raised issues related to fire doors, graffiti, external signage and security, among others.

Following extensive discovery and briefing of the issues, the subsequent five-day bench trial before Hon. **Maureen A. Tighe** did not go well for the landlord. At trial, Judge Tighe observed that an old, mostly unused office building presents challenges for tenants and landlords, and

> [t]hey're the kind of issues you work out in that kind of building, if they're real issues, but I thought [that the landlord] was using immaterial issues, or manufacturing issues that hadn't been there, as an attempt to characterize them as a default, and the bottom line is, there was no preponderance of evidence on any of these issues to convince me there's a default.[2]

Judge Tighe found that none of the alleged ongoing defaults were material enough to warrant forfeiture of the lease, explaining that "I just cannot read [§]365 to say any teeny, tiny infraction means [that] a Debtor-In-Possession loses the very valuable asset. That would be not in keeping with state law."[3] Accordingly, Hawkeye's assumption motion was approved without the need to satisfy the requirements of § 365(b)(1)(A), (B) and (C).

On appeal, the district court affirmed the legal conclusion that for the cure requirements of § 365(b) to apply, "a breach of an unexpired lease agreement must be sufficiently material to warrant the lease's termination under state law."[4] The district court justified the application of California state contract law by noting that other undefined

1 *Smart Cap. Invs. I LLC v. Hawkeye Entm't LLC (In re Hawkeye Entm't LLC)*, 49 F.4th 1232, 1237 (9th Cir. 2022).

2 Transcript of Proceedings at 100-01, *In re Hawkeye Entm't LLC*, Case No. 19-12102-MT (Bankr. C.D. Cal. Oct. 15, 2020) [Docket 269].

3 Transcript of Proceedings at 55, *In re Hawkeye Entm't LLC*, Case No. 19-12102-MT (Bankr. C.D. Cal. Oct. 16, 2020) [Docket 271].

4 *Smart Capital Invs. I LLC v. Hawkeye Entm't LLC (In re Hawkeye Entm't LLC)*, 2021 U.S. Dist. LEXIS 206568 *8 (C.D. Cal. Oct. 26, 2021).

terms in § 365 ("executory contract" and "unexpired") have previously been defined by state law standards.[5] No other bankruptcy decisions were cited in direct support of the district court's conclusion.

Analysis of the materiality of a default in the context of § 365 appears sporadically in case law in various circuits, typically in the context of whether the contract at issue is executory (*i.e.*, whether a material pre-petition breach rendered the contract nonexecutory)[6] or whether a lease provision renders the contract not capable of assumption.[7] In *Hawkeye*, the introduction of a "materiality" standard in bankruptcy court appears to have been more the result of that court's aggravation with an unsympathetic landlord, and the contentious factual record, than a diligent survey of bankruptcy case law. In addition, by applying a materiality test in this case, the bankruptcy court avoided having to parse the admittedly challenging language of § 365(b) as it relates to non-monetary defaults, "teeny tiny" or otherwise.[8]

In any event, Hawkeye's assumption of the lease was approved and affirmed without the need to provide the landlord with adequate assurance of future performance as required under § 365(b)(1)(A), (B) and (C), including prompt cure of defaults and compensation for pecuniary loss resulting from such defaults. Hon. Fernando L. Aenlle-Rocha of the district court concluded that there was no clear error in the bankruptcy court's findings that the alleged defaults were not "material" or, with the exception of the late rent payment, which had already been cured, that Hawkeye had not even technically breached the lease to begin with.[9] However, in an interpretive leap that the Ninth Circuit would ultimately not be able to endorse, the district court appeared to conflate a landlord's ability to oppose assumption of a lease by looking to the requirements of § 365, on the one hand, with the landlord's ability to terminate that lease for a material breach under state law on the other hand.[10] Adding a materiality requirement to the application of the protections of § 365(b) would (1) undermine the restorative policy of § 365(b), (2) confusingly permit a newly assumed lease to continue with outstanding non-material defaults, and (3) have the practical consequence of denying nondebtor contract counterparties the benefit of their bargain.

The Ninth Circuit affirmed the rulings of the lower courts permitting the assumption of the lease, but reversed on the narrow "materiality" issue. In short, the Ninth Circuit found that there was no basis in the Bankruptcy Code, California state law, or even in the lease itself to insert a materiality inquiry before applying § 365(b).[11] Moreover, regardless of the existence of "teeny tiny" defaults, the facially material payment default in April 2020 — although remedied prior to assumption of the lease — in and of itself required the bankruptcy court to undergo the full analysis and application of § 365(b) and precluded assumption solely under § 365(a).[12]

The court of appeals went on to rule that assumption of the lease pursuant to § 365(a) and the failure to apply § 365(b) was harmless error.[13] After all, the late April 2020 rent payment was ultimately made, and as the court noted, all of the other dubious "teeny tiny" defaults, by their very nature, do not lend themselves to any additional "adequate assurance" under § 365(b) beyond just the simple contractual obligation to abide by the terms of the lease itself. More to the point, as the court asked during oral argument, "So what?" So what if the bankruptcy court did not require additional adequate assurance; what sort of additional adequate assurance could the court reasonably have required, anyway?

Unable to find in the record a sufficient explanation of the harm caused by a failure to require adequate assurance, the court of appeals concluded that while the landlord "is entitled to assurance that Hawkeye will comply with the terms of [the lease], it is not entitled to use section 365(b)(1) as a means to get out of a bad deal so that it can make a better one."[14] So, for now, the beat goes on. Failure to apply § 365(b) was a harmless error, and the dance floor can remain open.

The ruling makes it clear that any sort of default, material monetary and non-material non-monetary alike, will require compliance with § 365(b). However, landlords, especially those with below-market leases, need to carefully consider whether it makes commercial sense to take a tenant to court to oppose lease assumption. In light of the dim view that most courts have for landlord demands for adequate assurance, and the critical role leases often play in a restructuring, contesting assumption will almost always be an expensive uphill battle. Unless the landlord can point to uncured monetary defaults, relying on inconsequential defaults, adequate assurance of compensation of pecuniary loss or adequate assurance of future performance is going to come across as tone deaf.[15] abi

5 *Id.* at *8-9.
6 *See In re Kemeta LLC*, 470 B.R. 304 (Bankr. D. Del. 2012).
7 *See In re Joshua Slocum Ltd.*, 922 F.2d 1081, 1092 (3d Cir. 1990).
8 A leading bankruptcy treatise describes the effort of parsing § 365(b)(1)(A) as leaving "the reader somewhat breathless, as well as perplexed as to what was intended." 3 *Collier on Bankruptcy* ¶ 365.06 (16th ed. 2022).
9 *In re Hawkeye Entm't LLC*, 2021 U.S. Dist. LEXIS 206568 at *10-22.
10 *Id.* at *5-7.
11 *In re Hawkeye Entm't LLC*, 49 F.4th at 1238-39.
12 *Id.* at 1237; *see also* Bill Rochelle, "A Cured Breach Still Invokes Section 365(b)(1)'s Landlord Protections, Circuit Says," *Rochelle's Daily Wire* (Sept. 28, 2022), *available at* abi.org/newsroom/daily-wire.
13 *In re Hawkeye Entm't LLC*, 49 F.4th at 1239-41.
14 *Id.* at 1240-41.
15 At oral argument, the Ninth Circuit did not appear at all swayed by the landlord's argument that it had actual pecuniary losses from the unsatisfied attorneys' fee provisions in the underlying lease at the time of assumption. Perhaps if this argument had been more fully developed in the lower courts, and the attorneys' fee provision itself was properly worded, the Ninth Circuit might not have found harmless error.