

YOUR TENANT FILES BANKRUPTCY — Now What?

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Many landlords and office managers perceive a tenant's bankruptcy to be the worst case scenario for them. While sometimes it is, it doesn't have to be, and in some circumstances, it can be a good thing. This article outlines generally the bankruptcy process and identifies the options available to the landlord when its tenant files bankruptcy.

Introduction

In general, the bankruptcy of a tenant of non-residential real estate creates a new environment for the landlord-tenant relationship. The tenant has the ability to preserve its lease notwithstanding either a "bankruptcy default" (i.e., filing a bankruptcy petition) or a non-bankruptcy default that otherwise would have permitted the landlord to evict the tenant. Furthermore, the Bankruptcy Code permits the tenant (now the debtor) to assign the lease for the value under certain circumstances. The landlord faces the prospects of trying to market space occupied by a bankrupt tenant or being forced to lease space to a tenant who otherwise may not have been able to lease space from the landlord. All of these issues are governed by one prevailing theme—whether the estate of the debtor (i.e., the other creditors of the tenant) would be made better off by permitting the debtor to reject the lease or by permitting the debtor to assume, or assume and assign its lease of the premises.

The Automatic Stay

The first thing anyone knows about bankruptcy is the automatic stay, but few understand its limits and that it can be lifted. Upon the filing of a bankruptcy petition by a tenant, whether voluntarily or involuntarily, all other parties generally are prohibited from taking an action against the tenant. This "freezing" is known as the "automatic stay" in bankruptcy. In essence, the landlord is prohibited from: (1) initiating or continuing eviction proceedings, (2) initiating or continuing actions for past due rent, accelerated rent, or damages or (3) sending a notice of termination to the tenant.

The automatic stay can be lifted by the Court, however. The Bankruptcy Code requires that relief from the automatic stay be granted "for cause." "Cause" may exist in the form of a tenant's inequitable conduct prior to filing or the trustee's failure to pay post-petition charges for use of the premises. In the case of secured creditors, "cause" includes lack of adequate protection of a security interest; however, it is unclear whether landlords are entitled to similar "adequate protection."

The stay may also be lifted if the lease was terminated prior to the tenant's bankruptcy. Neither a trustee nor the bankruptcy court can resurrect a non-

residential lease that has been terminated prior to the filing of bankruptcy. The Bankruptcy Code provides that any interest of a tenant-debtor in a lease which has terminated pre-petition is not property of the bankruptcy estate. Accordingly, the Code provisions relating to assumption and assignment of leases do not apply to leases terminated pre-petition. Whether or not a lease has been properly terminated, however, is a question of state law. Under Illinois law, for example, a lease may be terminated after proper delivery of a statutory five-day notice and expiration, without cure, of such five-day period. Thus, the first thing a landlord must determine is whether the lease was in fact terminated prior to the filing of the bankruptcy, i.e., was a five-day notice served and did the five-day period expire before the filing of the bankruptcy. If so, you may be able petition the bankruptcy court to lift the stay and allow you to proceed in state court with the eviction.

Post-petition Termination

Unless the lease has terminated before the filing of the bankruptcy petition, the lease will become "property of the estate." Subject to bankruptcy court approval, a lease which is property of the estate may be "assumed" or "rejected" by the tenant, as debtor in possession, or by the trustee. Until the lease is assumed or rejected, the debtor must timely perform all obligations of the debtor which accrue during the case, and, if these obligations are not performed, they become administrative priority expenses. If the debtor fails to pay post-petition rent, the landlord can petition the court to have the rent paid or have the lease assumed or rejected. As a result, after the filing of the bankruptcy, the landlord should insist that post-petition rent is paid on time because it may give leverage to the landlord.

A non-residential lease is deemed rejected if the trustee (or the debtor in possession) does not assume the lease within 60 days following the date of the order for relief (the date of filing in Chapter 11 cases), which 60-day period may be, and often is, extended upon motion by the trustee presented to the court within the initial 60-day period. In the Kmart bankruptcy, for instance, the period was extended for more than a year. If the 60-day period is not so extended and the lease is deemed rejected, the trustee shall immediately surrender the leased premises to the landlord. If the lease is rejected, the rejection is deemed to occur on the date immediately preceding the filing, and most of the claims arising therefrom are deemed unsecured claims.

What happens if the lease is assumed?

This is the good news. If there exists a pre-petition default, the trustee may not assume the lease unless the trustee (1) cures the default, (2) compensates, or provides adequate assurance to the landlord that the trustee will promptly compensate, the non-debtor party for any actual pecuniary loss from such default and (3), future performance under the lease. An assumed lease may not be assigned unless the trustee can provide adequate assurance of future performance, notwithstanding the existence or nonexistence of defaults at the time of such assignment.

Adequate assurance of future performance

When a landlord enters into a lease with a tenant, the landlord typically assesses the prospective tenant's ability to pay rent in the future. It is for that reason that landlords typically reserve the right to withhold consent to an assignment of the lease. These anti-assignment provisions are unenforceable in a bankruptcy, however. Instead, if the debtor wishes to assume and assign the lease, the debtor must give adequate assurance that the new tenant will be able to perform under the lease in the future. What constitutes "adequate assurance of future performance" will be determined on a case-by-case basis. At least one commentator has suggested that "in the case of an assumption of a real property

