



WHAT CAN I DO?

Bankruptcy Implications for Landlords & Tenants in a Tenant Bankruptcy: What You Need to Know

Introduction

Given the current economic climate and the uptick in chapter 11 bankruptcy cases, both landlords and tenants may be wondering about their respective rights in a potential tenant bankruptcy scenario. The below covers the basics and provides an overview of what landlords and tenants should be thinking about when faced with an actual, or threatened, tenant bankruptcy filing.

Bankruptcy Filings

The filing of a bankruptcy petition imposes an automatic stay, enjoining creditors from taking any action against property of the debtor's estate until such stay is lifted by the bankruptcy court.¹ When a tenant files for bankruptcy, a landlord is therefore prohibited from terminating the lease and evicting the tenant—any action by the landlord to the contrary may result in damages for violation of the automatic stay. Additionally, a tenant in bankruptcy may do any of the following with respect to an unexpired lease for real property:

- i. assume the lease (i.e., retain the existing lease and remain as the tenant of record),
- ii. assume and assign the lease to a third party (i.e., have the lease in its current form assigned to a new tenant) or
- iii. reject the lease (i.e., terminate the lease and vacate the property).

Assumption and assignment of the lease is available to a tenant debtor in bankruptcy notwithstanding an anti-assignment provision in the underlying lease, unless applicable law would prohibit such assignment, or the lease has been terminated under applicable non-bankruptcy law prior to the bankruptcy filing.²

¹ 11 U.S.C. § 362.

² 11 U.S.C. §§ 365(c)(1) and (c)(3), respectively.

Assumption, Assumption and Assignment or Rejection

- **Timing:** a tenant debtor has the earlier of (i) two-hundred and ten (210) days after the filing of a bankruptcy petition and (ii) confirmation of the debtor's chapter 11 plan, to decide whether it wants to assume or reject an unexpired lease of nonresidential real property³ (or before plan confirmation with respect to an unexpired lease of residential real property).⁴ If the debtor fails to elect to assume or reject a lease within that time frame, the lease is deemed rejected. The bankruptcy court may extend the 210-day period, for cause, for up to an additional 90 days.⁵
- **Obligations to Perform:** until a debtor decides to assume or reject the lease, it must timely perform the obligations thereunder that arise from and after the petition date, including, without limitation, rent payments, regardless of whether or not the debtor is occupying the premises.⁶ The bankruptcy court may defer the debtor's performance of such lease obligations, for cause, for the first sixty (60) days of the bankruptcy case.⁷ A landlord must also comply with its obligations under the lease—otherwise, a landlord may be found to be in breach thereof.
- **Requirements for Assumption:** in order to assume the lease, the debtor tenant must (i) cure any defaults under the lease, (ii) compensate the landlord for any actual pecuniary loss and (iii) provide adequate assurance of future performance.⁸
- **Assumption and Assignment:** in order to assume and assign the lease, the debtor and the assignee must (i) cure any defaults under the lease, (ii) compensate the landlord for any actual pecuniary loss and (iii) provide adequate assurance of future performance by the assignee.⁹ To the extent the leased property is located within a shopping center, then the assignment will also be subject to any related provisions under the lease, including, but not limited to, radius, use and exclusivity requirements, and such may not disrupt any tenant mix or balance in the shopping center.¹⁰ Upon an assignment, the debtor tenant is relieved of its obligations to the landlord under the lease on a go-forward basis. The the Bankruptcy Code also permits the landlord to require a security deposit from the assignee equal to what it would have otherwise required from a new tenant.¹¹
- **Rejection:** if the debtor rejects the lease, it must vacate the premises and the landlord has the right to assert a rejection damages claim, which is treated as a pre-petition general unsecured claim and is paid *pro rata* with other general unsecured creditors.¹² A landlord's rejection damages claim is capped at the greater of (i) one year's rent or (ii) the rent for fifteen percent (15%), not to exceed three years, of the remaining lease term.¹³ Note that the rejection damages cap only applies to future rent that would have otherwise been due but for the rejection, and any unpaid pre-petition rent would be included in the landlord's damages claim and added to the capped rejection damages amount. Note, however, that damages may be reduced if the landlord is able to mitigate such by finding a new tenant after the lease is rejected.

³ 11 U.S.C. § 365(d)(4)(A). Note the 210-day requirement was extended from 120 days in connection with the enactment of the Consolidated Appropriations Act of 2021 (the "CAA"). This change is expected to sunset on December 27, 2022, unless further extended by Congress.

⁴ 11 U.S.C. § 365(d)(2).

⁵ 11 U.S.C. § 365(d)(4)(B).

⁶ 11 U.S.C. § 365(d)(3).

⁷ *Id.* With respect to small business chapter 11 debtors (i.e., businesses with no more than \$7.5 million in liabilities), the court may extend a debtor's obligation to perform under a lease further, until the earlier of (i) an additional 60 days (for a total of 120 days of the bankruptcy petition) or (ii) the date on which the lease is assumed or rejected, in each case to the extent the debtor is experiencing or has experienced a material financial hardship due, directly or indirectly, to the COVID-19 pandemic. 11 U.S.C. § 365(d)(3)(B). Note this change was also added in connection with the CAA and is expected to sunset on December 27, 2022, unless further extended by Congress.

⁸ 11 U.S.C. § 365(b)(1).

⁹ 11 U.S.C. §§ 365(b)(1) and (f).

¹⁰ 11 U.S.C. § 365(b)(3).

¹¹ 11 U.S.C. § 365(l).

¹² In bankruptcy, general unsecured claims are only paid after (i) secured claims (including debtor-in-possession ("DIP") financing), (ii) administrative expense claims (such as professional fees) and (iii) priority general unsecured claims (such as taxes) have each been paid in full. Accordingly, general unsecured claims may only be entitled to pennies on the dollar in bankruptcy, if anything. Note, however, that after a lease is assumed, damages related to a subsequent rejection would have administrative expense priority.

¹³ 11 U.S.C. § 502(b)(6).

Pre-petition vs. Post-petition Lease Obligations

Additionally, any outstanding lease obligations, including rent, that arose pre-petition (i.e., prior to the bankruptcy filing), are treated as general unsecured claims. Lease obligations that arise post-petition, however, are treated as administrative expense claims, which receive payment priority under the Bankruptcy Code and must be paid in full in cash (unless the holder of such claim waives such requirement) in order for a bankruptcy plan to be confirmed.¹⁴ As discussed in [Understanding and Negotiating a DIP Budget](#), landlords may object to proposed DIP financing or the use of cash collateral if the DIP budget does not show timely payment of post-petition rent.

There is a circuit split regarding when rent obligations are deemed to have “arisen”. Depending on the situation, this could be significant and could impact venue selection for the debtor tenant. The two approaches are:

- **Billing Date Approach:** the billing date approach treats the billing date under the lease as the date on which the obligation to pay rent arises. For example, if rent is due on the first of each month and a tenant files for bankruptcy on November 16, the stub rent from November 16 through November 30 will be treated as a pre-petition, general unsecured claim and rent will not be afforded post-petition, administrative expense status until such becomes due on December 1.
- **Proration / Accrual Approach:** the proration or accrual approach, on the other hand, treats rent as having accrued each day, regardless of when rent is due under the lease. Therefore, the obligation to pay rent is deemed to have arisen immediately upon the bankruptcy filing and such will be treated as a post-petition, administrative expense claim.

Key Takeaways and Protective Measures:

1. **Know the respective rights of landlords and tenants in bankruptcy.** Such will inform any lease renegotiations in the face of a threatened or imminent bankruptcy filing. For example, a landlord may be more willing to accept a proposed rent reduction when faced with a potential lease rejection in bankruptcy.
2. **Landlords should require a security deposit.** Note, however, that the security deposit will be subject to the automatic stay and will only protect a landlord up to the capped damages amount in the event the lease is rejected.
3. **Landlords should require a letter of credit.** Most courts have held that letters of credit are not subject to the automatic stay and that a landlord may draw down on a letter of credit pursuant to its terms, notwithstanding the pending bankruptcy case.
4. **Landlords should obtain a guarantee from a third-party.** When a tenant files for bankruptcy, such does not prohibit a landlord from pursuing remedies against a non-debtor guarantor.

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¹⁴ 11 U.S.C. §1129(a)(9)(A).