

# Article

## What Every Landlord Should Know About Non-Residential Tenant Bankruptcies

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The escalating number of corporate bankruptcy filings over the past year has impacted the real estate market as much as any other sector of the economy, and, within the real estate market, commercial landlords may have the greatest exposure. It is therefore more important now than ever before for commercial landlords to have some familiarity with certain key issues that are likely to arise when a tenant seeks protection under the Bankruptcy Code. Below are some of these key issues, an understanding of which will allow a commercial landlord to protect its interests and limit costs and expenses.

### Automatic Stay

What is it? The automatic stay is a legal fiction that springs into effect automatically upon the filing of a bankruptcy petition. It is broad in scope and stops almost all collection actions against a debtor or its property.

What is Stayed? Examples of actions that are prohibited include: (i) a demand that the tenant pay a debt, which accrued before the commencement of the bankruptcy case, (ii) action to terminate the lease agreement, (iii) action to evict the tenant, and (iv) applying any security deposit held by the landlord.

What isn't Stayed? A lease agreement that expired or was terminated before the bankruptcy case commenced is outside the scope of the automatic stay. However, out of an abundance of caution, a landlord should consider seeking relief from the automatic stay before enforcing its rights under the lease.

Relief from the Automatic Stay. A landlord is entitled to seek relief from the stay, but the bankruptcy court has a great deal of discretion in deciding whether to grant the request. The bankruptcy court will probably lift the stay for nonpayment of rent accruing after the bankruptcy case commenced if the tenant fails to cure the postpetition default within a relatively short period of time. It is unlikely, however, that the bankruptcy court will lift the stay for nonpayment of prepetition rent.

Violations of the Automatic Stay. Violations of the automatic stay are treated very seriously and may result in a landlord paying damages and attorneys' fees.

*Ipso Facto* Clause. Generally speaking, an *ipso facto* clause is a lease provision that provides that the lease terminates or that lease obligations are modified solely because the tenant is insolvent or files bankruptcy. An *ipso facto* clause is unenforceable against a bankrupt tenant.

### Rejection, Assumption, or Assignment

Timing. A tenant has 120 days from the date of the order for relief to decide what it wants to do with the lease, though the bankruptcy court may extend the 120 day period for an additional 90 days for "cause." Any subsequent extension beyond the foregoing 120 day period may only be approved by the bankruptcy court upon prior written consent of the landlord. If the tenant fails to make its decision within the time period, the lease is deemed rejected.

Compel. While the Bankruptcy Code gives a tenant ample time to decide whether to reject, assume, or assume and assign a lease, the bankruptcy court may compel the tenant to make its decision in a much shorter time period upon a showing of "cause" (i.e., a failure to timely pay postpetition rent). During the period the tenant is deciding, the landlord should insist on timely payment of rent, common area charges and other charges provided in the lease.

## A. Rejection

Standard. The bankruptcy court will defer to the tenant's business judgment in determining whether to allow the bankrupt tenant to reject a lease.

Treatment. A lease rejection is essentially treated as a breach of the lease that occurred before the bankruptcy case was commenced and requires the tenant to immediately surrender possession of the premises to the landlord. However, damages caused by the lease rejection are limited to: (i) unpaid rent from the earlier of the filing date or date the landlord repossessed the premises, plus (ii) (a) the greater of one year's rent or (b) 15% of the rent owing (not to exceed three years).

Claim Priority. Unless the landlord is holding a security deposit, the entire amount of the landlord's rejection claim is an unsecured claim ranking in the same priority with other general unsecured claims.

## B. Assumption

Standard. The bankruptcy court will defer to the tenant's business judgment in determining whether to allow the bankrupt tenant to assume a lease.

Cure. To assume a lease, the tenant must (i) promptly cure most prepetition and postpetition defaults (there is a slight exception with respect to curing a default arising from a failure to perform non-monetary obligations), (ii) reimburse the landlord for any pecuniary losses resulting from the assumption, and (iii) provide the landlord with adequate assurance of future performance under the lease.

Shopping Centers. If the lease is for space in a shopping center, to satisfy the requirement of adequate assurance of future performance the tenant must demonstrate that: (i) the source of rent and, in the case of an assignment of the lease, the financial condition and operating performance of the proposed assignee and its guarantors (if any); (ii) any percentage rent due under the lease will not decline substantially; (iii) that the assumption or assignment of the lease (a) is subject to all provisions of the lease, including provisions addressing radius, location, use, or exclusivity, and (b) will not breach any such provisions contained in any other lease, financing arrangement or master agreement related to the shopping center; and (iv) the assumption or assignment of the lease will not disrupt any tenant mix or balance in the shopping center.

## C. Assignment

Prerequisites. To assign a lease, the tenant must first assume it. If there are defaults under the lease, the tenant must satisfy the requirements to assume the lease.

Anti-Assignment Clause. Lease provisions modifying the lease terms or terminating the lease upon a tenant's assignment of the lease are generally unenforceable.

Effect. The effect of an assumption is that the tenant's defaults will be elevated to an administrative expense priority. Administrative expense claims are paid before unsecured claims and typically are paid in full.

## Tenant's Performance Obligations While in Bankruptcy

Payments. A tenant who seeks bankruptcy protection is required to perform all obligations under the lease that arise after the bankruptcy filing, such as paying rent and related charges, until the lease is assumed or rejected.

Administrative Expense Priority Claim. A landlord is entitled to an administrative expense priority claim for unpaid postpetition obligations owed to the landlord under the lease. As noted above, administrative expense claims are paid before unsecured claims and typically are paid in full.

Maintenance Obligations. Enforcing maintenance obligations in leases can be difficult. The bankruptcy court will consider a variety of factors, including: (i) whether the item to be repaired was broken before or after the commencement of the bankruptcy case; (ii) whether the repair is necessary to protect the public; (iii) the repair cost; and (iv) whether the tenant is likely to assume the lease.

## Enforcing Lien/Security Interests

Statutory Liens. The statutory lien securing payment of rent is unenforceable if the tenant files bankruptcy.

Security Interest Provision. Many commercial leases have a clause granting the landlord a security interest in the furniture and fixtures within the leased premises. To perfect that security interest, the landlord must file an appropriate Uniform Commercial Code (UCC) financing statement.

Relief from the Stay. To exercise its rights under the lease without running the risk of violating the automatic stay, the landlord must obtain relief from the stay.

## Mitigating the Harm

Security Deposit. While a landlord may setoff the bankrupt tenant's security deposit against amounts owed under the lease, the landlord must first obtain relief from the stay.

Letters of Credit. Generally speaking, a landlord may draw on a letter of credit free from interference from the bankruptcy court. Unlike a lease security deposit, a letter of credit is an agreement between the landlord and the bank.

Third Party Guaranty. A third party guaranty is generally outside the scope of the bankruptcy court's authority. As such, a landlord can utilize third party guaranty to maximize the recovery of prepetition amounts owed to the landlord under a lease, with the added comfort of not having to get too involved in the bankruptcy case.

Rent Relief to the Debtor. A landlord may also want to take a more practical approach by lowering the bankrupt tenant's rent or deferring payments. If so, the landlord should always try to get something in return for its relief, such as an assumption of the lease.

## Primary Contacts



**Kevin Lippman**

Dallas  
214.855.7553  
[klippman@munsch.com](mailto:klippman@munsch.com)

## Related Practices

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