

When your commercial tenant faces bankruptcy: a primer for landlords

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The Bankruptcy Code contains a number of provisions specific to nonresidential leases. When the prospect of a tenant's bankruptcy arises, a landlord should have a basic understanding of these provisions and prepare to move diligently to protect its rights and minimize harm. In bankruptcy, a creditor who sleeps on its rights often loses them.

As a starting point, the landlord should understand that a tenant's bankruptcy does not prevent the landlord from evicting the tenant when the lease terminates "*by expiration of its stated term*" either before or during the bankruptcy. In all other situations, the landlord will likely need the assistance of the court to protect its rights early in the case.

In today's environment, even a tenant in bankruptcy may be more desirable than no tenant at all, but if a landlord does not want the tenant, the landlord may want to terminate the lease *before* the tenant files bankruptcy, if possible. This is because the tenant loses all of its rights in the premises once the lease has been terminated. If the lease is terminated before the bankruptcy filing for any reason *other than* the "expiration of its stated term," courts disagree as to whether the landlord can evict the tenant without bankruptcy court approval; so the safest course of action is to file a motion for relief from the automatic stay and ask the court for permission to evict. The motion should be granted because the tenant has no legal right to retain possession.

If the landlord does not terminate the lease before the bankruptcy filing, the landlord can not terminate the lease after the filing based upon a default by the tenant, even if the lease provides that the bankruptcy filing is a default.

At the outset of the bankruptcy case, the landlord must generally honor the lease. However, if there has been a default under the lease prior to the filing, the tenant cannot require the landlord to "provide services or supplies incidental to such lease" unless the landlord is compensated under the terms of the lease for the services or supplies.

The tenant is required to timely pay its post-petition rent when due until the lease is either "assumed" or "rejected" as discussed below; however the tenant can seek an extension to pay its rent in the first 60 days up to the 60th day. Unfortunately, the Bankruptcy Code does not contain a clear remedy if a tenant fails to do so. A landlord who is concerned about the tenant's timely paying its post-petition rent should consider filing a motion early in the case requesting an order requiring timely rent payments or, in the alternative, termination of the lease. This often puts the tenant under pressure to either pay the rent or vacate the premises. Unfortunately the landlord may still not get paid because the tenant may not have the available cash to pay its administrative claims. Courts are divided on whether to order immediate payment where there is a question whether the debtor will have sufficient funds to pay all of its administrative claims. Also, if the case is converted from Chapter 11 to Chapter 7, the portion of the rent accrued before the conversion may be subordinated to the costs of the Chapter 7 case and paid at the end of the case, if at all. Nonetheless, even if the remedies available to the landlord may be inadequate, the landlord should take advantage of the remedies available to it without delay to avoid further harm.

The debtor-in-possession or the trustee has 120 days to file a motion to “assume,” or adopt and go forward with, the lease; otherwise, the lease is deemed to be “rejected” which is deemed to be a breach of the lease as of immediately before the filing, and the tenant is required to immediately turn over possession to the landlord.

To “assume” a lease, the trustee or debtor must show the court that it will (1) “cure” all monetary defaults (and certain types of non-monetary defaults), (2) compensate the landlord for any damages caused by the defaults, and (3) provide “adequate assurance of future performance.” In a shopping center, “adequate assurance” includes a showing that the percentage rent due under the lease will not decline substantially.

The court can extend this 120 day period an additional 90 days “for cause” but no longer without the landlord’s consent. Also the landlord can seek a reduction of this period and may want to consider doing so where, for example, the tenant is no longer using the premises and either the landlord cannot count on the tenant paying the post-petition rent or would rather have the tenant vacate the space.

Note that the tenant has no right to modify the terms of the lease without the landlord’s consent; however, this process does provide the landlord an opportunity to negotiate a modified lease should it choose to do so.

With court approval, the debtor or trustee may also assume and assign the lease to another party, notwithstanding an anti-assignment clause, by essentially satisfying the same standard the debtor must meet to assume the lease. There are special provisions for shopping center leases which require the assignee to satisfy the shopping center’s restrictions relating to tenant mix, balance, use, exclusivity and the like.

Where the trustee or debtor rejects a lease and the landlord terminates the lease, the landlord has a right to file a proof of claim for damages for the breach of the lease but the claim is capped by statute to the greater of one year’s rent or 15% of the remaining rent under the lease, not to exceed three years. There is some controversy as to how to calculate the cap but because the cap is a limitation on, not a measure of, the damages, we think the better view is that the damages are first calculated under applicable law and then are reduced to the extent they exceed the cap.

While this discussion generally describes a landlord’s rights and obligations, there are numerous exceptions and special circumstances which may come into play in any particular case. A misstep by the landlord which harms the debtor or its business may expose the landlord to damages. So we strongly urge landlords to consult with capable bankruptcy counsel to assist in the process.