

THE COMMERCIAL LANDLORD'S BANKRUPTCY DESK REFERENCE



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INTRODUCTION

As the economy fluctuates, tenant bankruptcies become a greater risk for commercial landlords. Yet some landlords are not familiar with the rights provided to them under the Bankruptcy Code, nor are they aware of the protections provided to a tenant in bankruptcy. For example, certain lease provisions are unenforceable once a tenant files for bankruptcy. Should a landlord attempt to exercise its rights under the lease without first seeking approval from the bankruptcy court, the landlord may be subject to strong sanctions. The purpose of this booklet is to provide landlords with the questions and answers they should consider when a commercial tenant files for bankruptcy.

WHAT EFFECT DOES A TENANT'S BANKRUPTCY HAVE ON THE LEASE?

Once a tenant files for bankruptcy, it has three options regarding the lease: it can assume the lease and continue performing all obligations, or assume and assign the lease to a third party, or reject the lease and surrender the premises and terminate performance. Section 365 of the Bankruptcy Code gives the bankrupt tenant 120 days to decide if it will assume or reject the lease. During this period, the tenant can request one 90 day extension of time to decide whether to assume or reject. After the extension period expires, any further extensions require written consent from the landlord.

If the debtor-tenant fails to assume or reject the lease within the 120 day period, and no extension is granted, the lease is deemed rejected by operation of law. This is a significant provision for landlords and one of several reasons why landlords should stay fully informed as to the debtor-tenant's intentions regarding its lease. To be proactive, landlords (or their counsel) should review all pleadings filed in the tenant's bankruptcy proceeding to see if the debtor-tenant sought an extension of time to assume or reject. Additionally, landlords should review the tenant's motions to assume, motions to assume and assign, as well as motions to reject leases. The exhibits to these motions often contain schedules identifying the leases affected by the motion.

HOW DOES THE “AUTOMATIC STAY” OF THE BANKRUPTCY CODE APPLY TO LANDLORDS?

The automatic stay is one of the most powerful protections provided to debtors in a bankruptcy proceeding. The stay acts as an injunction that prohibits creditors (including landlords) from commencing or continuing any proceeding against the debtor which could have been commenced prior to the bankruptcy. Applied to landlords, the automatic stay prohibits efforts to collect unpaid rent, or seek eviction, setoff, lease termination or foreclosure, among others.

It is important for landlords to realize that the automatic stay becomes effective without notice or a hearing. Were a landlord (or any creditor) to be found in violation of the automatic stay, the debtor-tenant may be able to recover actual damages from the landlord, including attorneys' fees. If the violation is found to be intentional, the debtor-tenant may recover punitive damages.

In order to avoid the consequences resulting from violating the automatic stay, landlords should seek relief from the stay by filing a motion with the bankruptcy court. Under Section 362 of the Bankruptcy Code, creditors can seek relief from the automatic stay “for cause.” An example of “cause” includes the tenant’s failure to pay rent.

WHAT IS THE STATUS OF THE TENANT'S RENTAL OBLIGATIONS WHILE IN BANKRUPTCY?

Section 365(d) of the Bankruptcy Code requires the debtor-tenant to satisfy all the terms under the lease during the post petition period until the tenant either rejects the lease, or assumes and assigns it to a third-party. The landlord's claim for unpaid rent receives "administrative claim" status, which is a higher priority of claim than many of the other claims against the debtor. Creditors holding an administrative claim against the debtor will receive payment on their claims before "unsecured creditors," to the extent funds are available.

Should the debtor-tenant fail to pay the rent as provided under the lease, the landlord should file a motion for payment of post petition rent with the bankruptcy court and/or a motion for relief from automatic stay. The rent motion in some instances can be heard within thirty to sixty days from the date in which it was filed. However, if an evidentiary hearing is needed to resolve issues pertaining to the administrative rent claim, the motion could require several months before the court issues a decision.

Instead of seeking payment of rent, landlords may file a motion for relief from the automatic stay. With this alternative, the landlord seeks an order from the court allowing the landlord to enforce its rights under the lease due to the tenant's breach (such as evicting the defaulting tenant).

WHAT ARE THE LANDLORD'S “REJECTION DAMAGES”?

If the debtor-tenant seeks to terminate and surrender the lease, that is “reject it”, the landlord may be entitled to a “rejection damage” claim. A landlord is not entitled to the full amount of unpaid obligations for the balance of the lease. Instead, Section 502(b)(6) limits the recovery a landlord may receive for “rejection damages.” Under Section 502(b)(6) of the Bankruptcy Code, the landlord is entitled to rent due under the rejected lease for the greater of (i.) one year’s rent, or (ii.) fifteen percent (15%) of the rent due under the lease, not to exceed three years’ rent. Unlike the administrative rent claim, a rejection damage claim is a general non-priority unsecured claim paid only after all other claims.

The landlord’s rejection damage claim is capped under Section 502(2)(b)(6), but the landlord is entitled to include all amounts that constitute “rent” under the lease. Items that may include “rent” include utility fees, common area maintenance charges and taxes.


The Bankruptcy Code views a rejected lease as one that is in breach by the tenant. To preserve its rejection damage claim, the landlord needs to prepare and file a proof of claim. This differs from the procedure for administrative rent claims, which generally requires the landlord to file a motion for allowance and payment of the administrative rent claim. Once the rejection damage claim is properly filed with the court, the claim is deemed allowed unless the debtor-tenant, or another interested party, files an objection to the claim. Only claims that are “allowed” are eligible for payment, and again, only if funds are available.

WHAT ARE THE LANDLORD'S RIGHTS WHEN THE DEBTOR-TENANT DECIDES TO ASSUME THE LEASE?

Assumption of the lease is permissible even if the terms of the lease expressly prohibit assumption. Section 365 of the Bankruptcy Code requires a debtor-tenant to meet certain criteria in order to “assume” a lease. First, and most importantly, the tenant must cure any and all existing defaults, both monetary and non-monetary. Second, the debtor-tenant must provide “adequate assurance” to the landlord that the debtor will be able to perform under the lease going forward. The tenant’s obligation to cure defaults includes the payment of late charges or similar charges that arise under the lease. As discussed in section 8 below, the landlord may be able to recover attorneys fees in limited circumstances.

The Bankruptcy Code requires the tenant to demonstrate its ability to provide “adequate assurance of future performance.” Though this term is not defined within the Code, it has generally been interpreted to require the tenant to demonstrate its ability to meet its financial obligations under the terms of the lease going forward.

A debtor-tenant must serve the landlord with notice of its intention to assume the lease. Tenants often list the cure amount within a motion to assume the lease. However, the Code also allows the debtor-tenant to provide notice of the Landlord’s intent to assume the lease as part of the debtor’s plan of reorganization. Regardless of the method the debtor



selects, under either approach the landlord has only a limited amount of time to review and file an objection to the assumption of its lease and/or the proposed cure amount. If the landlord chooses to object to the assumption of its lease, it needs to file a written objection with the court.

WHAT ARE THE LANDLORD'S RIGHTS WHEN THE TENANT ASSUMES AND ASSIGNS THE LEASE TO A THIRD-PARTY?

In conjunction with assuming the lease, the Bankruptcy Code allows the debtor-tenant to assign the lease to a third party. The party who is assigned the lease must provide the landlord with adequate assurance that it can meet the financial obligations of the lease. If the party who is assuming the lease cannot provide the landlord with adequate assurance, the landlord has cause to object to the assignment.

Bankruptcy courts often apply the “business judgment” standard when considering whether to allow a tenant to assume and assign a lease. Under this standard, debtor-tenants are permitted to assign a lease provided it can show the transfer of the lease is a reasonable business decision. Although courts provide debtor-tenants with broad discretion on the decision of whether to assume and assign a lease, the debtor-tenant must still demonstrate the assigned party’s ability to cure defaults under the lease and make future payments.

HOW DOES A LANDLORD RECOVER ITS ADMINISTRATIVE RENT CLAIM?

Section 365(d)(3) of the Bankruptcy Code requires the debtor-tenant to “timely perform all the obligations . . . under any unexpired lease of nonresidential real property” until such time that the tenant assumes or rejects the lease. If a tenant files for bankruptcy and remains in possession of the property, yet fails to pay rent as provided for under the lease, the landlord should consider filing a motion for an administrative claim.

In drafting the Bankruptcy Code, Congress intended for tenants who remain in possession of property to abide by the terms of the lease. If the debtor-tenant maintains possession and use of the property, the tenant is receiving a benefit and the landlord is entitled to an administrative expense claim. Although the landlord is entitled to the “fair market value” for purposes of determining the amount of its claim, there is a presumption that the rental amount provided in the lease represents fair market value. If the tenant believes it is entitled to pay an amount less than the rate provided for in the lease, it has the burden of showing why the contract rate is not fair market value.

WHEN CAN A LANDLORD RECOVER ATTORNEYS' FEES FROM A TENANT IN BANKRUPTCY?

Landlords may be able to recover attorneys' fees incurred when a debtor-tenant seeks to assume the lease, or assume and assign the lease to a third party. To recover attorneys fees, however, the landlord must meet several criteria. First, the lease must expressly state that the landlord is entitled to recover attorneys' fees as additional rent or in connection with the collection of rent. Next, the landlord must have prevailed in the proceedings in which it seeks to recover attorneys' fees. "Prevailing" in a bankruptcy proceeding may include filing an objection to a motion of the debtor-tenant and receiving a favorable decision (i.e., objecting to the cure amount proposed by the tenant).

The matter in which the landlord seeks attorneys' fees must be in pursuit or enforcement of the landlord's rights under the lease, not matters where the landlord challenges the debtor-tenant's rights under the Bankruptcy Code. Finally, the attorneys' fees must be reasonable. To determine whether the fees are reasonable, courts will consider factors such as the amount in dispute relative to the fees requested, the debtor-tenant's good faith efforts to resolve the dispute and compliance with the Bankruptcy Code.

CAN THE LANDLORD APPLY THE TENANT'S SECURITY DEPOSIT TO THE LANDLORD'S CLAIMS?

Security deposits are considered property of the bankruptcy estate, and as such, generally required to be returned to the debtor. Even so, landlords are permitted in certain instances to setoff their rejection damage claim against the security deposit. This benefits a landlord for two reasons. First, instead of returning the deposit to the debtor-tenant, a landlord can setoff its claim against the deposit, and thus reduce the amount of the deposit that must be returned. Second, the landlord's rejection damage claim is a general unsecured claim, meaning it gets paid after all other types of claims under the Bankruptcy Code. However, the landlord's rejection claim can be setoff against the security deposit "dollar for dollar," which in essence raises the status of the rejection claim to secured status, up to the amount of the security deposit.

Landlords should not setoff any claims they have against the debtor-tenant's deposit without first receiving an order from the bankruptcy court granting the landlord relief from the automatic stay. If the parties reach an agreement as to the amount of the claim to be applied to the deposit, the debtor-tenant may consent to relief from the automatic stay.

HOW CAN A LANDLORD PROTECT ITSELF PRIOR TO AND DURING A BANKRUPTCY?

Requiring a third-party guarantor is one way in which a landlord may obtain better creditor protection when entering into a lease. The automatic stay does not prevent a landlord from taking action against a guarantor to a corporate debtor-tenants' lease, provided the lease guarantor is not in bankruptcy.

Landlords can also seek protection through letters of credit. Using a properly drafted letter of credit allows a landlord to draw on the proceeds of the letter of credit from a third party (the lender) should the tenant default under the lease. Letters of credit are generally not considered property of the tenant's bankruptcy estate. Some of the drawbacks to letters of credit include their complexity, both during lease preparations, as well as execution after default.

Once a tenant files for bankruptcy, it is important that the landlord stay informed regarding the status of the proceedings. This is especially true regarding claims bar dates and objection deadlines. If a landlord misses the deadline in which to file a claim, whether for rejection damages, administrative claims, or any other related expenses, the landlord may be barred from recovering on its claim. Similarly, if the debtor files a motion to assume the lease and assign it to a third party, landlords have a very limited amount of time to prepare and file an objection to the assumption. This deadline is also significant as a landlord may dispute the amount of cure provided by the landlord, or the landlord could dispute whether the party assigned to the lease is capable of complying with the terms of the lease.



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