Client Alert: Paying the Rent in Bankruptcy – An Overview of Chapter 11 for Commercial Tenants and Their Landlords

BY CESIRA NEWCOMB • MAY 5, 2020

Even in the halcyon days pre-coronavirus, a typical small business could not operate for more than two weeks without incoming revenue. In a matter of months, social distancing and mass unemployment having dramatically reduced consumer spending and companies are surviving by cutting energy usage, adjusting inventory purchases, and drawing on Paycheck Protection Program loans to backstop employee wages. Rent, however, is one expense that remains immutable.

Of course, landlords feel financial pressure, too. Lease revenue covers the landlord's mortgage, maintenance costs, insurance, and real estate tax liabilities. If the landlord is an investment trust it might have fiduciary duties to its shareholders that limit its options in aiding an insolvent tenant. Landlords are by no means in a position to support every business indefinitely.

So what happens if a business is unable to pay its rent, fails to reach a consensual rent restructure with its landlord, and files bankruptcy?

POWERS OF THE COMMERCIAL TENANT IN BANKRUPTCY

Once a business tenant files bankruptcy, it gains valuable leverage over the terms of engagement with its landlord. First, lease provisions that automatically terminate the lease if the tenant files bankruptcy are not actually enforceable in bankruptcy – the Bankruptcy Code overrides such clauses. Second, the tenant can transfer a below market (hence, valuable) lease to a third party over the landlord's objection, sticking the landlord with a new tenant that it didn't bargain for. Third, the tenant has the corollary right to reject a burdensome lease and pay the landlord what might be a fraction of the liquidated damages under the lease. Fourth, and perhaps most importantly, the Bankruptcy Code gives the tenant *time*: it has several months to decide whether to stay in its lease or walk away; meanwhile the landlord must continue performing its lease obligations.

A business tenant that intends to reorganize will file a petition under chapter 11 of the Bankruptcy Code. The chapter 11 tenant automatically gets four months to decide whether to assume or reject a lease. The court can extend this period an additional three months. If the tenant has not assumed the lease when this period expires, the lease is automatically deemed rejected and the tenant must immediately surrender the property to the landlord.

Rent payments aren't guaranteed during the four-to-seven-month period when the tenant it is deciding whether to stay or quit the premises. Section 365(d)(3) of the Bankruptcy Code says that the tenant is to "timely perform" its obligations under the lease. Bankruptcy courts do not always interpret this to mean that the tenant must immediately

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resume full rent payments. In the current bankruptcy case of Modell's Sporting Goods, for example, the bankruptcy court has allowed Modell's to "pause" its bankruptcy case while the COVID-19 quarantines are in effect, over the strenuous objections of several landlords who are effectively storing Modell's inventory without receiving any rent. Accordingly, the period between when the lease is assumed or rejected is one of great uncertainty for landlords.

The bankruptcy court will approve lease rejection provided the decision is a product of the tenant's sound business judgment. This is an exceedingly low bar for the tenant to clear. In most cases, it will come down to simple economics and business strategy: if the tenant's business fails to generate enough income at the location to earn a profit, the court will likely approve lease rejection. The Bankruptcy Code treats "rejection" as a breach of the lease, leaving the landlord with a claim for damages.

If the tenant decides to assume the lease, it must cure all monetary defaults or provide adequate assurance that such defaults will be promptly cured. This ensures that the landlord will receive all the money it is owed. In addition, the tenant must provide adequate assurance of its future performance. Such assurance can manifest in several ways, including the tenant's payment history, the presence of a guaranty, whether the terms of the lease reflect current market conditions, or the viability of the tenant's strategy for exiting bankruptcy.

In addition to assuming the lease, section 365(f) of the Bankruptcy Code allows the tenant to assign the lease to a third party notwithstanding any restriction on assignment in the lease itself. Either the tenant or the assignee must cure monetary defaults under the lease and the assignee must provide adequate assurance of its future performance.

RIGHTS OF THE LANDLORD IN COMMERCIAL TENANT'S BANKRUPTCY

Based on the forgoing, the ideal scenario for a landlord in a tenant bankruptcy is the immediate resumption of post-filing rent payments followed by the eventual assumption of the lease and curing of outstanding monetary defaults. In such circumstances, the landlord is made whole and ultimately benefits from the bankruptcy because the tenant theoretically emerges in better financial health.

In situations where the tenant rejects the lease and surrenders the premises, the landlord's claim can be bifurcated into two separate rights to payment: (1) an administrative expense claim for the tenant's use of the premises during the bankruptcy; and (2) lease rejection damages.

Administrative expense claims must be paid in full under the chapter 11 plan. This high priority makes them among the best claims a creditor can hold. It should be noted, however, that the purpose of an administrative expense claim is to reimburse the "actual, necessary costs and expenses of preserving the estate." *See* 11 U.S.C. § 503(b)(1)(A). The landlord's administrative expense claim is for the *reasonable value* of the use and occupancy of the premises during the case and only to the extent it benefited the bankruptcy estate. An administrative expense claim is not automatically measured by the contractual rent. If the lease was above market, the debtor and other creditors might object to an exceedingly large administrative claim by the landlord.

By contrast, the landlord's lease rejection damages are paid at the lower priority of general unsecured claims, where recovery is usually less than 100%. Moreover, section 502(b)(6) of the Bankruptcy Code caps lease rejection damages at the greater of one year of rent reserved under the lease or 15 percent of the remaining lease term. Courts are split on whether this cap applies to claims for physical damage to the premises, or whether the landlord may recover such damages in addition to its capped lease rejection damages.

Given the different priorities in payment of administrative and general unsecured claims, the date that the lease is rejected is of paramount importance. A tenant will want to reject a burdensome lease immediately in order to minimize any administrative claim. A landlord will want to claim as much administrative expense as possible. In the

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First Circuit, a lease is deemed rejected on the date the court approves rejection as opposed to the date when the tenant moves to reject. Debtors side-step this result by asking the bankruptcy court to enter an order *"nunc pro tunc"* (Latin for "now for then"). A *nunc pro tunc* order makes the order retroactive to the date that the debtor filed the motion. In February 2020, the viability of *nunc pro tunc* orders was placed in serious jeopardy when the Supreme Court decided *Roman Catholic Archdiocese of San Juan v. Feliciano*. The case had nothing to do with bankruptcy, but the Court observed that federal courts can only issue *nunc pro tunc* orders to reflect the reality of an action the court has *already performed* but not entered. The holding appears to prohibit a bankruptcy court from approving lease rejection retroactively.

As discussed above, the Bankruptcy Code abrogates *ipso facto* clauses that spring to life when a bankruptcy case is filed. Bankruptcy courts construe the Code broadly in this regard invalidating not only anti-assignment and termination clauses, but also the more creative efforts of landlords to prohibit lease assignment such as rights of first refusal, assignment fees, and prohibitions on conducting going-out-of-business sales. In short, bankruptcy courts look with disfavor on any contractual provisions that would limit the free alienability of leaseholds. Section 365(c) provides a narrow exception when "applicable law" excuses the landlord from rendering performance to any entity other than the debtor. For example, in a highly-regulated location like an airport, municipal laws will almost always require the airport authority to approve any lease transfer for a location within a secured area. A debtor must comply with such law when assigning a lease in bankruptcy.

The Bankruptcy Code provides additional protections to mall owners. The Bankruptcy Court can approve the assignment of a lease for space located within a shopping center only if the following conditions are satisfied:

- the financial condition and operating performance of the assignee must be as strong as the tenant's at the time tenant moves to assign the lease;
- the percentage rent due under the lease must not decline substantially upon the assignment;
- the assumption must be subject to all provisions of the lease including radius, location, use, or exclusivity provisions and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and
- the assignment may not disrupt the existing tenant mix in the shopping center.

These provisions make assigning a mall lease harder for the debtor-tenant and ensure that the existing tenant mix is preserved.

Finally, the tenant's power to assume and assign a commercial lease only extends to leases that are *unexpired* as of the bankruptcy filing. If the landlord has terminated the lease for nonperformance prior to the bankruptcy, the tenant will not be able to reestablish the lease in bankruptcy. Accordingly, landlords who desire to avoid the outcomes discussed above and are willing to evict rather than reach a financial accommodation with the tenant, should timely enforce their rights under the lease, and comply with all necessary protocols to terminate the lease following the tenant's default.

CONCLUSION

While landlords might blanche at the tenant's bankruptcy powers discussed above, they are a relatively favored class of creditors in bankruptcy. In chapter 11, a business can write down its secured debts, and pay a fraction of what it owes on its trade payables, but it can do nothing to unilaterally modify the terms of an existing lease. If the debtor needs the premises, it must pay the monetary cure. The landlord is a force, indeed, often *the force*, to be reckoned with in a chapter 11 restructuring.

As the economy begins to come back from the initial wave of COVID-19, it is expected that commercial lease

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restructuring will play a major role in the recovery. Whether tenants file chapter 11 or reach consensual agreements with their trade creditors, banks, and landlords, it is imperative that all stakeholders understand their rights under the Bankruptcy Code, because even out-of-court workouts will happen in the shadow of bankruptcy.

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