



Bankruptcy 101: a primer for landlords facing tenant bankruptcies

As the pandemic endures and businesses continue to struggle under restrictions and safety measures intended to control the spread, it is likely that a number of commercial and retail tenants will either threaten to file bankruptcy or actually do so in the coming months. What can you, as a building owner or manager, do to protect yourself and what can you expect if one of your tenants does so? This is an introductory and practical overview; the specifics of your situation will likely vary; early planning and knowing your options may help. Bankruptcy can be a fast moving process; if you sit on your rights for too long you will likely lose them. If you have questions, consult with counsel sooner rather than later.

Steps to Protect Yourself: Don't Overlook the Obvious

First, with respect to new leases, or any agreement or amendment to defer or forebear on rent payments, require adequate security for payment. Absent security, you will be just another unsecured creditor at the bottom of the bankruptcy pile if the tenant rejects the lease in bankruptcy. As discussed more fully below, cash, a letter of credit or a guaranty from a solvent third party each provides some, but not complete, protection. The security should also clearly cover non-rent repayment obligations of the tenant, such as abatements, tenant improvement allowances and obligations to repay brokerage fees.

Second, do not let your tenant get substantially in arrears in rent payments, at least not without a plan and security for eventual payment. Arrears may otherwise outstrip your security. Even if it does not, collection of a catch-up payment shortly before bankruptcy may be clawed back as a preference or stayed by governmental order as we have seen in connection with the COVID-19 pandemic.

Close communication between ownership and property management is key.

Different Types of Bankruptcies

Business bankruptcies come in two general flavors. In "Chapter 11" cases, the debtor (the person/entity in bankruptcy) attempts a plan to reorganize, cancel or reduce some of its obligations and remain in business or may attempt to sell its business as a going concern free and clear of all liens and encumbrances. In "Chapter 7" cases, the debtor goes out of business, its assets are sold by a trustee (including, potentially, below-market leases) and its creditors paid in order of priority, sometimes providing only pennies on the dollar for unsecured obligations.

Automatic Stay

Immediately upon the debtor's bankruptcy filing, generally all litigation or other attempts to collect rent and other debts owed by the debtor are stayed absent an application to the Bankruptcy Court to lift the stay with respect to a specific claim or litigation. However, the automatic stay does not stay any act to obtain possession of the leased property by a lessor under a lease of nonresidential real property that has terminated by the expiration of the stated term of the lease before the

commencement of or during the continuation of a bankruptcy case.

Filing a Claim

Your claim against the debtor/tenant must be filed with the bankruptcy court in the order for you to receive any compensation for the claim. Your claim will be deemed filed in a Chapter 11 case if the claim is listed on the debtor's schedules as undisputed, non-contingent and unliquidated, so you should promptly review the schedules. If you do not believe the amount reflected is correct, you need to file your own proof of claim (and anticipate a dispute). You also need to file your own proof of claim if your claim is not listed at all.

Get your ducks in a row quickly. Calculate the amount of your claim and find your supporting documents. You have a limited period in which to file a claim, generally 70 days after the filing of the petition in a Chapter 7 liquidation. In a Chapter 11 case, the deadline to file a claim (often called a "bar" date) is set by the Bankruptcy Court and sent to creditors in the official notice creditors receive that the debtor has filed. Note that at the commencement of the debtor's bankruptcy case (particularly a Chapter 11 case) the debtor often does not yet know whether it will assume or reject your lease (see discussion below). The lease may just be listed on a schedule of executory and unexpired leases. You will need to wait to see what action the debtor decides to take with respect to your lease. If the debtor does reject your lease, you will be given additional time to file a claim notwithstanding other filing deadlines.

The official proof of claim form can be found on the Bankruptcy Court website. We recommend that counsel file the claim for you and at the same time, file a notice of appearance with the court so that counsel receives notice of hearings, orders and other proceedings before the court that could affect your claim. There are sharks circling the debtor who will look to take chunks out of your security or claim. But you may not be done yet. Your claim is subject to review by the debtor, any trustee appointed by the Bankruptcy Court or even other creditors. It is possible that there will be an objection; the devil is in the details, so supporting your filed claim with calculations and documentation may forestall or limit an objection.

Any payment of your claim depends on the total of the claims submitted, the amount/value of the debtor's assets, and your place in the hierarchy of obligations that the debtor owes. So the value of your claim will not be known for some time.

Your Right to Terminate the Lease Upon Insolvency or Bankruptcy

You know those provisions in your leases that make bankruptcy a default allowing you to terminate, or that prohibit assignment of the lease without your permission?

Fuhgeddaboutit!

The Bankruptcy Code makes these provisions unenforceable and void.

Option to Assume or Reject Lease

Upon filing a Chapter 11 case, the debtor has a statutory period, 120 days (extendable to 210 days), to "assume" or "reject" commercial leases. In a Chapter 7 case, the trustee has 60 days (extendable to 120 days) to assume a commercial lease. The debtor may assume a lease either to continue to use the premises in its reorganized business, or to assign it to a third party (sometimes for a payment). When a trustee assumes a lease the motivation is almost always to assign it to a third party for a payment. The third party may either continue the business of the debtor or conduct a totally different business. Say "hello" to your new tenant and activity!

In both Chapter 7 and Chapter 11 cases, the court has the power to extend the time for performance of lease obligations for up to 60 days after the filing date. Many debtors take advantage of that by not paying post-petition rent during this 60-day period.

Assumption or rejection also affects the rents you can collect and the amount of your claim. You can and should amend your claim once you know what the tenant intends to do with your lease.

If Your Lease is Assumed by Tenant or Assigned to a New Tenant

To assume the lease, the tenant itself or its assignee must give you "adequate assurance" that it can satisfy the financial obligations of the lease. If the debtor wants to assume and keep your lease, it must provide adequate assurance if there has been a default under the lease other than a default relating solely to the financial condition of the debtor or the

commencement of the bankruptcy proceeding or a penalty to perform a non-monetary obligation. If the debtor wants to assume your lease in order to assign/sell it, you do not have to accept another deadbeat. The assignee must provide adequate assurance of future performance regardless of any default by the debtor. The proposed use of the premises must also comply with the use provisions of the lease – the bookstore can't transform into a nightclub, unless of course the lease allows "any legal use" or has similar broad use provisions. (There are special provisions as to use that apply to debtor-tenants in multi-tenant shopping centers.)

On the bright side, if the debtor or the trustee assumes the lease, all rents owed – pre-petition and post-petition – must be paid.

But don't count your chickens quite yet - there is often a negotiation. The tenant or proposed assignee typically will agree to assume the lease only if there is a renegotiation of its terms. Your tolerance for negotiation may depend in large part on what you believe your prospects are for finding another tenant. If you are unwilling to renegotiate, the response may be "here are the keys, go find yourself a new tenant, and forget about any pre-petition unsecured unpaid rent and damages for the rejection and early termination of the lease."

If Your Lease is Rejected

If the lease is rejected, you are entitled to possession of the premises. If the debtor tenant has a cash security deposit, it is an asset of the bankruptcy estate – you can't just grab it post-petition – but you are a secured creditor to be paid from that security in the bankruptcy proceeding for the period of the debtor's possession of the premises – pre-petition and post-petition. If the debtor tenant has no cash security deposit or the deposit is not enough, you are an unsecured creditor for any/all payment obligations of the debtor through the date of eviction, though with priority over other creditors as an administrative claim for post-petition, pre-surrender periods.

Your damages claim against the debtor for rejection of the lease – i.e. for any of the rent that would have been due for the balance of the lease term had the lease not been rejected - is limited to the lesser of one year's rent or 15% of the shorter of the balance of the lease term or three years. You may also be able to collect typical "additional rent" items, e.g. real estate taxes, common charges, costs, utilities or legal fees due under the lease for that period. Amounts you claim as clawbacks for the early termination of the lease, e.g. rent abatements or free rent periods, tenant improvement allowances and brokerage fees, are subject to the one year or 15% limit.

You may have separate remedies against a guarantor of the lease or against a bank that issued a letter of credit as security for the lease. Note that non-debtor guarantors do not get the benefit of the limitations on your claim for damages against the debtor for rejection of your lease discussed above. See below.

Your Rent Claim

It's complicated.

If the debtor makes a substantial catch-up payment or prepayment of rent to you within the 90 days prior to filing a bankruptcy petition (as opposed to regular timely payments of rent) it may be treated as a "preference" by the Bankruptcy Court and clawed back from you to the bankruptcy estate. If such a lump sum payment is offered or negotiated with the tenant pre-petition, try to have the payment made by a party other than the tenant – a solvent parent or an individual principal of the tenant.

If the lease is assumed, you are entitled to be paid all of the rent due under the lease – pre-petition and post-petition – either from the debtor or from the assignee (unless, of course, you agree to renegotiated terms as a condition of the assumption).

If the lease is rejected, and you have cash security, you are a "secured" creditor of the debtor for the rent due during the period up until the tenant vacates. But remember, post-petition the security is an asset of the tenant's bankruptcy estate and you cannot just grab it; you must get an order from the Bankruptcy Court to tap the security.

If the debtor retains possession of your premises after the bankruptcy filing, rent due for the period of post-filing possession

is an “administrative” claim with priority of payment over unsecured claims. This includes unpaid post-petition rent that accrues before the debtor ultimately rejects your lease.

“Unsecured” claims, such as the lease rejection damages claim discussed above, may get pennies in either the reorganization or liquidation plan of the debtor.

Claims for “additional rent” items, or to clawback concessions you gave to the tenant in the lease such as brokerage fees or landlord’s work expenditures and the like, raise additional issues. If you have security (cash deposit or other security that constitutes property of the debtor’s estate) the security secures your entire claim: unpaid pre-petition rent, unpaid post-petition rent and unpaid post rejection rent (subject to the limitations discussed above).

But What About That Guaranty or Letter of Credit Security For Which You Negotiated So Hard?

As a general rule, the stay that protects the debtor tenant upon filing a petition in Bankruptcy Court does not protect third-party guarantors of the lease, or a bank that issued a letter of credit as security for the lease. You retain your contractual rights and remedies against each, separate and apart from the tenant’s bankruptcy proceedings. Use them.

But it’s not that simple and there are exceptions and limits.

If you have a guaranty, in some instances a guarantor may claim that it is making a substantial contribution to the bankruptcy reorganization of the debtor, e.g. investing fresh money to allow the debtor to remain in business. The Bankruptcy Court may then stay claims against the guarantor on the theory that allowing the claims to proceed will dissuade the guarantor from making the contribution and will thus frustrate the reorganization. The law is unsettled on this issue.

If you have a letter of credit and make a demand for payment to the bank that issued it the bank, in turn, may make demands on or seize assets of the debtor that secured the letter of credit. The Bankruptcy Court may stay your demand against the bank for 60 days in order to give the debtor and the Court time to address the bank’s demands and the debtor’s loss of additional assets without prejudicing the debtor’s ability to reorganize.

As noted earlier, your claims against non-debtor guarantors are not subject to the limitations on your claim against the debtor-tenant for rejection of your lease.

And in the End

Yes, there are procedures to follow, rules to comply with and guidelines that are helpful, but it can be confusing. Nothing is simple and tenant bankruptcies create complications. We are here to answer your questions.

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