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## COMMERCIAL LANDLORDS AND BANKRUPTCY

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“They filed Chapter 11” are the four words in the English language no commercial property manager or owner ever wants to hear. As landlords and property managers well know, a Chapter 11 filing starts the meter running on an expensive, protracted, and often frustrating process lasting months or years, during which the landlord tries to collect rent as it falls due, all the while battling the debtor/tenant and other constituencies in the Chapter 11 case for control of the subject leasehold. This Client Alert will discuss the impact of a tenant’s bankruptcy on the landlord and tenant relationship, the bankruptcy process, strategies commercial landlords may employ to protect their interests once they hear those dreaded words (“they filed Chapter 11”), and protective lease provisions landlords may proactively negotiate to reduce the financial consequences of tenant financial distress and bankruptcy.

### **BANKRUPTCY CODE PROVISIONS GOVERNING UNEXPIRED COMMERCIAL LEASES**

**ASSUMPTION AND REJECTION.** Section 365 is the principal Bankruptcy Code section governing the treatment of “executory contracts and unexpired leases” in all bankruptcy cases. Section 365 provides for tenants either to “assume” and thereby, in common parlance, keep the tenant’s leasehold interest or “reject” it, thereby disaffirming, in common parlance, the tenant’s interest in a lease. Once the tenant files for Chapter 7 or Chapter 11 relief, it has a 120-day period to either assume or reject its interest in such lease. The court may extend such period for an additional 90 days for “cause.” No further extensions are permitted without the landlord’s written consent. During this period, the tenant must comply with all of its lease obligations, as discussed later in this Client Alert. If the tenant fails to timely assume or reject, at the end of the applicable time period the lease will be “deemed” rejected, and all of the consequences of rejection will apply.

Fundamentally, “assumption” means business as usual, subject to certain conditions imposed by the Bankruptcy Code drafted to protect a landlord’s interests. Among other things, assumption obligates a tenant to (a) cure existing monetary defaults, (b) pay damages to the landlord resulting from non-monetary defaults, (c) provide adequate assurance of future performance of the tenant’s obligations under the lease, and (d) require the tenant to fully perform all of its obligations on a going forward basis as if there never was a bankruptcy case.

In contrast, “rejection” means the tenant is relieved from paying future rent and of its other ongoing obligations under a lease. Such a rejected lease is deemed to have been breached by the tenant immediately prior to the bankruptcy filing, although, in most jurisdictions, rejection does not terminate the landlord and tenant relationship.

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\*Note: For convenience, in this Client Alert, we use the term “tenant” to refer to the party holding the tenant’s interest during the bankruptcy case, whether the party is the tenant itself, as a debtor-in-possession in Chapter 11, or a trustee appointed under Chapter 7 or 11 of the Bankruptcy Code.

“Rejection damage” claims are treated by the Bankruptcy Code as general unsecured claims, meaning such claims likely will be paid pennies on the dollar, rather than in full. Additionally, such claims are limited (the “cap”) under the Bankruptcy Code, as follows: a rejection damage claim may not exceed the sum of (a) any amounts owed at the time of the bankruptcy filing, plus (b) the greater of (i) the rent due under the lease for one year, or (ii) 15% of the rent due under the lease for the remaining term, but not to exceed three years of the future rent reserved by the lease in question. Also, courts in many jurisdictions require a landlord to apply the amount of any security deposit or letter of credit proceeds to reduce the claim after first applying the cap. Therefore, for example, if security held by a landlord exceeds the amount of the capped claim, the landlord will be required to turn over any excess amount to the tenant. Also, the rejection damage claims are subject to other factors, including whether operating expenses can be included in the claim and whether payments to statutory lienholders can be recouped and offset against any security. Moreover, a landlord, in many jurisdictions, will be required to mitigate its damages and provide evidence of its efforts to mitigate or risk further reductions of the amount of a rejection damage claim.

Two important practice pointers for landlords: first, it is of paramount importance not to miss a deadline for filing a proof of claim. In Chapter 11 cases, such deadline may be set by a bankruptcy court in the order providing for the rejection of a lease, in an entirely different court order, in a notice sent out by the bankruptcy court clerk’s office, or even in a plan of reorganization. In Chapter 7 cases, the notice generally is sent out by the clerk of the court, and in many cases, it is sent out at the earliest stages of a case, together with the notice of commencement. This early notice of a claims filing deadline can be a trap for the unwary. In Chapter 11, the failure to timely file a proof of claim will result in the disallowance of the claim, and in Chapter 7, in the subordination of the claim to the claims of all creditors who have timely filed their proofs of claim. Second, landlords should take care to monitor all aspects of the surrender of a leasehold when a tenant rejects to forestall the accrual of unnecessary liabilities arising from such rejection. For example, the landlord should make sure all utility services it will have to pay for, if the tenant does not, are terminated at the time of lease rejection.

In addition to assumption or rejection, the Bankruptcy Code provides that a tenant may assume and then assign its interest in a lease despite provisions restricting assignment, as such provisions are unenforceable under Section 365 of the Bankruptcy Code. Upon assignment, a tenant is released from future liability under the lease.

The Bankruptcy Code provides landlords with certain protections regarding any proposed assumption or assumption and assignment. First, the tenant must provide proof that a proposed assignee will have the ability to perform the tenant’s obligations under the lease. Second, the tenant must cure, or provide proof it will cure, all monetary defaults and pay damages for non-monetary defaults as a prerequisite to the assumption and assignment. Third, shopping-center landlords are afforded additional protections. These protections may include limitations on potential assignees based on various factors spelled out in detail in the Bankruptcy Code.

**THE AUTOMATIC STAY.** Once a tenant files for bankruptcy relief, the landlord’s right to evict the tenant or exercise other rights and remedies is prohibited, absent a grant of relief from the presiding court. Fundamentally, the automatic stay, found in Section 362 of the Bankruptcy Code, serves to prohibit all actions to collect from a tenant or to act against property of a tenant

or its bankruptcy estate, without permission from the presiding bankruptcy judge. Generally, the stay will remain in effect to prevent a landlord from exercising rights and remedies, so long as the tenant continues to be the subject of a bankruptcy case and a lease has neither been rejected nor assigned to a third-party assignee.

**UNENFORCEABLE LEASE PROVISIONS.** As mentioned above, provisions placing restrictions on assignment of the lease are unenforceable under Section 365 of the Bankruptcy Code. Use clauses, continuous operation clauses, and the like have been held by bankruptcy courts to be unenforceable restrictions on assignment and have been written out of leases to permit a debtor/tenant to assign its interest to a third party. The Bankruptcy Code further restricts the ability of a landlord to take action by voiding *ipso facto* default provisions commonly found in commercial leases (*i.e.*, default based on the tenant's insolvency, financial condition, bankruptcy, or the appointment of or taking possession by a bankruptcy trustee or custodian). Thus, a tenant's interest in an unexpired lease may not be terminated or modified after a bankruptcy filing, and any right or obligation under such lease may not be terminated or modified at any time after the commencement of a tenant's case, solely because of such events.

### **WHAT A LANDLORD SHOULD DO WHEN A TENANT FILES FOR BANKRUPTCY RELIEF**

If the worst happens and a tenant files for Chapter 11 relief, a landlord will be well served to act expeditiously to protect its interests. Upon filing of a tenant's bankruptcy, absent a compelling reason not to do so, a landlord, by appropriate counsel, immediately should file a Notice of Appearance and Demand for Notices with the bankruptcy court. By doing so, the landlord will receive notice of all important events in the bankruptcy case, including those that may affect the landlord's interest. Moreover, by filing such a notice, a landlord will be in a position to effectively monitor the tenant's case. By monitoring the case, the landlord will be in the best position to evaluate legal and financial developments occurring during the administration of the tenant's bankruptcy case that will have an impact on the landlord and tenant relationship.

For example, at the earliest stages of a bankruptcy case, a landlord should focus upon the tenant's availability of funds to perform its post-bankruptcy filing date obligations to the landlord and other creditors. In today's environment, virtually all Chapter 11 filers will be highly leveraged entities. All such entities, therefore, either will seek financing in the form of a debtor-in-possession loan or authority to use the cash proceeds of a pre-bankruptcy lender's collateral (*i.e.*, "use of cash collateral"). Critically important to the tenant's attempt to secure such financing will be a budgeting process, as every request to obtain bankruptcy financing will require the tenant to disclose its proposed budget for periods that may be as short as several days or as long as six months or more. Landlords can use the tenant's motion for financing as an opportunity to take any steps needed to make sure that rent is included in any budget proposed by a tenant. The proposed budget also will provide a landlord with a "snapshot" of the tenant's financial condition, including information regarding the tenant's ability to perform its ongoing obligations and prospects for a successful financial reorganization. The landlord, in this instance, will be able to use the overall Chapter 11 process, here the need to obtain financing via the court, to obtain critical information about the tenant.

Another critical issue for a landlord at the earliest stages of a tenant's Chapter 11 will be for the landlord to determine whether the tenant's interest in the lease is of value. The landlord should attempt to obtain answers to some or all of the following questions:

- Can the tenant survive without occupying the leased premises?
- Is the rent reserved by the lease above or below market?
- How much of the lease term remains?
- Are there options available to the tenant to extend the lease term?

Is there anything unique about the leasehold that will increase its value to the tenant or others (*e.g.*, a unique location or market penetration issues)?

The market for the leasehold and the value of the leasehold will be an important driver of a landlord's strategy during a tenant's Chapter 11 and, in particular, the decision of whether to try to recapture the leasehold or try to keep the tenant-in-possession. At one extreme of the spectrum, a landlord may want to take all measures available in an attempt to recover control of the leasehold. At the other end of the spectrum, a landlord may determine that the best course of action will be to ensure the tenant remains in possession and pays the rent reserved, or even a reduced rent because the market for the leasehold is depressed.

During the post-filing and pre-assumption or rejection period, a tenant is required to comply with its obligations under the affected lease, including the timely payment of the rent reserved. The bankruptcy court may extend the time for performance of any of the tenant's lease obligations that arise within the 60 days following the bankruptcy date, but the time for performance will not be extended beyond such 60-day period. There is a split among the courts regarding when rent accrues under a lease. This issue arises at the earliest stages of a tenant's bankruptcy case in connection with so-called "stub rent." "Stub rent" arises when a tenant files on a date other than the date when rent becomes due under a lease (*e.g.*, rent is due on the first day of each month and a bankruptcy filing occurs on the fifth day of a month, say April). The Courts of Appeal for the Third and Sixth Circuits require tenants to pay the "stub rent" as a post-filing date tenant obligation on a prorated dollar-for-dollar basis. In our example, the tenant will have to pay 24/30 of the rent reserved for the month of April. In contrast, the Second Circuit's rule is that the rent for each monthly period accrues on the date rent falls due. Thus, in our example, if rent is due on the first and the filing occurs on the fifth, the tenant is not required to pay rent in its bankruptcy case until the first day of the next applicable monthly period. In our example, all April rent will be considered to have accrued prior to the bankruptcy filing, and the tenant will start paying rent only when the calendar turns to May. The latter is a far less favorable outcome for a landlord, as it will be left with a tenant-in-possession for an entire month that is not paying rent, leaving a landlord with only an unsecured claim for the monthly period. (Note: the Fifth Circuit has not decided this issue.)

As we just have discussed, the Bankruptcy Code provides for the payment of post-filing date rent by a tenant as it falls due. What happens if the tenant fails to timely pay the rent during the pre-assumption/rejection period? Some courts will compel payment, while others will allow the landlord an unsecured administrative claim to be paid sometime in the future. The practice

pointer here is that a landlord should be vigilant with regard to rent payments falling due during a tenant's bankruptcy and expeditiously seek relief from the presiding bankruptcy court if rent is not paid when due.

Notwithstanding the Bankruptcy Code's provisions that generally are favorable to a tenant's interest in its bankruptcy case, a landlord can take steps to protect itself to avoid what the landlord is likely to view as an overly harsh outcome. Procedurally, a tenant in bankruptcy is required to file a motion with the court when it seeks to assume, reject, or assume and assign an interest in a lease. Such motion practice provides the well-counseled landlord with an opportunity to respond and complain about a tenant's overreaching, its failure to comply with the Bankruptcy Code regime, and the impact of assumption, rejection, or assumption and assignment, as the case may be, on a landlord's rights.

Other practice pointers in regard to protecting landlords within the statutory scheme are:

- Be familiar with and vigilant about the time periods governing assumption or rejection.
- Pay attention to assumption and rejection motions filed by the tenant that may not appear to directly involve the lease in question.
- Pay attention to events in the tenant's case that will reveal information about the tenant's plans for the future and the ability for it to finance its operation.
- Pay careful attention to deadlines for filing proofs of claim for "rejection" damages or estoppel notices with regard to monetary defaults to be paid as "cure" when a tenant's interest is being assumed or assumed and assigned.
- Carefully review any plan of reorganization filed by a tenant, as the plan may purport to affect assumption or rejection and otherwise impact a landlord's interests.

### **DRAFTING CONSIDERATIONS: PROTECTIVE PROVISIONS TO MITIGATE LANDLORD BANKRUPTCY RISK**

Landlords with foresight and an understanding of the risks created by tenant financial distress and bankruptcy can reduce the risk of loss by including lease provisions in their documents that anticipate the risk. Specifically, landlords should seek:

- a security deposit or letter of credit;
- parent, affiliate, or other third-party guaranties;
- favorable lease termination provisions, including conditional limitation language;
- strict limits on tenant holdover rights; and
- carefully crafted additional rent provisions relating to real estate tax payments, CAM charges, and the like, to account for timing issues for accrual and payment of such additional rent charges to anticipate the issues that may arise in a tenant bankruptcy.

To the extent a landlord obtains such protective provisions as part of a lease negotiation, such provisions will benefit the landlord. In the event a lease does not include such landlord

protections, all is not lost, as a landlord may be able to obtain such protections from the tenant as part of a lease workout if the tenant falls behind on its obligations. Any such workout should be completed with the advice of counsel familiar with the bankruptcy risks that may be created by a workout, including the avoidance of pre-bankruptcy transactions that may constitute a “preferential transfer” or “fraudulent conveyance” under applicable law.

## CONCLUSION

A tenant’s bankruptcy sets into motion a complex chain of events that has far-reaching effects on a landlord’s rights under its lease agreement with the tenant. The landlord should be aware of how a tenant’s bankruptcy will affect its rights under its particular lease. To that end, landlords with financially distressed or bankrupt tenants would be well advised to have an attorney assess what steps should be taken to best protect the landlord’s interest, both before and after the tenant files for bankruptcy protection.

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