

Commercial Landlord Issues in Bankruptcy

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I. Introduction

The purpose of this article is to educate legal practitioners and real estate professionals who are unfamiliar with the nuances of bankruptcy law about some of the common issues commercial landlords are likely to face in the event a tenant files a petition for relief under the Bankruptcy Code. While it is certainly helpful to have a familiarity with the provisions of the Bankruptcy Code, for purposes of this article, it is certainly not necessary.

Because this article is intended to be a practical guide for nonbankruptcy professionals, the article first discusses some basics of bankruptcy law and then discusses specific issues that a commercial landlord will likely face in the same sequence as those issues will likely arise during the course of the tenant's bankruptcy case. At the end, this article will address several procedures, both preemptive and reactive, a commercial landlord may choose to implement to mitigate damages resulting from a tenant's bankruptcy filing.



II. Bankruptcy Basics

A. The Bankruptcy Process

Bankruptcy cases involving leases are most likely to be filed under Chapter 7 (liquidation cases for both individuals and businesses), Chapter 11 (reorganization cases, primarily for business, but may include high-net worth individuals), or Chapter 13 (cases involving individuals with regular income). All bankruptcy cases are commenced upon the filing of the debtor's petition. For the most part, at least insofar as landlords are concerned, it does not matter much whether a tenant's bankruptcy has been commenced under Chapter 7 or Chapter 11. In fact, the line between a Chapter 11 reorganization and a Chapter 7 liquidation, while still very much distinct, has become somewhat blurred, as more and more practitioners are filing Chapter 11 petitions though they have no intention of reorganizing but, rather, simply want to liquidate, while retaining control of the process. Nevertheless, the following is a brief summary of Chapter 7, Chapter 11, and Chapter 13.

Chapter 7

Commonly referred to as a "straight bankruptcy," Chapter 7 is the most frequently filed bankruptcy case. In an individual's Chapter 7 bankruptcy case,

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all non-exempt property of the debtor as of the petition date is collected and administered by a Chapter 7 trustee. The Chapter 7 trustee will examine the debtor's situation and determine whether the debtor is entitled to a "discharge" of indebtedness. A discharge—the ultimate goal of every debtor in bankruptcy—extinguishes the liability of the debtor related to his, her, or its unsecured, prepetition debts. The Chapter 7 trustee serves as a custodian of the debtor's assets and serves as a fiduciary for the bankruptcy estate. The Chapter 7 trustee will liquidate the debtor's nonexempt property and make a pro rata distribution to creditors after payment of court fees and administrative expenses.

Chapter 11

In a Chapter 11 case, business entities (including corporations, partnerships, etc.) and high-net worth individuals can attempt to reorganize or liquidate while remaining in control of their business operations, as a "debtor-in-possession." Like a Chapter 7 trustee, a debtor-in-possession owes fiduciary duties to the bankruptcy estate. The debtor-in-possession also has the exclusive right to file a plan for its reorganization or liquidation for the first 120 days after the commencement of the bankruptcy case. Once the 120-day period expires, however, the debtor runs the risk of losing this privilege, unless the court, after notice and hearing, extends it for "cause."

Plans of reorganization or liquidation in Chapter 11 bankruptcy cases may differ substantially in terms of substance. Most plans of reorganization or liquidation include payments to creditors sometimes over the course of several years. But plans of reorganization or liquidation may also include lump sum payments to creditors, new shares of stock for old shares, or a sale of substantially all of the debtor's assets to another entity. In some instances, creditors have the option of receiving new shares of stock in the newly reorganized debtor entity. Although there are no stringent restrictions on the substance of a plan of reorganization or liquidation, the plan itself must be accepted by similarly situated creditors whom together hold claims totaling two-thirds in amount and over one-half in number. In certain circumstances, a plan may still be confirmed even though the foregoing voting threshold was not satisfied by a class of similarly situated creditors.

Chapter 13

Chapter 13 cases involve individual debtors who have a regular source of income—including individuals with sole proprietorships. There, the individual debtor proposes a plan for the repayment of his or her debts, pursuant to which the debtor's creditors typically receive payments over the course of three to five years. Like a debtor-in-possession in a Chapter 11 case, the debtor retains his or her assets, except that a trustee is automatically appointed to make distributions to creditors in accordance with the plan for the repayment of debts. Like Chapter 11, creditors are entitled to vote either for or against the plan. The plan must provide for a distribution of property of a value not less than the amount of the allowed claims, and it must commit all of the debtor's disposable income for three to five years to satisfying the claims of unsecured creditors. "Disposable income" is defined by the Bankruptcy Code as "current monthly income . . . less amounts reasonably necessary to be expended for the maintenance or support of the debtor or a dependent of the debtor or, for a domestic support obligation" and "for charitable contributions," as well as necessary business expenditures.

Chapter 13 is meant to require debtors to satisfy more unsecured claims than debtors in bankruptcy cases administered under Chapter 7 of the Bankruptcy Code. A Chapter 13 bankruptcy case may be commenced only by an individual with regular income whose prepetition, unsecured debts are noncontingent, liquidated, unsecured, and equal less than \$336,900 and whose prepetition, secured debts are noncontingent, liquidated, and equal less than \$1,010,650.

B. Types of Leases in Bankruptcy

Nonresidential Lease or Residential Lease

As a preliminary matter, the Bankruptcy Code distinguishes between "nonresidential" and "residential" leases. Nowhere, however, does the Bankruptcy Code define either term. While, at first blush, the distinction seems rather intuitive, courts have had difficulty characterizing leases in certain contexts, such as where a debtor's business is the operation of a nursing home or the subletting of residential apartments. In such instances, the majority of courts look to the nature of the property

itself in order to properly determine the character of a lease—that is, whether people reside in the property. Other courts, however, look to the nature of the lease in order to determine its character—i.e., whether it generates income for the debtor. Notwithstanding this apparent split amongst courts in the methodology used for characterizing a lease, whenever the Bankruptcy Code refers to a lease as a “nonresidential real property lease” or “nonresidential” lease, it is always referring to a commercial lease.

True Lease or Other Transaction

In addition to not defining the terms “nonresidential” and “residential,” the Bankruptcy Code fails to define the term “lease.” This absence of a definition, coupled with the fact that the Bankruptcy Code affords commercial lessors a heightened level of protection, has motivated some debtor-tenants to take the position that their lessor is not entitled to a heightened level of protection because the underlying transaction was actually a disguised mortgage arrangement or joint venture. Most courts look to state law to decide this issue. Almost uniformly, state law looks to the intent of the parties in determining whether a transaction is a “true” or “bona fide” lease. In determining intent, however, a growing number of courts are looking past the parties’ stated intentions to the “economic substance” of the transaction, or the parties’ objective intent as manifested under the terms of the transaction; e.g., which party ultimately receives the risks and benefits of ownership under the terms of the transaction, the lessee or lessor.

Following this “economic substance” approach, if the transaction has any of the following terms, it is less probable that it will be construed as a “true” or “bona fide” lease: (i) the lease has an option to permit the “lessee” to buy the property for little or no cost at the end of the lease term; (ii) the term is for the whole pecuniary life of the property; (iii) the rent is structured for reasons other than for consideration to the lessor for use of the property (e.g., to guarantee a specific rate of return); (iv) the cost of purchasing the property for the “lessor” was unrelated to market value, or represents the sum needed to finance the “lease”; (v) the “lessor” bought the land for sole purpose of its use by the “lessee”; (vi) the “lease” was structured for purposes of reducing taxes; or (vii) the

obligations normally incurred by the land owner (e.g., property taxes and insurance) are being assumed by the “lessee.” Although in practice what constitutes a “true” lease may not always be patently obvious, whenever the Bankruptcy Code uses the term “lease,” it is referring to a “true” or “bona fide” lease.



III. The Bankruptcy Case and Issues Particular to Commercial Landlords

A bankruptcy case is commenced upon the filing by a debtor of a petition for bankruptcy relief. As a matter of law, two significant events occur upon the commencement of a bankruptcy case: (i) the implementation of the “automatic stay” and (ii) the creation of “property of the estate.” In order for any creditor—including a commercial landlord—to make prudent decisions throughout the course of a debtor’s bankruptcy case, it is critical that it generally understand both the scope of the automatic stay and property of the estate. Therefore, we shall discuss each principle in turn.

A. The Automatic Stay

Generally

The automatic stay is a legal fiction that springs into effect automatically upon the filing of a bankruptcy petition. It operates as an injunction prohibiting any collection efforts against the debtor or the property of the bankruptcy estate to satisfy prepetition debt, as well as staying the commencement or continuation of any judicial proceeding against the debtor. The automatic stay is a fundamental

principle of bankruptcy law, and its purpose is to give the debtor a “breathing spell.” The automatic stay prevents creditors from participating in a “race to the courthouse” to compete for the repayment of debts. The automatic stay applies in bankruptcy cases administered under Chapters 7, 11 and 13, and in both voluntary and involuntary cases.

What is Stayed

As previously mentioned, the automatic stay prohibits the continuation of most prepetition collection or judicial actions, both formal and informal, against the debtor or “property of the estate” (explained below). With respect to landlords in particular, the automatic stay prohibits, among other things: (i) a demand for payment owed by the tenant that arose before the bankruptcy case; (ii) termination of the lease agreement; (iii) eviction of the tenant; and (iv) the application of any security deposit to amounts owed.

With respect to a Chapter 13 case, the automatic stay prohibits creditors from acting, commencing, or continuing any action to collect all or any part of a consumer debt from a co-debtor. The co-debtor stay, however, does not prohibit creditors from pursuing a debt related to a Chapter 13 debtor’s business obligation. Additionally, if the co-debtor actually received the consideration, as opposed to the Chapter 13 debtor, the stay does not shield the co-debtor. The co-debtor stay remains in place until the case is dismissed or the debtor receives a discharge, except in the event a creditor requests and is granted relief from the automatic stay.

What Is Not Stayed

A lease agreement that expired or was terminated before the bankruptcy case is outside the scope of the automatic stay. Theoretically, in such circumstances, a landlord could proceed with its remedies without approval from the bankruptcy court. So if, for example, a commercial landlord is in the process of evicting a tenant when the tenant files for bankruptcy relief, the landlord should be able to proceed with the eviction process. However, practicably speaking, because of the serious penalties for violating the automatic stay and the breadth of the stay, a landlord should seek approval from the bankruptcy court before enforcing its rights under the lease.

Relief from the Automatic Stay

To counterbalance the significant effect of the automatic stay, the Bankruptcy Code provides a procedure allowing a commercial landlord to seek relief from the automatic stay so that the landlord may enforce its state law remedies, such as an eviction action upon a tenant defaulting under the terms of a lease. It should be noted, however, that a bankruptcy court will often be reluctant to grant relief from the automatic stay unless the tenant has fallen behind in payment of rent subsequent to the commencement of the bankruptcy case.

Violations of the Automatic Stay

The automatic stay may be particularly frustrating for a commercial landlord, in that it impairs a landlord’s enforcement of its state law remedies. In the event a landlord undertakes actions that violate the automatic stay, such actions are voidable or void (depending on the jurisdiction). Significantly, the automatic stay is also backed by the bankruptcy court’s contempt powers. Pursuant to section 362(h) of the Bankruptcy Code, an individual injured by any “willful” violation of the stay is entitled to recover actual damages, attorney’s fees, and, where appropriate, punitive damages. A violation of the automatic stay is “willful” when the actor had actual knowledge of the bankruptcy case. At least some courts have held that neither intent nor recklessness is a factor. Accordingly, a landlord should seek relief from the automatic stay before taking any action that may arguably violate the stay, including a request for payment or setoff of a deposit.

Ipsa Facto Clause

Ipsa facto clauses in a lease are unenforceable against a tenant who has filed for bankruptcy relief. What is an ipsa facto clause? Generally speaking, an ipsa facto clause is a lease provision that provides that the lease terminates or is modified solely because the tenant is insolvent or files for bankruptcy relief. Any landlord who relies on an ipsa facto clause in seeking amounts owed by the tenant that arose before the bankruptcy case will likely violate the automatic stay and may suffer serious penalties as a result.

B. Property of the Estate

Generally

Like the automatic stay, property of the estate is a legal fiction that is created immediately upon the filing of a tenant's petition for relief under the Bankruptcy Code. Essentially, property of the estate consists of all legal and equitable interests of the debtor in property as of the commencement of the tenant's bankruptcy case.

What is Included

In the context of a bankruptcy case initiated by a commercial tenant, property of the estate will include any right the tenant has under a lease that had not been terminated prior to the filing of the bankruptcy petition. Most importantly, this will include the right of the tenant to possess the leased premises without interference from the commercial landlord.

What is Not Included

Conversely, a lease that has been terminated before the commencement of the tenant's bankruptcy case is not considered property of the estate. Since, as explained above, the automatic stay does not protect actions against property that does not constitute property of the estate, it follows then that the stay does not prohibit a commercial landlord from seeking to obtain possession of the leased premises where the lease expired either before the filing of the bankruptcy petition or expires during the course of the case. Again, however, because the consequences of violating the automatic stay are so severe, out an abundance of caution, the best practice is to seek relief from the stay before taking any action to possess the leased premises.

Use of Property of the Estate

A debtor tenant may use property of the estate, including, but not limited to, the debtor's use of what is defined as "cash collateral." Generally speaking, a debtor may use property of the estate, other than cash collateral, without permission from the court if such use is in the ordinary course of business. A debtor may use cash collateral—i.e., encumbered cash and cash equivalents—if each entity with an interest in cash collateral consents to such use or the bankruptcy court, after notice and a hearing, approves of the debtor's use. The debtor may use property of the estate that is not cash collateral when such use is outside of the ordinary course of business,

if after notice and a hearing the bankruptcy court approves of such use.

C. Use of Credit

In addition to being able to use property of the bankruptcy estate, a debtor tenant may also obtain credit during the course of its bankruptcy case. If, for example, a debtor is unable to obtain unsecured credit in exchange for giving a postpetition lender an administrative expense claim, the Bankruptcy Code allows a debtor to grant a postpetition lender a lien on unencumbered property, a junior lien, and, under some circumstances, a priming lien. In practice, postpetition lenders often secure liens on substantially all of the debtor's assets, including leasehold interests, by agreeing to extend credit to a debtor. At times, postpetition lenders even gain total control of a commercial property.

D. "First-Day" Motions

Bankruptcy cases can move at a rapid pace. This is particularly true at the beginning of the bankruptcy case. Indeed, it is common practice for debtors to file emergency motions (i.e., motions with limited notice), scheduling hearings on the motions within a day or two. Such motions are commonly referred to as "first day" motions. The shortened notice on these motions may result in creditors obtaining notice of the motions after orders have been entered on these motions. Creditors, and landlords specifically, must therefore be attentive in monitoring these emergency motions and hearings to make sure that they do not impact their rights. Although first day motions usually address administrative matters (e.g., appointment of counsel, administrative consolidation of cases, use of bank accounts), they can also address substantive matters, including, but not limited to, debtor-in-possession financing and use of cash collateral.

E. Tenant's Performance Obligations

Generally

A commercial tenant who seeks bankruptcy protection is required to perform all obligations under an unexpired lease that arises after the bankruptcy filing, such as paying rent and related charges, until the lease is rejected, assumed, or assigned. Although a court may allow a tenant to postpone performance of its lease obligations for a sixty (60) day period after

the filing of the bankruptcy petition, the court may not postpone such performance beyond this sixty (60) day period.

Administrative Expense Priority Claim

A landlord is entitled to an administrative expense priority claim for unpaid obligations owed to it that accrued after the bankruptcy case was filed. Administrative expense claims are paid before all other unsecured claims and typically are paid in full.

Maintenance Obligations

Enforcing maintenance obligations in leases can be difficult. The bankruptcy court will consider a variety of factors, including: (i) whether the item to be repaired was broken before or after the commencement of the bankruptcy case; (ii) whether the repair is necessary to protect the public; (iii) the repair cost; and (iv) whether the tenant is likely to assume the lease.

F. Rejection, Assumption, or Assignment

Generally

(Choices)

A tenant that files for bankruptcy relief, subject to court approval, may reject, assume or assign any unexpired lease. Questions as to whether a lease is “unexpired” are governed by the terms of the lease and state law. For a debtor that has numerous locations, such as a national retailer, the decision to reject, assume, or assign a lease, for reasons explained below, can be difficult but result in a significant benefit.

(Timing)

A commercial tenant in bankruptcy has 120 days to decide whether to reject, assume, or assign a lease. This deadline, however, may be extended upon motion of the debtor and later approval of the bankruptcy court, or upon the debtor receiving the landlord’s written consent. Typically, the duration of the extension should be enough time so that the tenant may make an informed decision about whether to assume, reject, or assign its lease.

If a commercial tenant fails to make a decision before the 120-day period expires, absent an extension, the lease is automatically deemed rejected. In the event the tenant seeks an order extending the 120-day period to assume or reject, the tenant must demonstrate “cause” as to why the 120-period should be extended. Though the court will evaluate each commercial lease

on a case-by-case basis, the following factors weigh in favor a finding of “cause” for an extension of the 120-day period for the tenant to assume or reject a lease: (i) there has not been sufficient time for the tenant to adequately evaluate its financial situation, as well as the value of the lease; (ii) the chapter 11 bankruptcy estate’s primary asset is the lease, which will play a key part in whether the tenant will be able to reorganize; (iii) the payments under the lease continue to be made to the lessor in a timely fashion; (iv) the bankruptcy case involves numerous leases and is significantly complex in and of itself; (v) there is a dispute as to whether the lease is a “true” or “bonafide” lease; and (vi) the lease concerns a building built on the lessor’s land and built by the lessee, and a reversionary interest to the lessor. Conversely, the following factors do not support a finding of “cause,” in evaluating whether an extension should be granted: (i) the tenant’s failure to pay rent; (ii) the tenant’s failure to file a plan within a reasonable period of time; and (iii) the tenant’s occupation of the premises and/or failure to pay taxes caused losses greater than any remedy that is available under the Bankruptcy Code.

Generally speaking, bankruptcy courts accommodate the debtor early in a Chapter 11 case, since any assessment as to the likelihood of a successful reorganization will be speculative. Of particular concern, the bankruptcy court may want to avoid the premature assumption of a lease by a debtor/tenant, and with it the accrual of an administrative claim, that will later be rejected.

If the bankruptcy court grants the motion, it is prohibited from extending the deadline for more than 90 days, such that a tenant may have a total of 210 days to assume or reject a nonresidential lease. Once the 210-day deadline expires, the tenant will only be able to obtain additional extensions if the landlord gives the tenant written consent to do so.

If the tenant fails to assume the lease before the deadline expires, the lease will be deemed rejected and the tenant is required to immediately surrender the property to the landlord.

(Compel)

Although the Bankruptcy Code gives a tenant 120 days to decide whether to reject, assume, or assign a lease, a landlord may compel the tenant to make an

earlier decision. To do so, the landlord must file a motion demonstrating “cause” (e.g., failure to pay rent after the bankruptcy case), and the bankruptcy court must subsequently grant the motion. Note that while the tenant is making its decision, the landlord should insist on timely payment of rent, common area and insurance charges, as well as other charges required under the lease.

Rejection (Standard)

In deciding whether to allow a rejection of a lease, the bankruptcy court will likely defer to the tenant’s business judgment. Simply put, the court will likely approve the motion to reject the lease if it believes that doing so makes sense in terms of optimizing value and is in the best interest of the bankruptcy estate. Usually, a tenant in bankruptcy will choose to reject its lease if: (i) the tenant anticipates liquidating its assets, or (ii) the tenant has multiple locations and considers a particular lease unduly burdensome, including rent that is above market.

(Treatment)

A lease rejection is treated as a breach of the lease that occurred before the bankruptcy case. It requires the tenant to immediately surrender possession of the premises. Damages caused by the lease rejection are limited to: (i) unpaid rent from the earlier of the date the tenant filed for bankruptcy relief or the date the landlord repossessed the premises, plus (ii) the greater of (a) one year’s rent or (b) 15% of the rent owing (not to exceed three years worth).

(Claim Priority)

Unless the landlord is holding a security deposit or is otherwise secured by a valid security interest in other assets, the entire amount of the landlord’s rejection claim is an unsecured claim ranking in the same priority with other general unsecured claims.

In some instances, the tenant will assume a nonresidential, commercial lease and later reject it. In such case, the landlord will likely receive an administrative claim for pecuniary amounts owed, with the exception of penalties, for two years after the tenant’s abandonment of the premises or rejection of the lease. Claims for the remaining amounts due will be unsecured.

Assumption (Standard)

In deciding whether to allow a tenant to assume a lease, the bankruptcy court will likely defer to the tenant’s business judgment. As stated before, in applying the business judgment standard, the court will probably approve the tenant’s motion to assume a lease if the lease adds value to the bankruptcy estate.

Specifically, a tenant may choose to assume a lease if: (i) the tenant is reorganizing its business and views the lease as a valuable asset to its business; or (ii) the tenant deems the lease an unnecessary part of its reorganization plan but intends on selling or assigning it on a later date. Whether a tenant is reorganizing its business or liquidating, it may opt to assign its lease when the economics of the lease are below market.

(Cure)

In order to assume a lease, a commercial tenant who has sought bankruptcy relief must promptly cure all outstanding defaults under the lease, with certain exceptions. Defaults under a lease that must be cured include most monetary defaults, both before and after the bankruptcy case was commenced. In addition, the tenant must also promptly reimburse the landlord for any pecuniary losses suffered by the landlord as a result of such outstanding defaults. Calculating pecuniary losses to a commercial landlord, however, may prove difficult. Finally, if a commercial tenant chooses to assume a lease, it must also provide the landlord with adequate assurance of its future performance under the lease. In terms of defaults that a tenant need not cure before assuming a lease, courts may not agree on precisely which exceptions apply, particularly with respect to nonmonetary defaults. However, many nonmonetary defaults that have already occurred, like the discontinuation of the tenant’s business or a tenant’s failure to meet performance obligations, are virtually impossible to cure.

(Shopping Center)

If the lease is for space in a shopping center, to satisfy the requirement of adequate assurance of future performance the tenant must demonstrate that: (i) the source of rent and, in the case of an assignment of the lease, the financial condition and operating performance of the proposed assignee and

its guarantors (if any); (ii) any percentage rent due under the lease will not decline substantially; (iii) the assumption or assignment of the lease (a) is subject to the lease terms, and (b) will not breach any other provision in a related agreement; and (iv) will not disrupt any tenant mix or balance in the shopping center.

Assignment (Prerequisites)

In addition to being able to assume or assign a lease, a tenant that files bankruptcy may also assign the lease. To do so, the tenant must first assume the lease. Therefore, if there are defaults under the lease, the tenant must satisfy the requirements for assumption, such as curing defaults, reimbursing the landlord for any losses on account of such defaults, and providing the landlord with adequate assurance of future performance under the lease.

(Anti-Assignment Clause)

Many leases may incorporate a provision that attempts to modify or terminate the lease upon the tenant attempting to assign the lease. However, any anti-assignment provision is ineffective against a tenant that has sought bankruptcy relief. Moreover, any assignment by the tenant in bankruptcy will relieve the tenant of its obligation to the landlord.

G. Enforcing Lien/Security Interests

Statutory Lien

A statutory lien securing payment of rent may be avoided by a tenant in bankruptcy.” However, avoidance of the statutory lien is not automatic. The tenant is required to file a complaint against the landlord avoiding the statutory lien.

Security Interest Provision

Many commercial leases have a clause granting the landlord a security interest in the furniture, fixtures, and equipment within the leased premises. To perfect that security interest, the landlord must timely file an appropriate UCC financing statement. Absent the timely filing of an appropriate UCC statement, the landlord will not have a perfected security interest in the furniture, fixtures, and equipment.

Relief from the Stay

In the event the commercial landlord has filed a UCC financing statement, and it wants to exercise its right

to the property covered by this security interest, the landlord must obtain relief from the stay to exercise its rights without running the risk of violating the automatic stay.

H. Filing Proofs of Claim

Who Needs to File

Generally speaking, any entity that is owed a debt by the debtor should file a proof of claim for the amount of the debt owed to it. This includes a landlord if the lease is rejected.

Bar Date

Following the commencement of a bankruptcy case, a deadline is set for creditors to file proofs of claims, and this deadline is commonly referred to as the “bar date.” If a landlord does not file a proof of claim, then it may not receive a distribution on account of its unsecured claim arising from the rejection of the lease. Proofs of claim in a Chapter 7 case or Chapter 13 case must be filed within ninety (90) days after the date first set for the section 341 meeting of creditors. It is not important whether the meeting is actually held on that date. Chapter 11 proofs of claim must be filed within the time period fixed by the bankruptcy court. Deadlines in Chapter 11 vary from case to case, depending to some extent on the complexity of the case and on the debtor’s counsel’s diligence in requesting that the court set a final date for filing. Once a landlord’s proof of claim is filed, it may be amended. Most likely, the landlord will need to amend the proof of claim if filed prior to the rejection of the lease.

Claim Amount

If a commercial landlord is owed any amount under the lease before the bankruptcy case was commenced, then the proof of claim should include that amount. In contrast, if there are any amounts owed under the lease that accrue during the pendency of the bankruptcy case, such amounts generally are an administrative expense claim and the commercial landlord should file a motion for payment of this amount. In the event the tenant chooses to reject the lease, the landlord should make sure the proof of claim incorporates the damages resulting from the rejection. Most likely these damages will be incorporated by way of amendment. Calculation of rejection damages is discussed in detail above. Conversely, if the tenant assumes the lease, then the

tenant is required to pay all amounts past due under the lease, regardless of whether it came due before or after the bankruptcy case commenced. Finally, if the lease contains a provision requiring the tenant to pay for attorney's fees related to the enforcement of the lease, then the proof of claim should also include the amount of attorney's fees expended by the landlord in the bankruptcy case.

I. Avoidance Actions

Preferences

An avoidance action is a suit brought by a debtor against a creditor to recover or "avoid" certain payments made before the bankruptcy case commenced. Subject to various defenses, a landlord may have received a preference if payment was made for or on account of an antecedent debt, within ninety (90) days before the filing of the bankruptcy petition and such payment enables the landlord to receive more than it would have received if the case were a case under Chapter 7, the transfer had not been made, and the debtor/tenant was insolvent at the time of the payment. Among the most common defenses, which are available to landlords and other creditors, are those known as the "ordinary course" defense and "contemporaneous new value" defense. With respect to the "ordinary course" defense, a landlord has an affirmative defense to a preference action if the payments in question were received either in the ordinary course of dealing between the parties or based on the usual course of business in the industry. With respect to the "contemporaneous new value" defense, a landlord can assert as an affirmative defense unpaid rent which accrued subsequent to the preferred payment to the landlord if such rent accrued prior to the rejection of the lease.

Fraudulent Transfers

Under the Bankruptcy Code, a fraudulent transfer is generally a payment that was made by the debtor within two years before the bankruptcy case began, in which the debtor either made the payment with the intent to defraud or did not receive reasonably equivalent value in consideration for such payment. Importantly, a fraudulent transfer action may be brought in conjunction with a fraudulent transfer action made pursuant to state law. If the action is made pursuant to state law, the look back period to avoid a transfer as fraudulent will be governed by applicable state law.

J. Mitigating the Harm

Security Deposit

There are many ways a commercial landlord can protect itself in the event a tenant files for bankruptcy relief. One very common way a landlord may protect itself is to obtain a security deposit when the lease is executed. A security deposit will make the landlord a secured creditor to the extent of the amount deposited. Additionally, a landlord may use the deposit to setoff any amounts owed under the lease in the event the lease is rejected. Before exercising the setoff, however, the landlord must first obtain relief from the automatic stay.

Letters of Credit

In addition to requiring a deposit, a commercial landlord might also require a tenant to provide a letter of credit. Indeed, a letter of credit is probably even more effective in protecting a landlord in the event a tenant files bankruptcy than a security deposit. Generally speaking, a landlord may draw on a letter of credit free from interference from the bankruptcy court. Unlike a lease security deposit, a letter of credit is an agreement between the landlord and the party posting the letter of credit, and any funds transferred to the landlord were property of the non-debtor/third-party. Therefore, most courts that have addressed the issue have concluded that neither the letter of credit nor the transferred funds constitute property of the estate and thus subject to the automatic stay.

Third-party Guaranty

Another option to commercial landlords is to obtain a third-party guaranty of the tenant's lease. Like a letter of credit, a third-party guaranty allows the landlord to look to someone other than a bankrupt tenant to satisfy the any default under the terms of the lease. A third-party guaranty is also usually outside the scope of the bankruptcy court's authority. As such, a landlord can utilize a third-party guaranty to maximize the recovery of prepetition amounts owed to the landlord under a lease, with the added comfort of not becoming too involved in the bankruptcy case.

Adequate Assurance or Liquidated Damages Provision

Another way commercial landlords are trying to protect themselves against exposure to tenant bankruptcies is by defining "adequate assurance of

future performance” in the event the tenant does in fact file for bankruptcy relief and later wants to assume the lease. While it is unsettled as to whether a bankrupt tenant must abide by any prepetition provision as to what constitutes adequate assurance of future performance, if such adequate assurance terms are reasonable, they will likely be persuasive to a judge if there is an adequate assurance dispute.

As mentioned above, a bankrupt tenant, who seeks to assume a lease, must cure any pecuniary damages suffered by the landlord as a result of the tenant’s default, yet such damages may be difficult to calculate. One way to alleviate any subjectivity to calculating such pecuniary damages is by incorporating a liquidated damages provision into the lease setting forth the amount of pecuniary losses that would result from the tenant’s failure to operate its business in accordance with the lease.

Rent Relief to Debtor

A commercial landlord that is hoping that a bankrupt tenant will assume the lease, but is unsure as to whether the tenant will choose to do so, might decide to take a more practical approach by lowering the tenant’s rent or deferring rent payments. If a landlord does decide to lower or defer rent payments in order to entice a bankrupt tenant to assume the lease, the landlord should always try to get something in return for its relief, such as confirmation that the tenant will in fact assume the lease or cure any prepetition defaults.

Duty to Mitigate

A landlord has a duty to make reasonable efforts to minimize the damages that the landlord suffered from the tenant’s rejection of the lease. The extent of the landlord’s duty to mitigate depends on the

remedy the landlord selects for the tenant’s breach. The tenant may not sue the landlord for a failure to comply with the landlord’s duty to mitigate; instead, the landlord’s failure to mitigate its damages only limits the landlord’s recovery against the tenant. Finally, the tenant has the burden of demonstrating that the landlord has failed to mitigate its damages, and that the amount of the damages the landlord could have avoided had the landlord not failed to mitigate its damages.

Monitoring the Bankruptcy Case

Whatever protections a commercial landlord implements to mitigate the harm against a tenant that has sought bankruptcy relief, the landlord will want to monitor the bankruptcy case and, specifically, the tenant’s compliance with the terms of the lease during the pendency of the case. If the tenant is unable to satisfy its obligations under the lease, the landlord may want to move for relief from the automatic stay so that it may terminate the lease and take steps to evict or request that the court compel the tenant to perform under the lease or to reject or assume the lease.

IV. Conclusion

In sum, it is important for every real estate professional to have some familiarity with bankruptcy law and the common issues that confront commercial landlords when a tenant files for bankruptcy relief. This article attempts to serve as a practical guide for nonbankruptcy professionals, discussing the issues that a commercial landlord will likely face, as well as various procedures a commercial landlord may implement to mitigate any resulting harm, when a tenant commences its bankruptcy case.

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