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BANKRUPTCY ALERT

Fallout from the Crisis: Telecom Tenants At Risk¹

I. Synopsis:

As the economic crises unfold, many expect that commercial real estate markets may soon be distressed, with bankruptcies and foreclosures to follow. If so, many telecommunications entities (both customers and providers) with collocation, hosting or lease agreements may find their possessory rights threatened by the prospect of a landlord's bankruptcy or foreclosure. This discussion examines the threat facing such "telecom tenants" along with possible protective measures available under the U.S. Bankruptcy Code. The discussion concludes with some practical steps that telecom tenants might consider taking both before and after a landlord's bankruptcy to mitigate these risks.

II. Introduction: Fallout from the U.S. Economic Crisis:

1. Telecom Tenants At Risk.

With much of the world in a recession or worse, the telecom industry will no doubt feel its share of the pain. Nortel Network's sudden decision to seek bankruptcy protection² – and Charter Cable's anticipated one³ -- may be just a prelude. With the

¹THIS IS A SPECIAL, COMPLIMENTARY ALERT ON THE IMPLICATIONS OF THE ECONOMIC CRISIS FOR THE TELECOM INDUSTRY. IT IS PROVIDED TO CLIENTS AND FRIENDS OF SAPRONOV & ASSOCIATES, P.C. FOR TUTORIAL PURPOSES ONLY. THIS ALERT IS NOT TO BE CONSTRUED AS A LEGAL OPINION OR LEGAL ADVICE. PLEASE CONTACT US IF YOU HAVE SPECIFIC QUESTIONS REGARDING THE ISSUES RAISED HEREIN. TO OPT OUT OF RECEIVING OUR ALERTS, PLEASE EMAIL US AT INFO@WSTELECOMLAW.COM.

² Ian Austen, *Nortel Seeks Bankruptcy Protection*, N.Y. Times, January 15, 2009, at B2.

³ *Charter Communications Reaches Agreement in Principle with Certain Debt Holders to Reduce Debt*, Business Wire, at <http://www.businesswire.com/news/home/20090212006003/en> (Feb. 12, 2009).

benefit of hindsight and a few lessons learned from the WorldCom era, this discussion identifies some implications of the crisis for buyers of telecommunications products and services, especially in light of possible (likely?) bankruptcies of carriers, broadband and cable providers, telecom equipment suppliers⁴ and, notably, their commercial landlords.

We have all been here before: telecommunications (telecom) industry veterans recall the Internet bubble and the collapse of all but the most solvent providers that followed in the late 1990's. Then as now, buyers of telecom, Internet and related goods and services were faced with the "travesty" of having to deal with a seller under protection of the U.S. Bankruptcy Code.⁵

Ominously, however, events this time may be more problematic. Many telecom providers of that era did indeed seek bankruptcy relief. But they, together with their Internet cohorts, were victims of an industry specific collapse. Today, the whole economy is threatened with a crisis not seen since the Great Depression. While we all hope that the recently enacted stimulus package will jumpstart the economy, bankruptcies will almost certainly follow in the near term – including, many predict, in the commercial real estate market.

2. Commercial Real Estate Bankruptcies: Telecom Implications.

While bankruptcies of telecom providers present grave problems for their customers, they are at least not unprecedented in many users' experience. Sophisticated buyers, both enterprise and wholesale, of telecommunications equipment and services know the rules of that game. The consequences of rejection (of customers' "executory contracts"⁶), the automatic stay, unilateral assignment rights, and other statutory protections enjoyed by carrier/debtors are all familiar and not discussed here.⁷ In a word, sophisticated customers know that such protective measures, whether in the form of "pre-bankruptcy protection clauses" or backup suppliers, must all be taken before – not after – the carrier/debtor files a petition for relief under the U.S. Bankruptcy Code.⁸ Less familiar, however, is the following scenario.

⁴ See *In re Nortel Networks Inc., et al.*, No. 09-10138(KG), (Bankr. D.Del. 2009). See also *In re Hawaiian Telecom Communications, Inc., et al.*, No. 08-13086(PJW), (Bankr. D. Del. 2008).

⁵ See W. Saponov & E. Holdrege, "Telecom Travesty: What a bankruptcy can mean for customers," 12 A.B.A. Sect. Bus. Law (2002), available at <http://www.abanet.org/buslaw/blt/2002-09-10/saponov.html>. ("Telecom Travesty"). The pre-bankruptcy protections discussed in that article are now familiar and not repeated here. These protections may or may not be available to telecom tenants, depending upon specific circumstances.

⁶ 11 U.S.C. § 365 ("Section 365") (Debtor has right to assume or reject executory contracts).

⁷ See generally, American Bankruptcy Institute: Bankruptcy Telecommunications Manual (H. Jason Gold, et al. eds.) (2nd ed. 2006) ("ABI Manual").

⁸ 11 U.S.C. § 101 et. seq. (2009). The Bankruptcy Code was amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8 (2005) ("BAPCPA"). Section references, unless otherwise indicated, are to Sections of the U.S. Bankruptcy Code (as amended).

If the forecasters are correct, the next wave of bankruptcies and distressed properties will particularly affect commercial landlords. Should that prove to be the case, the implications for telecom customers are potentially harrowing. Virtually all telecom providers – and many collocated customers – have commercial leases for equipment placement, other hosting arrangements and/or other collocation agreements. All such telecom tenants thus rely, directly or indirectly, on the landlord’s continued solvency and on their access rights to the building in order to enjoy the benefits of uninterrupted telecom services.

But what happens to such agreements if the landlord or building owner files for bankruptcy? Alternatively, what happens if the landlord defaults on its mortgage obligations and the lender/mortgagee forecloses on the property? And what happens when the building is sold in a bankruptcy sale? Unfortunately, the tenant- whether a true lessee or merely an occupant having a license to use the collocation space - may face eviction with little recourse.

III. Telecom Tenant Beware.

Veterans of the WorldCom era may find aspects of a landlord bankruptcy eerily familiar.

First, case law supports the treatment of so-called carrier interconnection agreements as executory contracts under Section 365,⁹ and (although there appear to be no reported cases) that reading could arguably be extended to telecom tenants’ collocation agreements.¹⁰ A telecom tenant could thus be faced with the possibility of rejection of collocation agreement by a bankrupt landlord. Second, the prospect of a telecom landlord’s bankruptcy is somewhat reminiscent of similar predicaments faced by non-debtor customers (grantees) of so-called “indefeasible rights of use” (IRUs) upon the IRU seller’s (grantor’s) bankruptcy.¹¹ IRUs are essentially long term lease agreements for access to and maintenance of fiber optic facilities. When Global Crossing and other IRU providers sought bankruptcy relief, many of their customers were left with uncertain IRU access rights - even if they had paid in advance for the facility. A landlord bankruptcy for a telecom tenant presents a similar scenario – but with an added, more frightening dimension.

⁹ See *ABI Manual* at 88-89, nn. 314-316 and accompanying discussion.

¹⁰ Such collocation agreements may be true leasehold interests or merely space licenses. Federal law permits telecommunications carriers and incumbent carriers controlling that space to negotiate the terms of collocation agreements. 47 U.S.C. § 251(c)(1)(6). Enterprise customers typically negotiate the terms of their collocation and hosting agreements under commercial rates, terms and conditions with carriers, who either lease or own the collocation space.

¹¹ See *ABI Manual* at 90-91 and cases cited therein.

1. Is the Telecom Tenant a True Lessee?

As with collocation agreements and IRUs, whether or not the telecom tenant has rights to access the bankrupt landlord's property depends upon the nature of its interest: specifically, whether the tenant's interest is a leasehold interest in real property or some other possessory right (*e.g.*, a license to use the space under a collocation agreement).

Upon a bankrupt landlord's rejection of an unexpired lease, Section 365(h)(1) of the Bankruptcy Code, a statutory holdover right, permits a non-debtor lessee of real property either (i) to treat the lease as terminated if the rejection amounts to such a breach as would warrant termination under the lease terms or applicable law, or (ii) if the lease term has commenced, to continue to occupy the property and otherwise "retain its rights under such lease...to the extent such rights are enforceable under applicable non-bankruptcy law."¹² A tenant having a mere license to be on the premises (as is common in many collocation agreements) has no such occupancy rights. In contrast, if such an entity had the rights of a true lessee under, for example, an equipment/collocation lease agreement in a tele-hotel, then it could survive the rejection of that lease agreement by a bankrupt landlord so long as it continued to make lease payments and otherwise perform its obligations.

But, even a true lessee may continue to occupy the premises only to the extent permitted "under applicable non-bankruptcy law." Therein lies the problem. A true lessee does not have such occupancy rights when the landlord defaults on its building loan/mortgage agreement and the lender/mortgagee exercises foreclosure remedies. Absent a subordination or non-disturbance agreement binding upon the lender/mortgagee, the latter's foreclosure rights supersede those of the lessee. In such circumstances, even if the landlord files for bankruptcy, Section 365(h)(1) does not protect the telecom tenant lessee as the lender mortgagee's senior rights arise under "applicable non-bankruptcy law":¹³ specifically, state law foreclosure remedies.¹⁴

2. Foreclosures and Bankruptcy Sales: What Happens to the Telecom Tenant When the Property is Sold?

Thus, while a telecom tenant that is a true lessee has a right of occupancy under the Bankruptcy Code upon the lessor's bankruptcy, that right is probably extinguished if a lender forecloses on the building. This is because the lender/mortgagee will have a security deed securing its mortgage that takes priority over any rights that a tenant might

¹² 11 U.S.C. § 365(h)(1)(A)(ii).

¹³ *Id.*

¹⁴ *See generally*, M. Barter, "Section 363 Sales," 59 Business Lawyer 2 (2004) at 479-480 and cases cited therein (discussing Indiana law granting mortgagee foreclosure rights as applicable non-bankruptcy law within meaning of Section 365(h)(1)) ("363 Sales").

obtain from the debtor/landlord.¹⁵ The lessee's rights under the lease, even if recorded in a memorandum of lease, would typically be junior to that of a senior mortgagee. Consequently, even a recorded lease would not alone (at least under some state laws)¹⁶ protect the tenant/lessee from a foreclosure sale by the senior lender/mortgagee and a "kick-out" by the subsequent purchaser. In such circumstances, unless the lessee were to have a non-disturbance or subordination agreement that is binding upon a senior mortgagee, a lessee's possessory rights under 365(h)(1) would not survive a foreclosure sale.

As a practical matter, most lenders would typically prefer to keep good paying tenants in the foreclosed property rather than evicting them. Even so, there is a possibility that the lender may force the tenant into *in terrorem* renegotiation of its lease agreement - especially one negotiated at "below market" rates prior to the foreclosure. Moreover, there is still another kick-out threat facing the telecom lessee in such circumstances: the sale of the debtor's building under section 363 of the Bankruptcy Code (a so-called "363 sale").¹⁷

Section 363(f) of the Bankruptcy Code permits an entity to purchase property of the estate, under conditions approved by the Bankruptcy Court, "free and clear of any interest" in such property. While the judicial circuits appear to be split on this issue,¹⁸ at least one Circuit Court of Appeals has held that such a 363 sale wipes out not only existing liens but also leasehold possessory interests under Section 365(h)(1).¹⁹ True, under Section 363(e) of the Bankruptcy Code, a telecom tenant/lessee whose rights are extinguished under a 363 sale would have the right to seek adequate protection from the Bankruptcy Court.²⁰ But, such protection would typically be some form of monetary

¹⁵ Where there is a clause in the lease making the rights of the lessee "subject to" a subsequent security deed, the foreclosed security deed has priority. *See Trust Co. Bank v. Atlanta v. Atlanta Speedshop Dragway, Inc.* 208 Ga. App. 867, 432 S.E. 2d 608 (1993).

¹⁶ Under Georgia law, for example, a prior mortgage or security deed recorded on the date of the lease takes priority, and a foreclosure leaves the lessee as a mere tenant at sufferance, subject to dispossessory proceedings. *First Federal Savings & Loan Assn. v. Shepherd*, 131 Ga. App. 692, 206 S.E. 2d 571 (1974). *See also 363 Sales supra* at 479-480.

¹⁷ 11 U.S.C. § 363 (allowing a trustee to sell property of a debtor's estate outside the ordinary course of business).

¹⁸ *See generally 363 Sales supra*.

¹⁹ *Precision Industries v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. Ind. 2003) ("*Precision Industries*"). *See id* and cases cited therein. In *Precision Industries*, the Seventh Circuit explained that section 363(e) provides a mechanism for lessees to protect their interests: it directs the bankruptcy court to "prohibit or condition [any sale of the underlying property] as is necessary to provide adequate protection of such interest." *Id.* at 545. The court reasoned that the lessee had a remedy available to it, and while it was not guaranteed continued possession of the property, the lessee was entitled to adequate protection and could seek to "be compensated for the value of its leasehold-typically from the proceeds of the sale." *Id.* at 548.

²⁰ Section 363(e) of the Bankruptcy Court provides, in relevant part, that "...on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing shall prohibit or condition such use, sale or lease as is necessary to provide

compensation and, probably insufficient to compensate the lessee for the loss of building access and other possessory rights.

3. And a Scary Outlook for Enterprise Customers.

In short, if the commercial real estate market does indeed become the next “bubble,” it will present ominous implications for telecom tenants – including the threat of eviction even under a well-negotiated lease. In such circumstances, the outlook for enterprise customers is also scary. Enterprise customers have contracts with carriers who are telecom tenants, with their own collocation, hosting, and central office lease agreements all subject to the landlord bankruptcy risks described above. A carrier/lessee providing hosting or collocation services whose landlord undergoes foreclosure or bankruptcy could perhaps exercise force majeure or other rights to excuse obligations to serve or perform obligations to the enterprise customer. Moreover, many enterprise agreements make enterprise customers’ occupancy rights expressly subject to compliance with the conditions of the carrier’s lease and the landlord’s rights.

Worse still, if a foreclosure resulted in the lender’s termination of the carrier/lessee’s right to be on the property, then the enterprise customer could conceivably be stuck – possibly without any right to retrieve their property (having no access rights to building) or other remedies (since the carrier’s obligations may well be excused by force majeure). If that were to happen in, for example, a “tele-hotel”, a collocation facility shared by multiple carriers, the consequences could be unthinkable – but that’s what they said about Lehman.

IV. What Should Telecom Tenants Do?

So what should telecom tenants do to protect themselves? The answer depends, in part, upon the time left on their lease, their negotiation leverage, the financial stability of their landlord, and (where their collocation space is on their carrier’s premises) that of their carrier and its landlord.²¹ Due diligence can perhaps put to rest – but in some cases may raise – concerns about the longevity of the lease and the lessor.

If there are such concerns, then the tenant’s efforts should start with an examination of the lease and the mortgage or security documents. Its right to be on the premises must be a leasehold interest protected by subject to Section 365(h)(1), not just a license or other terminable access right in the event of the landlord’s bankruptcy. The tenant should then file a memorandum of lease providing record notice of its leasehold interest in the property. All of these considerations are of scant value, however, if the

adequate protection of such interest.” See, e.g., *Precision Industries v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. Ind. 2003) (“*Precision Industries*”). But see *363 Sales*, supra at 490-491 (arguing that *Precision Industries* was wrongly decided).

²¹ For a discussion of pre-bankruptcy protections in dealings with carriers, see *Telecom Travesty*, supra.

tenant is not in a position to negotiate them. That goes to the status of the lease. Protections may be sought during the negotiation of the lease or its renewal: thereafter, there is little incentive or consideration for the landlord to make such concessions.

Second, the tenant should seek to have its rights protected by a non-disturbance and subordination agreement between the landlord and its mortgagee or other lien-holder of the property. Here, for example, is sample language from such an agreement:

“Lender may require any and all tenant leases for any portion of the Mortgaged Property hereafter executed to be subordinate to its mortgage; provided, however, that Lender shall agree that so long as any tenant is not in default of its lease, possession of the premises leased to it will not be disturbed in the event of foreclosure of the mortgage or conveyance in lieu of foreclosure. All tenants shall agree to attorn to lender.”²²

Importantly, Section 510 of the U.S. Bankruptcy Code provides that valid subordination agreements negotiated outside of the landlord’s bankruptcy are enforceable in the bankruptcy case.²³

Third, in the event of a landlord’s bankruptcy, a telecom tenant should both file a proof of claim and carefully monitor the bankruptcy proceedings. Among other things, a telecom tenant that is a non-debtor tenant/lessee should participate in (and if necessary object to) a Section 363 Sale that would convey the property “free and clear” of its lease.²⁴ Finally, the telecom tenant, again in its capacity as a lessee, should also seek “adequate protection” of its possessory interest under Section 363 of the Bankruptcy Code.

In conclusion, telecom tenants, among other worries brought on by the economic crisis, must add the possibility of commercial real estate bankruptcies to that list. This is an unusual time for these markets and, eventually, it too will pass. But for now, taking some of the above-discussed pre-cautionary measures may well be worth the effort. Please contact Walt Saprnov, Robert J. Butler, or Thomas E. Austin at Saprnov & Associates, P.C., (770) 399-9100 (or info@ www.wstelecomlaw.com) if you have any comments or questions about this alert.

²² *In re: 641 Associates, Ltd., Debtor v. Balcov Real Estate Finance, et al.*, Bankruptcy No. 91-11234S Chapter 11, Adversary No. 93-0363S, Adversary No. 93-0456S, U.S. Bankruptcy Court (E. Dist. Pa.) 1993 Bankr. LEXIS 1191.

²³ 11 U.S.C. § 510(a) (“A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable non-bankruptcy law.”).

²⁴ *See 363 Sales* at n. 156 *ff.* and accompanying discussion.