FAQS FOR COMMERCIAL LANDLORDS WHEN A TENANT FILES CHAPTER 11

When a tenant under an unexpired lease of nonresidential real property files a case under chapter 11 of the Bankruptcy Code, both tenant and landlord acquire rights and obligations that may contravene the terms of the lease or applicable nonbankruptcy law. Below are answers to common questions from commercial landlords whose tenants commence a chapter 11 reorganization case.

1. CAN THE LANDLORD SUE TO COLLECT UNPAID RENT, TERMINATE THE LEASE, OR EVICT THE TENANT BASED ON THE BANKRUPTCY FILING OR PRE-BANKRUPTCY DEFAULTS?

A landlord cannot seek any remedy based on a default under a lease resulting from the tenant's bankruptcy filing, the tenant's insolvency or financial condition, or the appointment of a trustee (or pre-bankruptcy custodian) for the tenant. Post-bankruptcy filing, the landlord also cannot enforce any penalty relating to a default by the tenant in its nonmonetary obligations. The Bankruptcy Code renders all such provisions unenforceable. [1]

It is common for a bankrupt tenant to be behind in its rent or otherwise in default under its lease when it files for bankruptcy. But a bankruptcy filing will prevent a landlord, at least temporarily and often until the date the tenant determines whether to assume or reject the lease, from pursuing remedies such as collection, termination or eviction based on pre-petition (i.e., pre-bankruptcy) defaults. The tenant benefits from the "automatic stay" immediately upon its bankruptcy filing.[2] The automatic stay is the key to the "breathing spell" that the Bankruptcy Code affords debtors and is a broad injunction that bars landlords and other creditors from commencing or continuing any proceeding against the tenant that could have been commenced before the bankruptcy filing. Violating the automatic stay may subject a landlord to liability for actual or punitive damages and attorneys' fees.

The landlord has the right to file a motion with the bankruptcy court for relief from the automatic stay in order to pursue remedies. Grounds for stay relief may include that the tenant has no equity in the premises and they are not necessary for its reorganization. Many courts, though, are reluctant (including with regard to a cash security deposit to rent default) to grant stay relief, especially at the early stages of a chapter 11 case, in order to give the tenant an opportunity to formulate a plan and obtain the "fresh start" chapter 11 was enacted to promote.

The above analysis does not apply to a lease of nonresidential real property that expired or terminated prior to the bankruptcy filing. In such instances, the lease is not property of the tenant's bankruptcy estate, cannot be assumed, and the landlord is not subject to the automatic stay in pursuing remedies.

2. HOW DOES BANKRUPTCY AFFECT THE TENANT'S OBLIGATIONS TO PAY RENT?

The answer depends on the period for which rent is due relative to the bankruptcy filing. The tenant practically will not have to pay any rent for the pre-petition period prior to any assumption (or assumption and assignment) of the lease.

The tenant, however, will have to perform the obligations under the lease that arise post-bankruptcy. Section 365(d)(3) of the Bankruptcy Code is akin to a statutory "hell or highwater" clause and requires the tenant to "timely perform all the obligations" under the lease (other than those related to bankruptcy, etc., described above) that arise "from and after the date of the order for relief" (i.e., the date a voluntary chapter 11 petition is filed) until the lease is assumed or rejected.[3] If the tenant does not perform under the lease post-petition, then the landlord may move the bankruptcy court for relief from the automatic stay to compel payment or a decision to assume or reject the lease.[4] Post-bankruptcy filing, the tenant must pay, as an administrative expense, rent, CAM, taxes, insurance, utilities, maintenance, repairs, and virtually all other monetary amounts due. For "cause," the court may extend time for performance of an obligation that arises within 60 days of the bankruptcy filing until (but not beyond) that 60-day period. Prior to the COVID-19 pandemic the finding of cause to defer rent was unusual, but the hardships imposed by the pandemic caused some courts to grant such deferrals. Unsurprisingly, requests for 60-day rent "holidays" have become slightly more common. In addition, the pandemic rules were different for small business debtors operating under subchapter V of chapter 11.[5]

A. POST-PETITION OBLIGATIONS; STUB RENT

Most tenants will forego rent payments on the first of the month in which they plan to file for bankruptcy to preserve cash, knowing that the automatic stay will prevent landlords from pursuing remedies for the failure to pay such rent. Courts have split on their approach regarding the landlord's right to collect rent for the period between the date of the bankruptcy filing and the date the next rental payment is due, commonly referred to as "stub rent." Some courts apply a "proration" approach, which treats rent as a daily accrual regardless of when payment is due. Under the proration approach, the bankrupt tenant becomes obligated to pay rent commencing on the date of the bankruptcy filing.

Other courts apply a "billing date" method, which treats the billing date under the lease as the trigger for the tenant's post-petition obligations. If rent was due on the first on the month, then under the billing date approach rent under the lease during the month in which the debtor commenced its chapter 11 case is not an obligation that the tenant must timely perform. But even where the billing date approach does not require the tenant to pay stub rent specifically, the landlord may be able to recover stub rent under more general provisions of the Bankruptcy Code that require the tenant to pay claims arising post-petition, known as "administrative expenses."[6] Establishing entitlement to an administrative expense requires a showing that the rent is an actual and necessary cost of preserving the bankruptcy estate. This often is not a difficult showing to make because the tenant benefits from the use and occupancy of the premises. As a result, even where the court applies the billing date method, tenants may agree to pay stub rent (or a portion thereof) in order to avoid the time and expense of litigating administrative expense issues.

B. POST-PETITION OBLIGATIONS; GOB SALES

Many distressed retailers will have identified inventory to liquidate and leases to reject as soon as possible after a chapter 11 filing. While the Bankruptcy Code requires the tenant to perform its obligations post-petition and many commercial leases prohibit "going-out-of-business sales," most bankruptcy courts will grant a retailer's motion to conduct GOB sales that don't comply with the terms of the lease. Orders approving GOB sales often contain specific provisions as to hours, signage, etc., and can be negotiated between the landlord and debtor-tenant, but the landlord should expect that a tenant operating in chapter 11 will be permitted to conduct a reasonable GOB sale notwithstanding provisions in the lease to the contrary. The tenant will be obligated to pay rent while occupying the premises to conduct a GOB sale.

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1 11 U.S.C. § 365(e)(1).
2 See generally 11 U.S.C. § 362(a).
3 11 U.S.C. § 365(d)(3). In an involuntary chapter 11 case the date of the order for relief is the date the bankruptcy court grants (or the tenant consents to) the request that it be subject to the bankruptcy court's jurisdiction. In involuntary cases, which are uncommon, the landlord's claim for rent between the date of the filing of the involuntary petition and date the court enters the order for relief likely will be entitled to priority and have to be paid in full in order for the tenant to confirm a chapter 11 plan. See 11 U.S.C. § 502(f).
4 Some debtors may argue that the landlord is not entitled to full rent, but only to the fair market rent that qualifies as an administrative expense as an actual and necessary cost of preserving the bankruptcy estate. See 11 U.S.C. § 503(b). Many courts, though, will deem the rent in the lease as the fair market rate absent evidence to the contrary.
5 The Consolidated Appropriations Act of 2021 (the "CAA"), enacted on December 27, 2020 in response to the COVID-19 pandemic, allowed a small business debtor that commenced a case under Subchapter V of chapter 11 of the Bankruptcy Code prior to December 27, 2022, an extension of up to 120-days (a possible initial 60-days, plus a possible additional 60-days) following the bankruptcy filing (or the date the lease is assumed or rejected, if earlier), of the time within to perform post-petition obligations under an unexpired lease of nonresidential real property. This extension may be granted if the debtor has experienced or is continuing to experience a material financial hardship due, directly or indirectly, to COVID-19.
6 See 11 U.S.C. §§ 503(b), 507(a).

3. WHAT ARE THE TENANT'S OPTIONS REGARDING THE LEASE?

A bankrupt tenant has three legal options for addressing a lease of nonresidential real property in bankruptcy, the existence of which often leads to a fourth. The three legal options are assumption, assumption and assignment to a third party, and rejection. The tenant's rights regarding each of these options may give it leverage over its lessor, which often leads to a fourth, practical option of renegotiation.

Assumption, assumption and assignment, and rejection are all subject to the bankruptcy court's approval upon notice to the landlord. The court will apply a flexible business judgment standard in making its determination. Unless the lease is severable into multiple contracts—i.e., there is a master lease and various lease schedules covering different premises—the tenant cannot cherry-pick which provisions of the lease it wants to abide by but must assume, assume and assign, or reject the lease *in toto.*

A. ASSUMPTION

Assumption is the debtor-tenant's agreement to continue performing its obligations under the lease in exchange for retaining its rights under the lease. Generally, a tenant will assume those leases that have value because, for example, the rent is below market or the premises have strategic benefits for the business. After assumption, the tenant's monetary and nonmonetary obligations under the lease have administrative expense status that must be paid in full in cash in order to confirm a chapter 11 plan of reorganization. As a result, tenants often wait as long as possible to determine whether to assume a lease.

The Bankruptcy Code places certain conditions on assumption of a lease designed to protect the landlord.[7] The tenant must cure, or provide adequate assurance that it will promptly cure, defaults under the lease (including pre-petition defaults). The tenant must pay all amounts outstanding under the lease and cure most nonmonetary defaults (other than those related to bankruptcy and financial condition). There may be certain types of defaults that are not curable (such as an obligation to maintain or insure the property for an earlier period), and other defaults from which a court may excuse the debtor on a case-by-case basis (depending on the nature of the default). But in general the tenant's failure to cure (or provide adequate assurance of a prompt cure) is grounds for the landlord to contest assumption of the lease.

The tenant also must provide "adequate assurance of future performance" under the lease. Other than with respect to shopping centers (discussed below), the Bankruptcy Code does not define "adequate assurance of future performance" but it usually refers to both the tenant's financial wherewithal (i.e., ability to pay rent and other monetary obligations) and capacity to perform operationally under the lease. The tenant must compensate the landlord (or provide adequate assurance of prompt compensation) for any actual losses resulting from breach of the lease as a condition to assumption.

I. SPECIAL RULES FOR SHOPPING CENTERS

The Bankruptcy Code largely leaves courts to define "adequate assurance of future performance" on a case-by-case basis, but does set minimum standards of adequate assurance for leases in a shopping center. [8] Assumption or assignment of a tenant's shopping center lease requires adequate assurance of:

A. the source of rent and other consideration and, for an assignment, that the financial condition and operating performance of the proposed assignee (and any guarantors) shall be similar to the financial condition and operating performance of the debtor-tenant and its guarantors as of the time the debtor became the lessee;

B. that percentage rent will not decline substantially;

C. assumption and assignment covers all of the lease, including provisions governing use, radius, location and exclusivity, and won't breach any provisions in other leases (or certain other agreements) related to the shopping center; and

D. that assumption and assignment will not disrupt the shopping center's tenant mix or balance.

The Bankruptcy Code does not define "shopping center" and leaves the issue to the courts. Courts apply a myriad of factors to determine whether a group of stores is in a shopping center, including whether the leases are with one landlord, tenants have common areas and maintenance obligations, there are interrelated restricted use provisions and other factors.

B. ASSUMPTION AND ASSIGNMENT

Assumption and assignment often occurs when the debtor-tenant wants to include the lease in a broader sale of some or substantially all of its assets to a third-party buyer/assignee. The Bankruptcy Code permits the tenant to assume and assign most commercial property leases even where the lease expressly prohibits assignment without the landlord's consent.[9] A tenant also may argue that certain use or other restrictions in the lease are tantamount to an unenforceable anti-assignment clause that a bankruptcy court can override, especially where the landlord included the provisions for the purpose of limiting assignments.

In addition to meeting the "cure" requirements for assuming a lease, assumption and assignment requires demonstration of adequate assurance of future performance by the assignee. As with assumption, this generally requires the assignee to establish its ability to pay rent and other charges and to perform operationally under the lease. When an assignment becomes effective, the assignee is bound by the lease and must comply with its terms, and the tenant (and its bankruptcy estate) no longer have any liability or obligations.

C. REJECTION

If the tenant determines that assumption or assignment is not in its interest (because, for example, the rent is above-market) then it will seek bankruptcy court authorization to reject the lease. Rejection constitutes a pre-petition breach of the lease and effectively releases the tenant from any ongoing obligation to perform.[10] Upon rejection, the landlord retains its right to collect rent for the post-bankruptcy period prior to the effective date of the rejection. But, absent a deposit or other security (discussed below), the landlord's claim for the tenant's future non-performance—i.e., the claim for rent for the remaining post-rejection term of the lease—is a general unsecured claim for breach of contract.[11]

Moreover, section 502(b)(6) of the Bankruptcy Code forces a mitigation of damages on commercial landlords by capping their lease rejection damage claims. The general unsecured claim of a lessor under a rejected commercial property lease is capped at the sum of (1) the rent reserved under the lease for the greater of (a) one year or (b) 15% or the remaining lease term, not to exceed three years, plus, (2) any amounts outstanding under the lease as of the date of the bankruptcy filing. If the 502(b)(6) cap is less than the damage claim as calculated under applicable law (usually state law), then the cap represents the maximum amount of the landlord's allowed claim for lease rejection damages against the tenant's bankruptcy estate. It is the threat of rejection, and the corresponding capped general unsecured claim of the landlord (which may receive little or no recovery in the chapter 11 case), that often gives the debtor-tenant leverage to renegotiate leases in its chapter 11 case.

4. HOW LONG DOES THE TENANT HAVE TO DECIDE WHETHER TO ASSUME OR REJECT?

Section 365(d)(4) of the Bankruptcy Code gives the tenant 120 days following the bankruptcy filing within which to assume or reject an unexpired lease of nonresidential real property. The tenant also can seek further extensions of up to 90 days for cause, but any extensions beyond the 90-day period require the landlord's consent.[12]

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7 11 U.S.C. § 365(b)(1).
8 11 U.S.C. § 365(b)(3).
9 11 U.S.C. § 365(f).
10 Tenants sometimes seek authority to abandon equipment or other property located at the leased premises. See 11 U.S.C. § 554. Courts often approve such abandonment but allow the landlord to assert a damage claim for costs incurred in connection therewith..
11 See 11 U.S.C. § 365(g). In the rare instances where a lease is rejected after it has been assumed, the resulting claim for breach is an administrative claim, not a prepetition claim. See 11 U.S.C. § 503(b)(7).
12 The CAA amended the Bankruptcy Code to extend for an additional 90 days the deadline for trustees or debtors in possession to assume or reject non-residential real property leases, for a total of 210 days from the initiation of the bankruptcy case. Because the Bankruptcy Code already allows this initial period to be extended by an additional 90 days "for cause", a debtor that commenced its chapter 11 case prior to December 27, 2022 has up to 300 days to decide whether to assume leases.

5. CAN A LANDLORD APPLY A SECURITY DEPOSIT, DRAW ON A LETTER OF CREDIT, OR PURSUE A GUARANTOR?

A landlord holding a security deposit generally is entitled to benefit from its security, subject to important caveats. First and foremost, security deposits must be applied against the landlord's capped lease rejection damages claim; security deposits cannot be applied against amounts exceeding the cap. Thus, the security deposit should in most cases be applied first to the prepetition rejection claim (which, absent the security deposit, might otherwise be worth only a percentage of its face value) before applying the deposit to any unpaid post-petition rent (to which there is a legal entitlement to full payment where funds are available). Second, a landlord should not apply a security deposit without court approval (in the form of relief from the automatic stay). The tenant likely has a reversionary interest in the security deposit, making the deposit property of the bankruptcy estate and placing it under the automatic stay's protection.

Unlike a security deposit, a letter of credit is an independent contract between the landlord and the issuing bank, not the debtor-tenant, and thus is not subject to the automatic stay (although the landlord should consider any limit on its rights if the debtor is entitled to notice of the draw on the letter of credit). A landlord holding letter of credit can likely apply it to pre-petition rent default. Second, while the law is split there is some authority allowing a landlord to draw on a letter of credit in the full amount of its lease rejection damages, not merely the amount of its section 502(b)(6) capped claim, where the landlord does not file a claim against the tenant for lease rejection damages.[13] Other courts have treated the letter of credit as akin to a security deposit and limited application of the proceeds to the capped claim, at least where the landlord filed a proof of claim.[14]

Neither the cap on lease rejection damage claims nor the automatic stay apply to the landlord's claim under a guaranty (including a non-recourse carveout or "bad boy" guaranty), so long as the guarantor itself is not in bankruptcy. If the guarantor is in bankruptcy, then the claim against the guarantor may be limited to the amount of the statutory cap. In addition, a bankrupt guarantor benefits from the automatic stay and the landlord, absent stay relief, cannot seek to enforce its guaranty against a bankrupt guarantor.

13 *See, e.g., In re Stonebridge Techs, Inc.*, 430 F.3d 260 (5th Cir. 2005).
14 *See, e.g., In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197 (3rd Cir. 2003).

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Andrew V. Tenzer is a partner in Nutter's Corporate Department and a member of the Bankruptcy, Restructuring and Workout practice group. Andrew focuses his practice on advising lenders, troubled companies, and buyers and sellers of distressed assets in chapter 11 reorganization and in out-of-court and cross-border restructurings. In addition, he frequently handles non-insolvency related syndicated financings, securitizations, and structured finance transactions. Andrew has extensive experience serving as a trusted legal adviser to domestic and multinational companies in a wide range of industries, including financial services, technology, manufacturing, energy, and retailing.

REPRESENTATIVE EXPERIENCE

- Wells Fargo, as agent for the prepetition and DIP lenders, in the chapter 11 and CCAA cases of Bumble Bee Foods LLC
- Citibank, N.A., as agent for the prepetition and DIP lenders, the chapter 11 cases of Arsenal Resources Development LLC
- Barclays PLC, as agent for the prepetition and DIP lenders, in the chapter 11 cases of Mattress Firm, Inc.
- Truist, as successor to SunTrust, as agent for the lenders in the UK administration and CCAA proceedings of Kew Media Group
- Bank of America, as agent for the senior secured lenders, in the chapter 11 cases of Open Road Films LLC
- Essar Global Fund Ltd., as plan sponsor and DIP lender, in the restructuring and chapter 11 cases of Trinity Coal Corporation
- White Oak Global Advisors LLC, as agent for the prepetition lenders, DIP lenders, and credit bidder, in the chapter 11 cases of Epic Companies, LLC
- Royal Bank of Canada, as agent for the pre-petition lenders and DIP lenders, in the chapter 11 restructuring of GST AutoLeather, Inc.
- Great American Capital Partners, as term loan agent and lender in the chapter 11 cases of Hancock Fabrics and its affiliates
- Royal Bank of Canada, as agent, in the $3.5 billion exit financing for chapter 11 debtor Energy Futures Intermediate Holdings
- Spiegel Inc. and Eddie Bauer Inc., major U.S. and international retail and catalog merchants, in their chapter 11 reorganizations

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Timothy M. Smith is a senior partner in Nutter's Real Estate Department and a member of the firm's Executive Committee. Both public and private companies rely on Tim's 36 years of experience in real estate acquisition, disposition, leasing, joint venture, and financing transactions. Tim represents clients in land use and permitting matters, including subdivision, environmental, wetlands, and zoning issues.

Institutional owners and corporate tenants engage Tim to represent them in leasing, acquisition and financing of office space (including downtown office towers and headquarters leases), laboratory space, manufacturing facilities (including GMP facilities), and warehouse and industrial buildings. Institutional landlords also utilize Tim's expertise in retail leases of shopping centers, life style centers, enclosed malls, and mixed use buildings.

REPRESENTATIVE EXPERIENCE

- National real estate owner on leases for portfolio of warehouse and industrial space for locations in MA, NH, NJ, RI + PA
- Institutional landlord on leases of industrial, warehouse and laboratory facilities in in MA and New Jersey, including recent (i) 846,000 SF lease of warehouse and distribution building in Hamilton Township, NJ and (ii) 427,000 SF lease of warehouse and distribution facility in Jersey City, NJ
- Real estate development firm, as ground tenant, in connection with three separate ground leases for Phase A of the Enterprise Research Campus, which is owned by an entity owned and controlled by Harvard University. Space to be subleased for office + lab space, hotel + residential uses
- Large biotechnology company on a national basis on acquisition, disposition, leasing (tenant and landlord), and building management matters for headquarters, office, laboratory, and warehouse space, including recent (i) lease and option to purchase for 400,000 SF of space over 20 year term for a build-to-suit headquarters office and laboratory facility in Maple Grove, Minnesota and (ii) lease for 210,000 SF of laboratory space in Duluth, Georgia
- Institutional landlord on leasing and property management matters at 125 Summer Street, Boston, MA (office + first floor retail), 60 State Street, Boston, MA (office + first floor retail), 225 Franklin Street, Boston, MA (office + first floor retail), and 745 Atlantic Avenue, Boston, MA (office + first floor retail)
- Institutional landlord on leases for office and ground floor retail space at the following properties: 55 Cambridge Parkway, Cambridge, MA, 84 State Street, Boston MA, 40 Broad Street, Boston MA, and various office buildings in the Fort Point Channel District of Boston, MA