

CREDITOR'S RIGHTS TOOLKIT

What Rights Does a Tenant Have When the Landlord Files for Bankruptcy?

For a lessee of commercial real property, a landlord's Chapter 11 filing may raise questions about the status of their lease and their rights in the bankruptcy. While the Bankruptcy Code provides the debtor landlord with powerful tools, such as rejecting leases or assuming and assigning them to a buyer, it also affords tenants special rights designed to provide a measure of stability and predictability. Understanding these rights is critical for a tenant seeking to get the benefit of their bargain under the lease and avoid needless disruption to business operations.

Key Issues

- **TIMING OF A LANDLORD'S DECISION TO ASSUME OR REJECT A LEASE**

Under Section 365(a) of the Bankruptcy Code, a landlord that is a debtor in bankruptcy may choose to assume, assume and assign to a buyer, or reject leases of nonresidential real property. During the period prior to assumption or rejection, a tenant must continue paying rent under its lease. In a Chapter 7 case, an unexpired lease of residential real property is automatically rejected if the bankruptcy trustee fails to assume or reject it within 60 days of the petition date (unless the court grants an extension of this deadline for cause), but no such deadline exists for a lease of nonresidential real property. In a Chapter 11 case, the Bankruptcy Code does not impose a specific timeframe for a debtor landlord to make this determination, but the timing of that decision may be tied to broader case milestones, such as plan confirmation or approval of an asset sale. Where no fixed deadline applies, tenants must actively monitor the case and, if necessary, may seek relief from the court to expedite the debtor landlord's (or trustee's) decision if delays prejudice their leasehold rights or otherwise create some material harm.

- **TENANTS' RIGHTS UNDER SECTION 365(H) OF THE BANKRUPTCY CODE**

Section 365(h) of the Bankruptcy Code gives lessees important protections when a debtor landlord (or trustee) rejects an unexpired lease of real property. Unlike other contract counterparties, a tenant's remedies are not limited to filing a claim for damages upon rejection of their lease. Instead, a tenant may either (i) treat the lease as terminated and vacate the property while pursuing a claim for damages, or (ii) elect to remain in possession for the remainder of the lease term (including any extensions enforceable under nonbankruptcy law).

- **CONSEQUENCES OF REMAINING IN POSSESSION POST-REJECTION**

If a tenant chooses to remain in possession of the leased property after rejection, the tenant's rights of use, possession, quiet enjoyment, assignment, and subletting remain intact. In the case of shopping centers, any restrictions relating to use, tenant mix, exclusivity, and location also remain enforceable under applicable nonbankruptcy law when a tenant remains in possession. Once a lease is rejected, however, the landlord is no longer obligated to provide ongoing services such as utilities, maintenance, or repairs. The tenant must continue paying rent, but may offset the costs of covering the landlord's unperformed obligations. For example, if a tenant pays for utilities or arranges maintenance that the landlord was previously responsible for, those amounts may be deducted from the rent.

- **ADEQUATE ASSURANCE, CURE OBLIGATIONS, AND SECTION 365(H) PROTECTIONS IF A LANDLORD PROPOSES TO ASSIGN THE LEASE**

If a debtor landlord proposes to assume and assign the lease to a buyer, the Bankruptcy Code requires that all defaults capable of being cured must be cured before the lease can be assigned. In addition, the proposed assignee must provide adequate assurance of its future performance under the lease. Assumption and assignment procedures are often approved by the bankruptcy court as part of a sale process and will contain milestones and deadlines to object. If the landlord proposes to sell its assets, courts are divided as to whether property may be sold "free and clear" of a tenant's rights in the lease, including under Section 365(h). In this scenario, a tenant should be active in the case and object to the sale if and as necessary to ensure whatever rights it does have are fully preserved under any order approving the sale.

Takeaway

The Bankruptcy Code grants nondebtor tenants special rights that allow them to stay in possession of the property even if the lease is rejected (albeit without ongoing services from the landlord). In the event the landlord proposes to assume, or assume and assign, a lease, the tenant should be active in the bankruptcy case to ensure that cure and adequate assurance obligations are satisfied and that its rights under the Bankruptcy Code are preserved. A tenant may protect its rights by staying alert to case developments and, if necessary, filing a motion in the case to expedite the debtor landlord's assumption or rejection decision. Because of these complexities, tenants should engage competent bankruptcy counsel who can track filings, object to adverse motions, and negotiate protections to preserve the tenant's statutory rights during the bankruptcy process.