



Bankruptcy Basics: Commercial Landlords with Tenants in Bankruptcy

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A. The Basics

What can the landlord do when its tenant files for bankruptcy? What shouldn't it do?

What happens to the lease? How long does the tenant have to accept or reject?

What types of claims can the landlord file?

1. The Filing

✓ Chapter 7 vs. Chapter 11

- A chapter 7 bankruptcy is a structured liquidation.
- A chapter 11 bankruptcy is a reorganization.
- Property of the estate.
- The use, sale, or lease of property of the estate is governed by 11 U.S.C. 363.

1. The Filing

✓ Property of the Estate

- Defined broadly under 11 U.S.C. § 541(a) to include “all legal or equitable interests of the debtor in property as of the commencement of the case.”
- Specifically does not include a lease of nonresidential property that has “terminated at the expiration of the stated term of such lease during the case.” 11 U.S.C. 541(b)(2); *see also* 11 U.S.C. 362(b)(10).

1. The Filing

✓ **The “Automatic Stay” (*it’s not just eviction*). The automatic stay prohibits:**

- 1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
- 2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
- 3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
- 4) any act to create, perfect, or enforce any lien against property of the estate;
- 5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
- 6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
- 7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
- 8) the commencement or continuation of a proceeding before the United States Tax Court concerning a tax liability of a debtor that is a corporation for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the date of the order for relief under this title.

11 U.S.C. 362(a)(1)-(8)

1. The Filing

✓ The “Automatic Stay”

- Automatic. *See* 11 U.S.C. § 362.
- No “self help” or other action against the debtor or property of the estate outside of the bankruptcy proceeding.
- A violation gives rise to liability for actual damages and even sanctions. *See* 11 U.S.C. § 365(h).

1. The Filing

✓ “Ipso Facto” Provisions in a Lease

- A lease provision triggered by the insolvency of the debtor, the filing of bankruptcy, or the appointment of a trustee is not enforceable against a debtor in bankruptcy.
- For example, 11 U.S.C. § 365(e)(1) provides:

Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

1. The Filing

✓ **Hypothetical – *would the following provision in a lease risk trouble down the road?***

In the event of an act of bankruptcy by or insolvency of Tenant, or the appointment of a receiver for Tenant or a general assignment for the benefit of Tenant's creditors, then the security deposit will be deemed immediately assigned to Landlord.

1. Does the clause affect “property of the estate”? ✓
2. Would enforcement of the clause upon a filing for bankruptcy violate the automatic stay? ✓
 - Is it an act to exercise control over property of the estate?
 - Is it an act to enforce a lien against property of the estate?
3. Is it an unenforceable *ipso facto* provision? ✓
 - Is it triggered by the bankruptcy, insolvency, or appointment of a receiver?
 - Does it modify or terminate the lease or any obligation under the lease?

Conclusion: This provision is unlikely to be enforced in a bankruptcy case.

2. Assumption / Rejection Period

- ✓ The debtor ordinarily has **120 days** to decide whether it will assume or reject an unexpired lease of nonresidential real property (a “commercial lease”). *See* 11 U.S.C. § 365(d)(3).
 - Under the 2021 Consolidated Appropriations Act enacted on December 27, 2020, the initial period was temporarily increased from 120 days to **210 days** after the filing for the tenant to assume or reject the commercial lease. This is set to expire December 27, 2022.
 - The court may grant a single 90-day extension for “cause.”
 - The court may not grant an additional extension without written consent of the landlord.

2. Assumption / Rejection Period

- ✓ **Pending assumption or rejection**, the debtor must timely perform all commercial lease obligations.
 - The landlord's *collection* of post-petition lease payments does not violate the automatic stay.
 - What if the tenant does not pay rent during the pendency of the bankruptcy case?
 - The bankruptcy court may delay the tenant's performance of any lease obligations during the first 60 days of the bankruptcy case.
- ✓ Special rules apply when dealing with a Chapter 11, Subchapter 5 case (a "Small Business Debtor Reorganization").
 - For example, the bankruptcy court in a Small Business Debtor Reorganization case may delay performance under a lease for 120 days (up from 60). This revision to the Bankruptcy Code was passed as part of the 2021 Consolidated Appropriations Act and will expire on December 27, 2022.

3. Types of Claims

- ✓ Claims can be either “Administrative”, “Secured”, or “Unsecured”.
- 1. **Administrative expense claims** are paid first and must be paid in full before any other claims are paid.
 - **Postpetition lease arrearages** give rise to an administrative claim calculated as fair-market value of the debtor’s use and occupancy of the leased space.
 - If the debtor fails to timely pay rent pending assumption or rejection of the lease, the landlord may file a motion for an administrative claim pursuant to 11 U.S.C. § 503.
- 2. **Security Interests** are generally not stripped in bankruptcy, absent special circumstances.
- 3. **Unsecured claims** are paid last, generally subject to a heavy discount, if paid at all.
 - **Prepetition lease arrearages** give rise to an unsecured claim.
 - Any under-secured portion of an otherwise secured claim is treated as an unsecured claim.

4. Collateral

- ✓ Often a landlord will take a security interest in property of the tenant.
- ✓ Whether a creditor is under- or oversecured leads to different protections:
 - If a creditor is **undersecured**, it may seek **adequate protection**. See 11 U.S.C. §§ 361, 362(d), 363(e), 364(d).
 - If a creditor is **oversecured**, it is entitled to “**interest** on such [secured] claims, and any **reasonable fees, costs**, or charges provided for under the agreement or State statute under which such claim arose.” 11 U.S.C. § 506(b).
- ✓ Secured creditors also have an automatic superpriority claim (ahead of all unsecured claims and administrative expenses) to the extent it becomes undersecured due to diminution in the collateral during the bankruptcy case. 11 U.S.C. § 507(b).

4. Collateral

- ✓ Recall, a secured creditor is generally entitled to “adequate protection.”
- ✓ Adequate Protection may include:
 1. Single or periodic cash payments;
 2. Replacement liens or additional liens;
 3. “Such other relief”
- ✓ A subordination agreement as between secured creditors, whether entered into pre- or postpetition, is enforceable under the Bankruptcy Code. 11 U.S.C. § 510.

4. Collateral

- ✓ Fights over adequate protection primarily arise in two contexts:
 1. Debtor's use of cash collateral over which the creditor has a security interest:
 - Cash collateral is defined to include cash, cash equivalents, and cash proceeds of other collateral liquidated during the bankruptcy. *See* 11 U.S.C. § 363(a).
 - Adequate protection. *See* 11 U.S.C. §§ 361, 363(e).
 2. A Debtor's Request to Obtain DIP ("Debtor in Possession") Financing:
 - DIP Financing acts as a capital infusion necessary to successfully reorganize.
 - Priming liens.
 - "Rolling up" of prepetition liens.

4. Collateral

✓ Hypothetical – *Recovery of fees*

1. Let's say you're an oversecured creditor. Recall an oversecured creditor is entitled to "reasonable fees, costs, or charges provided for under the agreement." Which of the following lease provisions would you prefer rely upon?
 - *Upon the filing of bankruptcy by Tenant, Tenant shall be liable to Landlord for all court costs and reasonable and necessary attorney's fees.*
 - *In the Event of Default, Landlord shall be entitled to recover all court costs and reasonable and necessary attorney's fees from Tenant incurred in collecting rent or otherwise enforcing Landlord's rights under this Lease.*
 - *The prevailing party in any legal proceeding based upon this Lease shall be entitled to reasonable attorneys' fees and expenses and court costs.*
2. Be mindful that relying on the bankruptcy, insolvency, or appointment of a receiver as an "Event of Default" may be challenged as an unenforceable *ipso facto* provision, which the debtor successfully did in *In re FKA FC, LLC*, 545 B.R. 567 (Bankr. W.D. Mich. 2016) (awarding \$0 in court costs and attorney's fees because no default occurred).

B. Assumption



or



Rejection

Assumption



Rejection

- ✓ The debtor has the option to assume, assume and assign, or reject its lease. *See 11 U.S.C. § 365.*
 - Debtor has 210 days (+ maximum 90-day extension for “cause”) to assume or reject its lease.
 - This will revert back to 120 days on December 27, 2022.
 - A commercial real property lease is deemed automatically rejected at expiration of this time period and the debtor must vacate the premises.
- ✓ The debtor must timely perform all obligations under commercial real property lease pending assumption/rejection. *See 11 U.S.C. § 365(d)(3).*
- ✓ Pending assumption or rejection, the landlord will want to make sure its claim is properly scheduled, and/or to file a proof of claim.

Assumption



- ✓ The Bankruptcy Code permits assignment to a third-party lessee even if it is prohibited in the lease.
 - 11 U.S.C. § 365(f) expressly permits assumption and assignment of a lease “notwithstanding a provision” in the lease “or in applicable law.”
 - A number of courts have held that profit sharing-upon-assignment clauses are an unenforceable restriction on assignment. *See, e.g., In re Headquarters Dodge, Inc.*, 13 F.3d 674, 682 (3d Cir. 1993)
- ✓ **Upon assumption or assumption & assignment**, the tenant is required to:
 1. Cure virtually all types of outstanding defaults (including unpaid rent) under the lease or provide adequate assurance that it will do so;
 2. Provide compensation for any actual pecuniary losses resulting from such defaults or adequate assurance that it will do so;
 3. Provide adequate assurance of future performance under the lease.

Assumption



- ✓ If the tenant decides to assume the lease, it must assume the entire lease.
- ✓ The landlord and tenant may agree to modify the terms of the lease subject to bankruptcy court approval.
- ✓ Tenants often assume and assign their leases as part of a sale of the tenant's assets to a third party, or when the rental rate under the lease is below market.
- ✓ The Debtor must provide the landlord notice of its intention to assume or assume and assign the lease and may do so in either a motion to assume or a plan of reorganization. The landlord will have a limited time to file a written objection.
- ✓ Additional protections for shopping centers. *See* 11 U.S.C. 365(b)(3).



Rejection

- ✓ The debtor may reject the lease and turn over the premises. A rejection is treated as a breach immediately prior to the bankruptcy filing. *See* 11 U.S.C. § 365(g).
- ✓ Upon rejection, the lease is immediately terminated and the Landlord has a **Rejection Damages Claim**. In that case, the landlord may assert:
 1. A general unsecured claim for damages arising out of the rejection (e.g., lost post-petition rent, the costs of re-letting the premises and attorneys' fees, all to the extent such amounts are specifically provided for under the lease).
 2. An administrative claim for any unpaid post-petition rent relating to the period between the bankruptcy filing date and the rejection date.
- ✓ A landlord's rejection damages claim is capped at: The greater of: (1) one year's rent, or (2) 15% of the rent due under the lease, not to exceed three years' rent. *See* 11 U.S.C. § 502(b)(6).

C. Special Rules





Special Rules

✓ Letters of Credit and Guarantees

- LOCs and rights against a third-party guarantor are not considered property of the bankruptcy estate (as defined in 11 U.S.C. § 541).
- Thus, the landlord may, in several jurisdictions including the Fifth Circuit, draw on a LOC or seek to enforce rents against a guarantor outside of the bankruptcy proceeding and without bankruptcy court approval and without regard to the statutory cap; HOWEVER,
- If the landlord files a proof of claim, any draw on its LOC or enforcement against the guarantor is subject to the rejection damages cap. Thus, it is important to assess whether a landlord may have rights to draw against a LOC or against a third-party guarantor before filing a proof of claim.



Special Rules

✓ Attorney's Fees

- Landlords may be able to recover attorneys' fees incurred when a debtor assumes or assigns a lease. To recover attorneys fees, however, the landlord must meet several criteria:
 - i. The lease must expressly provide that the landlord is entitled to recover attorneys' fees above and beyond rent (i.e. in the event of a default);
 - ii. The landlord must have prevailed in the proceeding in which it seeks to recover attorneys' fees;
 - iii. The legal right must derive from the lease and independently from state law or the Bankruptcy Code; and
 - iv. The attorneys' fees must be reasonable. considering factors such as the amount in dispute compared to the fees requested, and the debtor's good faith efforts to resolve the dispute



Special Rules

✓ Adversary Proceedings

- Any issue which is contested is a “contested matter” pursuant to Federal Rule of Bankruptcy Procedure 9014.
- A contested matter can be heard and decided either (1) upon a motion within the bankruptcy proceeding on an expedited basis, or, (2) as a separate “adversary proceeding” with its own petition and case number. An adversary proceeding may be based on state, federal nonbankruptcy or bankruptcy law.
- An adversary proceeding is largely governed by the Federal Rules of Civil Procedure, as codified (with some caveats) in Federal Rules of Bankruptcy Procedure 7002 *et seq.* (for example, FRCP 12 will be codified as FRBkP 7012, 13 as 7013, and so on).
- Certain proceedings *must* be brought as an adversary proceeding. See Fed. R. Bankr. P. 7001.



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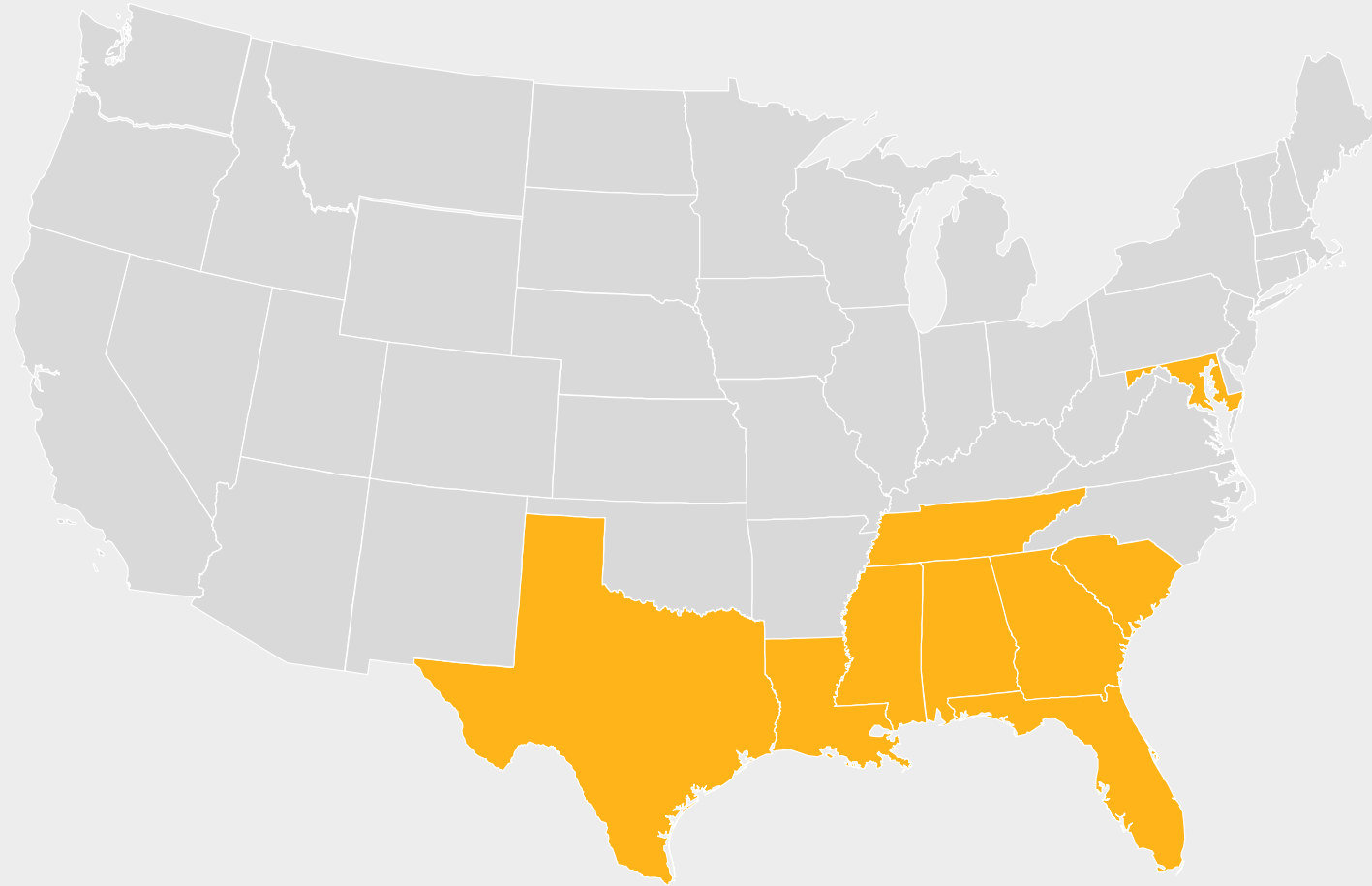
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