

## **YOUR TENANT HAS FILED BANKRUPTCY – NOW WHAT?**

A growing number of retail tenants are filing bankruptcy due to lingering problems in the economy. This article provides an overview of some rights and remedies available to both a landlord and a tenant when the tenant files bankruptcy. As an illustrative example, assume that the tenant and landlord enter into a lease with rent due on the 1<sup>st</sup> day of each month. The tenant misses two months of rent. The landlord serves the tenant with a 3-day notice to pay rent or quit (or such other notice for non-payment of rent as may be set forth in the lease). The tenant then files bankruptcy on the 15<sup>th</sup> day of the third month.

### 1. Automatic Stay.

When the tenant files bankruptcy, an automatic stay immediately goes into effect. The automatic stay is a statutory injunction that prohibits actions by creditors, landlords and others to obtain possession or control of the tenant's property or to assert claims against the tenant. In the above example, when the tenant files bankruptcy, the landlord is automatically stayed from bringing an unlawful detainer action against the tenant after the 3-day notice to pay rent or quit (or other default notice) has run.

### 2. Post-Petition Rent.

If the tenant stays in possession of the leased premises after filing bankruptcy, the tenant is required to pay post-petition rent to the landlord and to keep those rent payments current as long as the tenant occupies the leased premises. Unpaid pre-petition rent is classified as an unsecured claim which is paid with other unsecured claims after secured and priority claims. Unpaid post-petition rent while the tenant occupies the leased premises is entitled to be paid as an administrative claim before general unsecured claims.

In the above example, whether the tenant's obligation to pay post-petition rent begins on the fifteenth day of the month in which the bankruptcy is filed or on the first day of the following month depends on where the tenant files bankruptcy. Some bankruptcy courts hold that rent due on the first day of the month is for the entire month. If the tenant files bankruptcy on the fifteenth day of the month, the rent for the entire month, including the remainder of the month after the tenant files, is considered pre-petition rent. In these courts, in the above example, the tenant would owe three months of unpaid pre-petition rent and would be required to pay post-petition rent commencing the first day of the month following the month in which tenant files bankruptcy.

Other courts prorate the rent based on the bankruptcy filing date with the tenant paying post-petition rent from the date the tenant files bankruptcy. In those courts, in the above example, the tenant would owe two and one-half months of unpaid pre-petition rent and would be required to pay post-petition rent commencing the fifteenth day of the month in which tenant files bankruptcy.

If the tenant fails to pay post-petition rent or perform other lease obligations on a timely basis, the landlord can file a motion with the bankruptcy court seeking either relief from

the automatic stay in order to evict the tenant or an order compelling the tenant to pay such rent or reject the lease.

### 3. Assumption/Rejection.

The tenant has two options in bankruptcy with respect to its lease: assumption or rejection. Rejection is simply a breach of the lease. Assumption means that the lease continues in full force and effect in accordance with its terms.

When the tenant rejects the lease, the tenant must vacate the premises and turn over possession to the landlord. The landlord then has an unsecured claim in the bankruptcy for the landlord's damages caused by the tenant's breach of the lease. This claim is determined according to state law, subject to certain limits imposed by the bankruptcy code. The bankruptcy code caps the landlord's claim for breach of the lease at an amount equal to the rent required to be paid under the lease for the greater of one year *or* 15% of the remaining term of the lease, not to exceed three years.

So when a tenant files bankruptcy and rejects its lease, the landlord must first determine its damages for breach of lease under state law. Once state law damages are determined, the bankruptcy cap is applied. If the state law damages are less than the bankruptcy cap, the landlord has a claim in the bankruptcy equal to its state law damages. If the state law damages are greater than the bankruptcy cap, then the landlord has an unsecured claim in the bankruptcy equal to the bankruptcy cap. The landlord is entitled to add unpaid pre-petition rent and damages to its claim. The landlord also may have an administrative claim for unpaid post-petition rent if the tenant remained in possession of the lease premises post-petition without paying rent. In addition, the landlord's claim may be reduced by any security deposit held by the landlord.

A tenant assumes a lease if the tenant wants to remain in possession of the leased premises or it wants to assign the lease to a new tenant. In order to assume the lease, the tenant must cure all defaults under the lease (with certain non-monetary exceptions). In addition to complying with the other terms of the lease, the tenant must pay all pre-petition and post-petition rent owing under the lease to the landlord. In the example above, the tenant would have to pay the unpaid pre-petition rent, as well as any rent due post-petition, to the landlord in order to assume the lease.

### 4. Assignment.

Even if the lease expressly provides that it cannot be assigned, the bankruptcy code permits the tenant to assume the lease and assign it, provided that the assignee provides adequate assurance that it can perform the terms of the lease after the assignment. This situation usually arises when the rent is below market and the tenant does not intend to continue to occupy the premises. In that situation, an assignee may pay the tenant in order to take over the lease. A landlord can object to assignment on the ground that the assignee is not creditworthy; however, such objections are typically difficult to win.

5. Use.

Shopping centers are given special treatment under the bankruptcy code with respect to use restrictions. Use restrictions in a lease are honored, for the most part, if the lease is in a shopping center. If the lease is not in a shopping center, generally speaking, a use restriction will not be enforced by the bankruptcy court, absent extraordinary circumstances.

6. Time in Which to Assume or Reject.

Prior to the 2005 amendments to the bankruptcy code, a tenant in bankruptcy had ninety days to decide whether to assume or reject a lease. This initial 90-day period could be and routinely was extended by the bankruptcy court. There was no limit on how many times an extension could be granted or how long the extensions could last.

The 2005 amendments to the Bankruptcy Code imposed overall limits on the time for a tenant to decide to assume or reject a lease. The tenant has an initial 120-day period in which to decide to assume or reject the lease. This initial 120-day period can be extended for up to another 90 days; however, no further extensions can be granted without the express consent of the landlord. Unless the landlord consents, the tenant now has a maximum of 210 days to assume or reject a lease. At the end of this 210 days, the lease is deemed automatically rejected if it has not been assumed.

7. Designation Rights.

Below market leases may be a valuable bankruptcy asset of the tenant. A practice has evolved of tenants selling sell “designation rights” early in the bankruptcy case. This practice allows a tenant to receive an early cash payment for its leases, rather than waiting to receive payments as it assumes and assigns each lease.

Sales of designation rights generally occur with leases that the tenant no longer intends to use in its operations or a part of a sale of all of the tenant’s assets. A third party pays the tenant for the right to tell the tenant whether to assume or reject the lease, and if a lease is assumed, to whom the lease is to be assigned. The purchaser of the designation rights then receives whatever compensation the tenant would have received upon the assumption and assignment of the lease. If an assignee is willing to pay money in order to take over a below market rate lease, the purchaser of the designation rights receives that payment instead of the tenant. The landlord retains its rights under the bankruptcy code to object to any proposed assignee.

8. Conclusion.

This articles discussed some of the basic bankruptcy principles applicable to landlords and tenants when the tenant files bankruptcy. The rights and obligations of landlords and tenants in bankruptcy are complex and are continuing to evolve after the 2005 amendments to the bankruptcy code.

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