

Top 10 Questions For Landlords to Ask When a Tenant Files for Bankruptcy

As uncertain economic times continue, particularly in the retail sector, commercial tenant bankruptcies are on the rise. Goodwin's Financial Restructuring group presents 10 questions (and related practice points) for landlords to consider if one of their tenants files for chapter 11.

Question 1

What Can I Do if My Tenant Is Not Paying Rent, But Has Not Yet Filed For Bankruptcy?

- If the tenant has not yet commenced a bankruptcy case:
 - Send a notice of default and termination as soon as legally possible; strictly follow applicable state law.
 - If there is bankruptcy risk, consider exercising enforcement rights pre-bankruptcy, including draws on security deposits and letters of credit and demands on guaranties.
- If there is no collateral securing the payment obligation, consider requesting collateral for future obligations.
- Refrain from deviating from contract payment terms, if possible, to minimize preference risk.
- *Practice Point.* Know your contractual rights, and timely enforce them.



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Question 2

What Can I Do if My Tenant Is Not Paying Rent, and Has Filed for Bankruptcy Relief?

- Once the tenant has filed for bankruptcy, landlord rights are more limited:
 - Immediately upon the filing, the “Automatic Stay” is triggered – which prevents contract counterparties, including landlords, from, among other things:
 - Commencing or continuing actions or proceedings to recover on pre-bankruptcy claims
 - Enforcing pre-bankruptcy judgments
 - Taking possession or exercising control over property of the debtor’s estate
 - Creating, perfecting or enforcing liens
 - Collecting, assessing or recovering on pre-bankruptcy claims
 - Setting off any pre-bankruptcy debts
- For landlords, this means:
 - You should **not** send a default notice or take any action to collect on pre-bankruptcy arrearages
 - You **cannot** terminate the lease or take any action to evict the tenant
 - You **cannot** apply a pre-bankruptcy security deposit without court permission
- *Practice Point.* Timely and aggressively evaluate exercising “bankruptcy rights” – including seeking relief from the Bankruptcy Court from the automatic stay and/or making a request for adequate protection. Enforce rights and remedies against non-debtor parties.

Question 3

Are There Certain Types of Collateral That I Can Collect On?

- Cash security deposits:
 - Pre-bankruptcy: Landlord can apply security deposit in accordance with lease terms.
 - Post-bankruptcy: Landlord cannot use the security deposit to pay for pre-petition or post-petition rents or other charges without court permission.
- Letter of Credit:
 - Pre-bankruptcy: Landlord can draw down in accordance with letter of credit and lease terms.
 - Post-bankruptcy: Generally, court approval is not required before drawing down. However, counsel should be consulted to ensure that (i) there is no language in the letter of credit or lease documents that would make drawing on the letter of credit problematic, and (ii) the court has not entered a specific order regarding letters of credit.
- Third-Party Guarantor:
 - Pre-bankruptcy: Landlord can seek payment from third party in accordance with lease terms.
 - Post-bankruptcy: If the guarantor is not in bankruptcy, landlord can likely enforce remedies against the guarantor.
- *Practice Point.* Certain types of collateral can be more easily accessed in a tenant bankruptcy than others, and language in collateral documents will dictate whether landlords can draw on such collateral. Speak with your bankruptcy professionals when determining what type of collateral to require and how language in the collateral documents is drafted.

Question 4

Will My Rent Get Paid?

- Pre-bankruptcy rent:
 - Once a tenant files for bankruptcy protection, they cannot make any rent payments that first arose prior to the bankruptcy filing date; the issue of when claims arise requires a detailed analysis.
 - Landlord will have to timely file a proof of claim in the bankruptcy case, which claim will be afforded general unsecured creditor status (if not secured by a security deposit or other collateral), subject to the rejection damages cap.
- Post-bankruptcy rent:
 - The Bankruptcy Code requires that all rent obligations arising after the filing of the bankruptcy case must be timely paid in the ordinary course until the debtor assumes or rejects the lease.
 - Careful attention should be given to accrued claims (taxes, common area maintenance charges, tort claims and indemnity claims).
 - The court may extend, for cause shown, the time for performance of any such obligation that arises within 60 days after the bankruptcy filing date.
- Stub Period rent:
 - Courts are split on whether a debtor/tenant must timely pay rent obligations that accrue for the period from the bankruptcy filing date (i.e., the “Petition Date”) to the next scheduled payment date (i.e., the “Stub Period”). Courts take the following approaches towards stub rent:
 - Proration Approach (9th and 10th Circuits): Courts applying this approach hold that a debtor’s rent obligation arises on a daily basis post-petition; the debtor is obligated to timely pay rent for the Stub Period, even if the rent was technically due prior to the bankruptcy filing.
 - Billing Date Approach (3rd, 6th, and 8th Circuits): Courts consider when the rent was due (i.e., the “Billing Date”); if rent is billed prior to the petition date, it is a pre-petition general unsecured claim, even if some portion of the month accrues post-petition.
- *Practice Point.* In jurisdictions where timely payment of Stub Period rent is not required, landlords may still be entitled to an administrative claim in the bankruptcy case for the Stub Period rent under Bankruptcy Code section 503(b)(1) as an “actual, necessary cost and expense of preserving the estate.”

Question 5

When Will I Know What The Tenant Intends to Do With the Lease?

- Subject to the time limits imposed by the Bankruptcy Code and/or other procedures approved by the Bankruptcy Court, the debtor may assume or reject executory contracts and unexpired leases.
- For cases filed on or before December 27, 2022, the tenant will have 210 days (which may be extended for cause by an additional 90 days) to make the determination of whether to reject, assume, or assume and assign the lease.
 - *Reject.* The debtor may choose to reject (i.e., terminate) the lease, which is a statutorily permitted breach of contract. The court order approving rejection often provides that the debtor may abandon personal property at the leased location, and landlord may dispose of same, although careful attention needs to be given to the rights of any secured creditor and any applicable subordination agreements governing the same.
 - *Assume.* The debtor may choose to assume (i.e., re-affirm obligations under) the lease, provided that defaults are cured and adequate assurance of future performance is provided.
 - *Assume and Assign.* The debtor may choose to assume the lease and assign it to a third party, provided that defaults are cured and adequate assurance of future performance is provided.
- Courts will generally defer to the debtor’s business judgment in determining whether to approve a debtor’s request to assume, assume and assign, or reject a lease.
- A debtor can assume a lease and later reject it.
- *Practice Point.* Preserve rights by timely objecting to any motion to or notice of assumption, assignment or rejection; rights and remedies not timely taken are lost forever.

Question 6

If My Lease is Rejected, Can I Get Compensated for Remaining Term Rent and Related Damages?

- A landlord whose contract is rejected can assert a general unsecured claim for “rejection damages.”
- In many recent retail cases, general unsecured claims have received minimal recoveries (i.e., less than 10 cents on the dollar).
- The landlord is entitled to a claim comprised of pre-petition arrearages plus “rejection damages” equal to the greater of rents due for: (i) one year; or (ii) 15% of the remaining term, not to exceed three years.
 - Courts are divided as to whether the calculation pursuant to clause (ii) is 15% of the remaining rent under the lease (Bankruptcy Courts in MD, IL, MI, NJ and NY follow this rule) or 15% of the remaining time of the lease (Bankruptcy Courts in CA, CO, FL, DE and PA follow this rule), in either event not to exceed the sum of the next three years’ rent. There is no clear majority favoring either approach.
- To the extent not paid, landlord is also entitled to post-petition rent obligations, which are payable as an administrative expense.
- If a lease is assumed but later rejected, landlord’s administrative claim will be limited to the monetary obligations due under the lease (with limited exclusions) for the two-year period following the later of the rejection date or turnover date, with the balance being an unsecured claim subject to the rejection damages cap.
- *Practice Point.* Case law is split as to whether claims relating to maintenance, clean-up costs, repair costs, and costs to dispose abandoned property are (i) subject to the cap, and (ii) entitled to administrative expense status.

Question 7

Can My Tenant Assign the Lease to a Third Party Without My Consent?

- Yes. With certain exceptions, a bankrupt tenant can assume and assign a lease to a third party without landlord consent (subject to landlord’s ability to object to cure amounts and adequate assurance of future performance).
- Assumption or rejection is all or nothing; a tenant/debtor must assume or reject the whole lease. Where leases are integrated with other agreements, the scope of the integration could be a contested issue.
- However, parties may negotiate amendments to the lease or contract as part of an assumption.
- The debtor must cure defaults under the lease to assign the lease to a third party. In other words, pre-petition and post-petition obligations must be paid 100 cents on the dollar, and non-monetary defaults must be either cured or compensation paid, unless otherwise agreed by landlord.
- The debtor or assignee must show adequate assurance of future performance, meaning proof that they will be able to perform under the lease.
- Special requirements for shopping center leases, including:
 - assignee must take the lease subject to radius, location, use, and exclusivity provisions;
 - assignment must not disrupt any tenant mix or balance in such shopping center; and
 - financial condition of any proposed assignee must be the same as the tenant at the time the lease was first executed.
- *Practice Point.* When a debtor proposes to assume and assign a lease, a landlord must be vigilant in reviewing the terms thereof and timely raise objections if the lease or the law are not being followed.

Question 8

If the Debtor Proposes a Lease Amendment, What Should I Focus On?

- Threat of rejection v. amendment (who has the leverage?).
- Any proposed waiver or reduction of cure amounts.
- Economic terms, including base rent, percentage rent, total rent, rent due date, renewal options, and rent escalation during option periods.
- Effectiveness of amended terms in the event of subsequent lease rejection.
- Proposed revisions to the force majeure clause.
- *Practice Point.* A proposal to amend a lease is not a promise that the lease will be assumed. Ensure that language protects landlord’s interest in the event the lease is ultimately rejected.

Question 9

Are Payments I Received Pre-Bankruptcy Safe from Clawback?

- If the debtor made any payments during the 90-day period prior to the bankruptcy filing date, those amounts could be subject to clawback as preferential unless one or more defenses to avoidance are available.
- Defenses to Preference Claims:
 - Secured Creditor Defense
 - Example: The landlord may set off a preference claim to the extent of a security deposit or other collateral held.
 - Subsequent New Value Defense
 - Example: The landlord permits a tenant to remain in the property after the alleged preferential rent payment was made.
 - There is a split in authority regarding whether the new rent needs to remain unpaid, with a majority of courts, including the 11th Circuit, 4th Circuit, 8th Circuit, 9th Circuit, and 5th Circuit, holding that both paid and unpaid new value applies, and the 7th Circuit holding that credit is only given for any unpaid new value.
 - Ordinary Course of Business Defense
 - Example: The tenant has consistently paid rent five days late over the past two years, and the payments in question were paid five days late.
 - Contemporaneous Exchange for New Value
 - Example: Landlord provides services to the debtor, and landlord contemporaneously applies the alleged preferential payment to the invoice for those services.
 - Covered Rental Arrearages (COVID-19 Amendment, expires December 27, 2022)
 - Example: Lease entered into pre-petition; lease amended after March 13, 2020; and amendment deferred or postponed payments otherwise due under the lease or contract. This defense does not apply to the payment of fees, penalties, or interest imposed in the post-March 13, 2020 amendment.
- *Practice Point.* Any lease amendment or consent to assumption and assignment of a lease should include a broad release, including a release of any estate causes of action against landlord.

Question 10

Big Picture Question: What Do I Need To Keep Top-of-Mind if My Tenant Files for Bankruptcy?

- Engage counsel early to monitor key dates and potential impact on landlord rights, including timely payment of post-petition obligations, notices of rejection, deadlines to file proofs of claim, notices of cure costs, debtor in possession financing terms, and plan terms, and evaluate if relief from stay or adequate protection requests should be made.
- Consider joining the unsecured creditors' committee. Members of the Committee consult with the debtor, investigate the debtor and its business operations, and participate in forming and negotiating the chapter 11 plan, and Committee counsel fees are paid by the debtor's estate.
- Consider teaming up with other institutional landlords; strength in numbers.
- Timely file proof of claim, with an addendum that explains details and includes supporting documentation.
- *Practice Point.* Proactive participation is critical to protecting rights, especially in cases where the debtors have significant leased real estate. Close parsing of language in lease assumption/rejection notices, bar date orders, financing orders, sale motions and plan documents is required to ensure that landlord rights are protected and preserved.

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