

# Pratt's Journal of Bankruptcy Law

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# Bankruptcy Implications for Commercial Landlords with Bankrupt or Near-Bankrupt Tenants

*By Amy Simon Klug and Meg Raker\**

*With tenant closures and lease defaults on the rise in the wake of the economic downturn caused by the COVID-19 pandemic, tenant bankruptcy filings are a major concern for landlords across the real estate industry. This article is intended as a guideline for commercial landlords evaluating their leases and workout options—but it is not an exhaustive list of all of the intricacies and consequences that may follow a tenant bankruptcy.*

Tenant credit and security issues and certain lease negotiations (including modification or termination agreements) happening now may be impacted by a tenant bankruptcy in the future. Commercial landlords considering new lease negotiations, or the workout or evaluation of existing leases, with some understanding of such issues in the bankruptcy context will be in a better position to protect themselves in the event of a tenant bankruptcy.

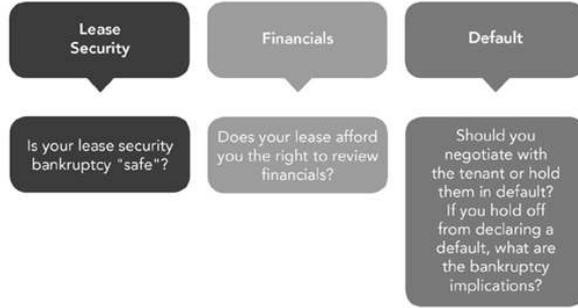
As tenant closures and lease defaults are on the rise in the wake of the economic downturn caused by the COVID-19 pandemic, tenant bankruptcy filings are—and will continue to be—a very real concern for landlords across the real estate industry. This article is intended to serve as a guideline for commercial landlords in an evaluation of their leases and workout options—but it is not an exhaustive list of all of the intricacies and consequences that may follow a tenant bankruptcy.

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## LANDLORDS WITH BANKRUPTCY KNOWLEDGE BEFORE A TENANT FILES FOR BANKRUPTCY WILL BE IN A BETTER POSITION TO PROTECT THEMSELVES IN THE EVENT THE TENANT FILES FOR BANKRUPTCY

a. What should a landlord consider **prior** to a tenant filing for bankruptcy?



b. What are the practical implications for a landlord **after** the tenant files for bankruptcy?



## PRE-BANKRUPTCY CONSIDERATIONS

### Types of Lease Security and Bankruptcy Implications

Landlords should analyze the benefits and risks associated with each "form" of lease security and determine which will best suit the landlord's needs during the lease term and in the event the tenant files for bankruptcy.

<b>Form of Lease Security</b>	<b>Pros</b>	<b>Cons</b>	<b>Practical Implications</b>
<b>Cash Security</b>	For a defaulting, non-bankrupt tenant, this is the most liquid and easiest/quickest way to apply a tenant's lease security to cure a tenant's default.	Upon the filing of tenant's bankruptcy case, this will be considered part of the debtor's bankruptcy estate, which means that the landlord has a secured claim for the amount of the deposit, a benefit not enjoyed by unsecured creditors.	The landlord cannot take the security deposit to reduce the tenant's default unless and until the court approves a motion to do the same, or, until the bankruptcy proceeding is over and the secured claim is paid out. Carefully review your tenant's financials and consider whether a liquid option is the short term will adequately secure the tenant's obligations.
<b>Letter of Credit</b>	In general, letters of credit are not considered to be part of the debtor's bankruptcy estate, meaning that the bankruptcy automatic stay does not prevent a landlord from drawing on a letter of credit after the tenant files for bankruptcy.	There is an administrative burden associated with obtaining and maintaining letters of credit. A tenant must find a bank that will issue a letter of credit in a form acceptable to a landlord, and must pay a fee to the bank. Landlords must take steps to draw on the letter of credit in strict conformity with the terms therein.	Because a letter of credit is generally considered independent from the bankruptcy estate, a landlord may have more flexibility with this type of lease security by being able to draw on the letter of credit while the tenant is in bankruptcy. The landlord should be aware of any requirements in the lease or letter of credit to formally declare a tenant in default.

			before drawing on the letter of credit. If the tenant files for bankruptcy before such notice of default is sent, the landlord may need to seek relief from the court before taking any further action
<b>Third-Party Guaranty</b>	Bankruptcy does not prohibit landlords from collecting a non-bankrupt, third-party guarantor.	A guaranty, in and of itself, provides no cash security. Collection may require intense negotiations and litigation. Even if you obtain a judgment against the guarantor, the guarantor may be insolvent or otherwise judgement-proof.	In all cases, the guaranty should be clear that landlords should not first be required to collect against the defaulting tenant.

**POST-BANKRUPTCY FILING IMPLICATIONS**

**The Automatic Stay**

All pre-petition debts, including rent arrearages, are to be handled through the bankruptcy process. As such, when a debtor files for bankruptcy, the automatic stay is instituted to halt all lease enforcement and collection actions in connection with pre-bankruptcy lease arrearages against the tenant and its property. Once the tenant files for bankruptcy, the tenant is required to remain current on its financial obligations, including the payment of rent, unless the tenant seeks and obtains permission from the court not to do so through either a motion to extend the time period to make rent payments by up to 60 days or through a motion to reject the lease. Practically speaking, what can you, as a landlord, do and not do after the tenant files for bankruptcy?

Actions Landlord Can Take	Actions Landlord Cannot Take Absent Court Approval
<ul style="list-style-type: none"> <li>✓ File a motion to lift the automatic stay so that the landlord can:                             <ul style="list-style-type: none"> <li>○ initiate or continue the eviction process if the debtor has failed to cure its pre-petition rent arrearages or fails to pay its current rent obligations                                     <ul style="list-style-type: none"> <li>▪ if the tenant fails to pay its post-petition rent, then this rent amount will be considered an "administrative expense," with priority over unsecured creditors</li> </ul> </li> <li>○ offset rent arrearages from an outstanding tenant allowance or excess additional rent payments (i.e., overestimated share of taxes, insurance and operating expenses)</li> </ul> </li> <li>✓ Draw on the letter of credit if all conditions of the letter of credit are satisfied</li> <li>✓ File a motion to compel payment of unpaid post-petition rent</li> <li>✓ Proceed under lease guaranty against non-bankrupt guarantor</li> </ul>	<ul style="list-style-type: none"> <li>✗ Send tenant a notice of default</li> <li>✗ Take any action to commence or continue any action to collect pre-bankruptcy arrearages under lease</li> <li>✗ Take any action to exercise control over or take possession of tenant's property, such as to foreclose on tenant's furniture, fixtures and equipment (FF&amp;E)</li> <li>✗ Sign a lease amendment or agreement to modify lease</li> </ul>

### Assumption and Rejection of Leases

A debtor must assume, assume and assign, or reject a lease within 120 days following the date that the tenant files its bankruptcy case, which can be extended for up to 90 days by court order for cause. Any further extension of this time period requires the prior written consent of the landlord. Failure to timely do so will require the tenant to surrender the leased space.

**Assumption:**  
Lease stays alive as-is.

Tenant must:

1. Cure defaults (including replenishing security deposit) or provide assurance that it will do so.
2. Compensate landlord for "any actual pecuniary loss" resulting from the debtor's breach.
3. "Provide adequate assurance of future performance."

**Assumption and Assignment:**  
Lease is assumed and then assigned to third party (overriding any lease transfer restrictions).

Tenant is relieved of any obligation to perform under assigned lease.

Tenant and assignee must take steps 1 and 2 from assumption. *Note: The landlord has the option to require additional security.*

**Rejection:**  
Generally constitutes a breach of the lease, giving rise to an unsecured rejection claim.

Tenant must vacate and is excused from further performance.

Rejection claim is capped, being the rent reserved under lease without acceleration for the greater of one year or 15 percent, not to exceed three years, of the remaining term of the lease.

**Preferential Transfers and Fraudulent Conveyances**

Will a bankruptcy court be able to claw back a cashed security deposit or rent paid by the tenant prior to the bankruptcy filing?

What Is It?	Implications on Lease Security and Tenant Payments
<ul style="list-style-type: none"> <li>• Generally, a <i>preferential transfer</i> is a payment made by the tenant:                             <ul style="list-style-type: none"> <li>o to or for the benefit of the landlord;</li> <li>o within 90 days prior to tenant's filing of the bankruptcy petition;</li> <li>o while the tenant is insolvent;</li> <li>o on account of preexisting debt; and</li> <li>o that enables the landlord to receive more than it would have received if the tenant had filed a Chapter 7 liquidation case.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Typically, payments made in the "ordinary cause" of business are not preferences.                             <ul style="list-style-type: none"> <li>o Atypical debt collection or restructured payments may fall outside the ordinary course of business exception.</li> </ul> </li> <li>• Lease termination payments are generally not considered preferences because they are not on account of an antecedent debt.</li> <li>• Lease termination payments may be considered a fraudulent conveyance <i>unless</i> the value of the benefit to the tenant/debtor for not having to pay rent going forward and any other benefit received is reasonably equivalent to the value of the lease termination payment.</li> <li>• The landlord's application of a cash security deposit on account of past due rent may be recoverable as preference.</li> </ul>

<ul style="list-style-type: none"> <li>• Generally, a transfer can be avoided by a trustee within two years of date the tenant filed its bankruptcy case as a <i>fraudulent conveyance</i> if the transfer:             <ul style="list-style-type: none"> <li>o was made with the actual intent to hinder, delay or defraud creditors, or</li> <li>o was not made for reasonably equivalent value, and                 <ul style="list-style-type: none"> <li>o was made while the tenant was insolvent or which rendered the tenant insolvent, or</li> <li>o was engaged in a business or a transaction for which any remaining property was unreasonably small capital, or</li> <li>o the tenant intended to incur or believed it would incur debts that would be beyond the tenant's ability to pay as the debts matured.</li> </ul> </li> </ul> </li> </ul>	
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**Rent Abatement and Deferrals**

Although there are a number of factors that will come into play when a landlord is considering different rent modification options, landlords should at least be aware of the treatment of these two primary structures in the event of a tenant bankruptcy.

- *Rent Abatement:* In some leases or rent modification agreements, a landlord will agree to abate certain months of rent but require, in the event of default, that all abated rent payments become immediately due and payable. If a debtor assumes the lease and cures the default, the abated rent may be reinstated. If the debtor rejects the lease, then context and circumstances will determine whether the landlord's claim for the abated rent will be considered "unpaid rent" or a prohibited penalty for default. As in many bankruptcy considerations, substance over label will be determinative.
- *Deferral:* In the event of a rent deferral agreement, the parties may agree that the landlord will forego enforcement of certain rental obligations for a set time frame and that such obligations are to be repaid at a later

date. If the tenant files for bankruptcy before repaying these deferred amounts which come due post-petition, the landlord may have an administrative claim for those deferred rent payments, provided that the bankruptcy court determines that the obligations to pay arises post-petition.

### **PRACTICAL TAKEAWAYS**

If you have the right to review your tenants' current financials, now is the time to do so. If your tenant is financially unstable and currently in default, send a notice of default (even if it is just a friendly one). There is no reason not to do this while you are engaging in workout discussions. Further, if you terminate the lease before your tenant files bankruptcy, the tenant does not have a leasehold interest that would be property of the tenant's bankruptcy estate protected by the automatic stay. It is never too late to review your lease to determine how secure the lease actually is.

As courts of equity, bankruptcy courts not only consider the specific facts and circumstances of each case but also, because of the overriding goal of reorganization in bankruptcy, may subordinate other legal rights and policies. Therefore, there is no one-size-fits-all answer to the challenges that commercial landlords are facing.