DAILY BUSINESS REVIEW

The Ten Commandments of Landlords and Commercial Tenants in Bankruptcy

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By **David Samole** | June 25, 2020 at 10:06 AM

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The year 2020 needs to be done. It is the middle of the year, and it seems like we are in the middle of the 10 plagues. Coronavirus, murder Hornets, Kobe Bryant's death, record-breaking unemployment, social isolation, civil unrest and global economic recession. Yuck.

Discretionary consumer spending is limited due to social distancing measures, especially at brick-and-mortar premises like retailers in shopping malls. In these transitory economic moments when unexpected events shock our system, we crave comfort, certainty and more efficient markets. Many companies are streamlining their physical footprint on account of widespread telecommuting policies and economic incentives. During this pandemic period, commercial rents have come under siege with landlords and property owners struggling to carry their debt service.

These factors have produced an active Chapter 11 bankruptcy season during this period, and it appears we are just getting started. Bankruptcy courts have been dealing with these matters under the dire financial distress and exigencies that have arisen during this pandemic. Since we are enduring the 2020 version of the 10 plagues, below is a top 10 Q & A list that can be couched as the "Ten Commandments of Commercial Landlords and Tenants" in bankruptcy.

- **What can happen to a lease in a tenant's bankruptcy filing?**

Commercial tenants have three options with unexpired leases in bankruptcy: assume the lease and continue performing all obligations, assume and assign the lease to a third party who takes over the lease, or reject the lease, surrender the premises and terminate performance. This decision can happen over a landlord's objection.

Tenants have an initial 120-day period to assume commercial real estate leases. Tenants may request one 90-day extension—which usually is granted over objection if post-petition rent is current. A court cannot extend this 210-day period without the landlord's written consent. No bankruptcy cases during this pandemic period have extended this period without landlord consent, and it is not likely that a court can do so under the current version of the Bankruptcy Code—even under the duress of this pandemic.

- **Does the "automatic stay" of the Bankruptcy Code apply to landlords?**

Landlords need relief from the automatic stay to enforce its lease rights including eviction, termination or foreclosure. To bypass potential bankruptcy issues, landlords should conclude evictions or lease terminations AND re-take the premises PRIOR to the bankruptcy filing.

- **Do commercial tenants have to pay rent while in bankruptcy?**

Tenants have to "pay to stay." The Bankruptcy Code requires tenants to keep current with lease payments and do so within the first 60 days of the case. Claims for unpaid rent during the bankruptcy receive a higher priority "administrative expense" status. This only relates to rent during the bankruptcy, not rent that was owed prior to the bankruptcy, which remains a general unsecured claim and does not have to be paid until the lease is assumed.

During the pandemic, courts have been faced with mothballed businesses and force majeure clauses. Some courts have extended the 60-day period based on adequate protection of such administrative expense obligations being paid going forward in the form of bankruptcy "DIP" financing, budget line items in approved cash-flow budgets, and other indicia of likely payment under applicable facts and circumstances.

- **If a lease is rejected, what are the landlord's "rejection" damages?**

"Rejection damage" claims are prepetition rent owed plus rent due under the remaining lease term. The Bankruptcy Code caps the landlord's remaining rent claim at the greater of one year's rent, or 15% of the rent due under the lease, not to exceed three years' rent.

In retail cases, there have been "going-out-of-business" (GOB) sales. Lease terms prohibiting GOB sales are not enforced in bankruptcy, as necessity and creditor fairness prevail. Landlords can address duration of GOB sales, hours of operation, mall regulations, and signage/advertising.

- **What are the landlord's rights when the lease is assumed?**

Tenants must provide for "prompt cure" of monetary and non-monetary defaults, and "adequate assurance" that the tenant will perform under the lease. "Prompt" is not defined under the Code—case specific. Rule of thumb is to compare the cure period with the remaining lease term. Merely staying current with postpetition obligations does not establish adequate assurance of future performance. The tenant's exit financing and tested financial projections are included as evidence of assurance of future performance.

- **"Assumption" can be better than "critical vendor" status.**

Assumption provides a defense against preferential transfer lawsuits (i.e., those claw-back lawsuits seeking to avoid and recover payments made within 90 days prior to a bankruptcy case). This protection usually is not stated in orders approving lease assumptions, but this is a growing consensus. Critical vendors/essential suppliers generally do not receive protection against preferential transfer lawsuits.

- **What are the landlord's rights when the lease is assumed and assigned to a third party?**

Anti-assignment clauses in leases are not enforceable in bankruptcy. The debtor-tenant must demonstrate the new tenant's ability to cure defaults under the lease and make future payments. The new tenant shows it is financially viable via a mix of historical financials, current liquidity, and going-forward projections; and sufficient experience in the particular industry if specialized business being taken over in the space, e.g., a restaurant. Shopping center leases have additional requirements to satisfy "adequate assurance of future performance" including, but not limited to, tenant mix, radius, use, and exclusivity conditions to consider (some centers cannot have competing big box stores, like Target and Wal-Mart).

- **Can landlords recover attorney fees in bankruptcy?**

Landlords may recover attorneys' fees in the tenant's bankruptcy if the lease provides for attorneys' fees in connection with rent collection and the landlord "prevails" in the proceedings. "Prevailing" in a bankruptcy proceeding is considered when protecting or enforcing the landlord's rights under the lease, not matters where the landlord challenges the debtor-tenant's rights generally under the Bankruptcy Code. Attorney fees must be reasonable including the amount in dispute relative to fees requested, the debtor-tenant's good faith efforts to resolve the dispute and compliance with the Bankruptcy Code.

- **How can commercial landlords better protect themselves?**

Three modes of protection are: letters of credit; personal guaranty and security deposits.

Letters of credit (LOC) involve banks agreeing to irrevocably cover obligations of its customer to a third party, allowing a landlord to draw on the proceeds of the LOC should the tenant default under the lease. LOCs generally are not considered property of the tenant's bankruptcy estate. Notably, caselaw

appears split whether a landlord’s lost profits damage claim for remaining lease term is capped or not under the Bankruptcy Code when using a LOC. LOCs are NOT subject to claw-back lawsuits, except if the LOC is set up during the 90-day preference period or collateral is added within that period.

Landlords may pursue a personal guaranty, provided the lease guarantor is not in bankruptcy. If the guarantor also is in bankruptcy, the rejection damage cap will apply. The guarantor could receive a co-debtor stay without even filing bankruptcy on its own, but that is the subject of additional litigation.

Security deposits are industry standard, but they are considered property of the bankruptcy estate. Landlords sometimes are permitted to set-off their claim against the security deposit, which enables some landlord recovery ahead of unsecured creditors; and reduces the deposit amount to be returned. Landlords get comfort orders from the court prior to applying security deposits even when negotiated with the debtor-tenant.

- **What happens to tenants when the landlord is the Chapter 11 debtor?**

The debtor-landlord can reject a lease and no longer perform any of its duties, but it cannot use bankruptcy to evict a tenant that prefers to stay in possession. The tenant may elect to remain in the premises for the remaining lease term, which tenant must pay the rent required under the lease but it can offset any damages caused by the landlord’s nonperformance.

When the debtor-landlord seeks to sell property free and clear of such leasehold interests, there is a caselaw split whether a tenant’s leasehold interest is extinguished. However, those cases holding that a tenancy may be extinguished upon sale of property generally include adequate protection and buy-out treatment of the tenant. Note: landlords should include some type of

valuation of the leasehold interest in the lease documents, as valuation hearings are entirely uncertain.

Conclusion

We are all undergoing a changing landscape re-entering commerce and the workplace during this pandemic period. Flexibility and maneuverability in the marketplace are essential across industries, including the commercial real estate sector. The rules of engagement are complicated during financial distress, but hopefully better understanding some of these concepts and discussion points can assist commercial landlords and tenants encountering these issues during these uncertain times.

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