

Article

A Primer on Commercial Landlord Issues in Bankruptcy

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The rising number of bankruptcy filings may be having the greatest impact on the commercial real estate sector — particularly landlords of commercial real estate. Below are a few key issues landlords, and their counsel, should understand as an increasing number of tenants seek economic shelter in the provisions of the Bankruptcy Code.

THE AUTOMATIC STAY & THE TENANT'S PERFORMANCE

If a tenant files bankruptcy, an automatic stay springs into effect. A stay prohibits most collection actions, including: (i) demanding prepetition lease payments; (ii) terminating the lease; (iii) evicting the tenant; and (iv) applying a security deposit to amounts owed.

What does this mean to the landlord going forward?

If the lease expired or terminated prepetition, the tenant won't be protected from eviction by the stay. Theoretically, the landlord could move forward immediately; however, due to the serious penalties for violating a bankruptcy stay, it is always the best practice to seek leave from the bankruptcy court beforehand. If the lease has an ipso facto clause, a provision modifying or terminating the lease because the tenant becomes insolvent or files bankruptcy, it will not be enforceable and the landlord should proceed as if the lease is still in effect.

If the lease is still in effect, the tenant will be required to make postpetition lease payments until the lease is assumed, rejected or assigned. If the tenant fails to make these payments, the landlord may seek relief from the stay to evict the tenant. The landlord will receive an administrative expense claim for any unpaid postpetition lease obligations. These claims are paid before general unsecured claims and often in full.

REJECTION, ASSUMPTION OR ASSIGNMENT

A tenant in bankruptcy must choose to reject, assume or assign its lease within 120 days from the filing date. This deadline may be extended for "cause" or with the landlord's consent. Likewise, the deadline may be shortened upon a showing of "cause" by the landlord (for example, if the tenant fails to pay postpetition rent). If the tenant does not make a timely decision, the lease is deemed rejected.

A lease rejection is treated as a prepetition breach requiring the tenant to surrender the premises. The landlord's damages are limited to: (i) unpaid prepetition rent; and (ii) the greater of (a) one year's rent or (b) 15 percent of the rent owing (not to exceed three years). These rejection damages are usually treated as a general unsecured claim, unless a landlord is holding a security deposit. To preserve its claims however, the landlord must make reasonable efforts to mitigate its damages.

To assign a lease, it must first be assumed and defaults must be cured. If a lease has an anti-assignment claim, a provision modifying or terminating the lease upon assignment, it will generally not be enforced.

To assume a lease, a tenant must: (i) promptly cure most defaults; (ii) compensate the landlord for related losses; and (iii) provide adequate assurance of future performance.

If the lease is for shopping center space, the tenant must also ensure that the assumption will not place the landlord in a worse financial position than it was in when the lease commenced. Specifically, the tenant must: (i) provide the source of payment and, in the case of an assignment of the lease, the financial condition and operating performance of the proposed assignee (and guarantors, if any); (ii) stipulate that any percentage of rent due won't decline substantially; (iii) confirm that the assignee (a) is subject to the lease terms (e.g., radius, location, use, or exclusivity), and (b) won't breach similar provisions in any related agreement; and (iv) won't disrupt any tenant mix.

If a lease is assumed, prepetition default damages will be considered as an administrative expense claim and paid before general unsecured claims.

ENFORCING LIENS, SECURITY INTERESTS & MITIGATING HARM

Landlords have limited remedies when a tenant files bankruptcy. For instance, the landlord's statutory landlord lien is unenforceable.

The landlord does however have options. Within the bankruptcy arena, and assuming the landlord filed the proper financing statements, it may pursue its security interest in the tenant's personalty. After seeking leave from the automatic stay, the landlord may exercise the full array of state law remedies, set-off amounts owed against security deposits, etc.

Outside the supervision of the bankruptcy court, the landlord may draw on a letter of credit, or pursue third-party guarantors.

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