

## **BANKRUPT, BOTHERED AND BEWILDERED: WHEN A COMMERCIAL TENANT FILES FOR BANKRUPTCY**

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Commercial bankruptcies are unfortunate and common occurrences in the current market downturn. The purpose of this article is to familiarize landlords with the major legal consequences of a commercial tenant declaring bankruptcy.

When a commercial tenant files a bankruptcy petition, including a petition for reorganization under Chapter 11 of the U.S. Bankruptcy Code (the “Code”), the petition acts as an “automatic stay” that prohibits the landlord from instituting or maintaining any action to terminate the lease, evict the tenant, or even pursue collection efforts. The automatic stay generally remains in effect for the duration of the bankruptcy case, unless it is terminated or modified by order of the Bankruptcy Court. The purpose of the automatic stay is to give the debtor breathing room and an opportunity to deal with its assets in an orderly fashion. Landlords who violate the stay may be liable for damages, and even cited for contempt.

A commercial tenant in bankruptcy (or the bankruptcy trustee, if one has been appointed) has the option to assume or reject any or all unexpired leases. The election to assume or reject should be made within 120 days after the date of the bankruptcy filing, but this time period may be extended by the Bankruptcy Court for an additional 90 days. Any further extension of time is permitted only with the landlord’s consent. (Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, a debtor could delay the decision to assume or reject leases, with the Court’s permission and without the landlord’s consent, for an indefinite period, and it was not uncommon for debtors to delay the assumption/rejection process for a year or more. Because of the stringent time periods now in effect, debtors may make the decision as to which leases will be terminated prior to the bankruptcy filing, instead of waiting to see how particular locations fare.)

After the bankruptcy petition is filed, if the tenant continues to occupy the leased premises while deciding whether to assume or reject the lease, the tenant is required to comply with all of the terms of the lease, including payment of rent. The tenant may, and often does, seek authority from the Bankruptcy Court to delay paying rent for up to 60 days after filing the bankruptcy petition, so that the tenant may make a reasoned decision regarding whether to assume or reject the lease. Unpaid post-petition rent becomes an “administrative expense” in the bankruptcy case. An administrative expense enjoys a high priority in the Bankruptcy Code’s payment scheme.

A lease that is not assumed within the 120 (or 210) day period is deemed rejected, and the tenant is required to surrender the premises to the landlord immediately. If the tenant does not immediately surrender the premises, the landlord may go to the Bankruptcy Court for an order compelling the tenant to vacate the premises.

A lease that is “rejected” is treated as being breached immediately prior to the time that the bankruptcy petition was filed. The landlord’s claim resulting from the breach of the lease is thus treated as a “pre-petition” claim. The Bankruptcy Code generally limits the pre-petition damage claim of the landlord for the rejection of a lease to (i) any unpaid rent payable under the lease prior to the date the bankruptcy petition was filed or the date the property was turned over to the landlord (whichever occurred earlier), plus (ii) the rent payable under the lease for the greater of 1 year or 15% (not to exceed three years) of the remaining term of the lease. Thus, the Code provides an extremely advantageous means for a commercial tenant to terminate unwanted leases, and is frequently utilized by national multi-unit retailers who want to get out from under leases of underperforming stores.

If a lease is guaranteed, the guaranty will remain effective, unless the guarantor is also in bankruptcy. However, if the guarantor is in bankruptcy, the claim of the landlord will be subject to the same statutory cap that limits a claim against a tenant in bankruptcy.

A lease that is “assumed” remains in effect, and the tenant must continue to pay rent and comply with all lease provisions. If the lease is assumed, the debtor retains the option to reject the lease later in the bankruptcy proceeding, but the damages arising from a subsequent rejection are not as limited. Damages for a subsequent rejection or termination of the lease are capped at the monetary obligations under the lease for approximately two years from the date of the rejection. Unlike damages from an early rejection of the lease, which are treated as a general, unsecured claim, damages from a later lease rejection is payable as an administrative expense.

A lease of a tenant in bankruptcy may be assumed by the tenant only if 1) all defaults (other than certain non-monetary defaults) are cured, or the debtor provides adequate assurance that the defaults will be promptly cured; 2) the debtor compensates or provides adequate assurance that it will be able to provide compensation for any prior defaults; and 3) the debtor provides adequate assurance of future performance under the lease. In the case of shopping center leases, “adequate assurance” of future performance includes assurance that the source of rent is comparable to when the lease was originally entered into, and that percentage rent will not decline substantially.

If a lease is assumed, it may generally be assigned by the debtor, regardless of whether the lease prohibits, conditions or restricts assignments, so long as the debtor provides adequate assurance of future performance by the assignee under the lease. In the case of shopping center leases, adequate assurance includes assurance that the assignee will be in compliance with all radius, use and exclusivity provisions in the lease, as well as any financing or master agreements relating to the shopping center, and that the assignment will not disrupt the shopping center’s tenant mix or balance.

Generally, if the lease is to be assumed (or assumed and assigned), the debtor must assume the lease with all of its terms intact, except those terms that limit the tenant’s right to assign the lease. The lease cannot be amended without the consent of the

landlord. This consent will often be requested by the tenant in order to make the lease more affordable or more attractive to a potential transferee. This is an opportunity for the landlord and tenant to change the lease in an effort to maintain continuity, and perhaps a solid, if financially troubled, tenant. A landlord will often consider a request for amendments to the lease if the lease is above market, the prospects for replacing the tenant are dim, or the occupancy rate of the landlord's building or shopping center is already low.

Because a lease may not be assumed if it is terminated before the bankruptcy action is filed, a landlord who suspects that a tenant's bankruptcy filing is imminent may want to terminate the lease immediately, if permitted by its terms. Pre-bankruptcy termination of a troubled lease may avoid altogether the possibility of the lease being assumed, and perhaps assigned, particularly if the rent under the lease is below market.

While a landlord cannot prevent a tenant from filing for bankruptcy, the possibility of such an occurrence should always be kept in mind when the lease is negotiated, particularly when the landlord is spending significant tenant improvement dollars. Legal counsel should be consulted promptly if (or, in the current economy, *when*) a tenant bankruptcy filing occurs, or, better yet, when such a filing appears to be on the horizon.

If you are facing a situation involving a tenant filing bankruptcy or have any other debtor/creditor related issues, please contact John A. Roberts (410-727-6671, or [jroberts@rosenbergmartin.com](mailto:jroberts@rosenbergmartin.com)). If you are facing a situation involving a tenant filing bankruptcy or have any other leasing issues, please contact Cynthia L. Spell (410-649-4984, or [csspell@rosenbergmartin.com](mailto:csspell@rosenbergmartin.com)).

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