

DEVIL IN THE DETAILS

Understanding Landlord and Tenant Rights in Bankruptcy

Even Out-of-Court Agreements Happen in Law's Shadow

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As the economy begins to come back from the initial wave of COVID-19, it is expected that commercial lease restructuring will play a major role in business survival. What happens if a business is unable to pay its rent, fails to reach a consensual rent restructure with its landlord, and files bankruptcy?

Once a business files Chapter 11 protections, it gains valuable leverage over the terms of engagement with its landlord.

First, the bankruptcy code overrides automatic termination provisions that are triggered with the bankruptcy filing. Second, the tenant can reject a burdensome lease and pay the landlord what might be a fraction of the liquidated damages under the contract. Third, with limited exceptions, the tenant can assign its lease to a third party over the landlord's objection. Fourth, chapter 11 gives the tenant time: up to seven months to decide whether to stay in its lease or walk away.

If the tenant decides to assume and/or assign 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 (or its assignee) must provide adequate assurance of its future performance.

If the tenant decides to reject the lease, it need only convince the bankruptcy court that its decision is based on sound business judgment. This is an exceedingly low bar for the tenant to clear. In most cases, it will come down to simple eco-

nomics 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 Landlord's Rights

The period between when the lease is assumed or rejected is one of great uncertainty for landlords. On the one hand, the landlord must continue to perform, providing the tenant with access to the premises and maintaining common areas. On the other hand, rent isn't guaranteed during this time. The bankruptcy code says that the tenant is to "timely perform" its obligations under the lease. Courts do not always interpret this to mean that the tenant must immediately resume full rent payments.

Landlords who rely on rights of first refusal, assignment fees or "going dark" prohibitions to resist a tenant's proposal to assign its lease to a third party might find themselves out of luck.

If the tenant rejects the lease, the landlord is left with an administrative expense claim for the tenant's use of the premises during the bankruptcy and lease rejection damages.

Happily for landlords, administrative expense claims must be paid in full in Chapter 11. It should be noted, however, that the claim is measured by the reasonable value of the use and occupancy of the premises during the case and this value is not necessarily equivalent to the contractual rent. If

the lease was above-market, the debtor might object to an exceedingly large administrative claim.

By contrast, the landlord's lease rejection damages are paid at the lower priority of general unsecured claims. Recovery is almost always less than 100 percent. Moreover, 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.

As discussed above, bankruptcy courts have the power – and are, indeed, required to – ignore lease provisions that restrict assignment. Landlords who rely on rights of first refusal, assignment fees or "going dark" prohibitions to resist a tenant's proposal to assign its lease to a third party might find themselves out of luck. The bankruptcy code provides additional protections to mall owners, however, requiring that a proposed assignee will not disrupt the tenant mix in the shopping center.

Know Your Rights

Despite these bankruptcy powers, a tenant in Chapter 11 can do nothing to unilaterally modify the terms of an existing lease. If it needs the premises, it must pay the monetary cure. If the tenant wants to assign the lease, it must select a capable assignee. Moreover, the 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.

Whether tenants file Chapter 11 or reach consensual agreements with their landlords, it is imperative that both sides understand their rights, because even out-of-court workouts will happen in the shadow of the bankruptcy code. ◀

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