

Davis & Gilbert
ADVANTAGE

When a Commercial Tenant Files Bankruptcy: What Landlords Need to Know

FOR MORE INFORMATION

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The rapid outbreak of the novel coronavirus (COVID-19) has caused widespread business disruptions. Bankruptcy cases will likely be on the rise as a result, particularly in hard-hit, consumer-facing industries like retail, which has already seen the recent bankruptcy filings of Payless Shoes, Destination Maternity and Modell's Sporting Goods. Against this backdrop, there is no better time than the present for a refresher on the special protections afforded commercial landlords under the Bankruptcy Code, and the counterbalancing restrictions imposed on their rights as creditors.

Davis & Gilbert partner **Joseph Cioffi** and counsel **Massimo Giugliano** address questions frequently asked by landlords when a commercial tenant files for bankruptcy. These responses should aid any landlord facing a commercial tenant bankruptcy for the first time and serve as a reminder of the protections and pitfalls that exist for even the most bankruptcy-savvy landlords.

Q: What is the main difference between a chapter 7 and chapter 11 bankruptcy case?

A: In a chapter 7, an appointed trustee assumes control of the debtor's business and collects and liquidates the debtor's assets for the benefit of creditors. In contrast, in a chapter 11, the debtor typically maintains control of its business and attempts to reorganize and emerge from bankruptcy through a plan of reorganization. As a chapter 11 debtor, one of the commercial tenant's reorganization goals may be to shed itself of unfavorable leases of nonresidential real property.

Q: What are the debtor's rights with respect to a commercial lease?

A: The debtor can (i) assume, (ii) reject, or (iii) assume and assign the lease to a third party. In general, in order to assume (or assume and assign), all defaults under the lease must be cured, and the debtor or assignee must demonstrate its ability to perform under the lease. If the leased space is in a shopping center, additional requirements must be met, including that the assumption or assignment will not disrupt the shopping center's tenant mix.

Q: How long does the debtor have to decide to assume, reject, or assume and assign a commercial lease of real property?

A: A debtor generally has 120 days from the filing of its bankruptcy, which may be extended up to 210 days with bankruptcy court approval. Any further extensions require the consent of the commercial landlord.

Q: If the debtor rejects the lease, is the landlord entitled to damages?

A: Upon rejection, a landlord may assert a claim for “rejection damages,” which are capped at the greater of one year’s rent or 15% of the remaining lease term, not to exceed three years’ rent, plus unpaid pre-bankruptcy rent. The cap on a landlord’s rejection damages is not applicable to a non-debtor that guaranteed the debtor’s obligations under the lease.

Q: If the lease is rejected, what is the procedure for receiving a distribution?

A: A proof of claim, along with supporting exhibits, must be completed and filed with the bankruptcy court in a timely manner. Because the landlord’s rejection damages are expressly limited under the Bankruptcy Code so as not to prevent other creditors from receiving distributions from the estate, insolvency counsel should be consulted to assist with filing a claim.

Q: Can the landlord prevent assumption and assignment by enforcing an anti-assignment clause in the lease?

A: Anti-assignment clauses or clauses that require a landlord’s consent to assign are generally unenforceable in bankruptcy as a matter of public policy.

Q: Can the landlord prevent assumption (or assumption and assignment) by enforcing a lease provision that provides for automatic termination of the lease upon the filing of a bankruptcy petition?

A: These clauses are called “*ipso facto clauses*” and are generally unenforceable under the Bankruptcy Code. Legal advice should be sought before attempting to terminate any unexpired lease of nonresidential property to determine if alternative permissible methods exist to protect the landlord’s interests.

Q: Can a landlord attempt to collect unpaid rent or continue/commence eviction proceedings during the course of the bankruptcy case?

A: The filing of a bankruptcy petition immediately gives rise to an “automatic stay,” which generally prohibits any act to collect unpaid debt or to continue/commence any proceeding against the debtor.

Q: Can a landlord draw on a security deposit during the course of a bankruptcy case to satisfy unpaid rent?

A: The ability to draw generally depends on whether the deposit is in the form of cash or a letter of credit. In general, a landlord may not draw on a cash security deposit during the course of a bankruptcy case, but may draw on a letter of credit. However, with court permission, a cash security deposit can usually be applied to offset unpaid rent.

Q: Is the debtor obligated to perform its obligations under a commercial lease during the course of its bankruptcy case?

A: Yes. As a counterbalance to the several limitations and restrictions placed on landlords as creditors, and rights granted to commercial tenants as debtors, the Bankruptcy Code provides that the tenant as debtor must perform all post-bankruptcy obligations under a commercial lease until it assumes, rejects, or assumes and assigns the lease. This requirement is a unique protective right for landlords that is generally not afforded under the Bankruptcy Code to other creditors under commercial contracts.

The coronavirus outbreak has already proven to be one of the most devastating events in our country's history and has had a disastrous impact on our economy — an economy that was booming just a few weeks prior. Although recent legislation by state and federal governments, including the historic \$2 trillion stimulus packages, will provide much needed relief for individuals and businesses, widespread bankruptcy filings seem all but inevitable. If and when that occurs, commercial landlords must be ready to navigate the challenges that will follow, and it starts by becoming familiar with the special protections afforded commercial landlords under the Bankruptcy Code, and the counterbalancing restrictions imposed on their rights as creditors. With the assistance of experienced bankruptcy counsel, commercial landlords can utilize these protections to maximize recoveries, curtail vacancy periods, and successfully manage through this unprecedented crisis.