

What We Know

ARTICLES & INSIGHTS

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Uh-Oh — Your Commercial Tenant Just Filed Bankruptcy: Options, Deadlines and Opportunities

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You have worked diligently to fully lease your commercial property—the leases have been signed, the tenants have moved in, and the rent is flowing. You are already spending the excess cash flow from the property. Out of the blue, the mailman delivers an envelope with a return address that begins “United States Bankruptcy Court.” A major tenant of yours has filed a bankruptcy proceeding. You star at the piece of paper wondering why this happened and what are your options. The recent bankruptcy filing of retailing giant K-Mart served notice that no tenant, large or small, is immune from the legal and economic pressures that force the filing of a bankruptcy petition. Being prepared for a tenant’s bankruptcy can minimize the impact on a commercial landlord.

A bankruptcy filing by a tenant leasing non-residential real property triggers a series of deadlines and concerns for the landlord. The first issue the landlord must address is whether its lease is going to be assumed or rejected. The United States Bankruptcy Code requires a Debtor lessee of non-residential real property to either assume or reject a lease within 60 days of the bankruptcy petition date. If the Debtor fails to assume the lease within such time period, the lease is deemed rejected. Courts have liberally granted Debtors extensions of this time deadline (subject to the Debtor’s continued performance of the underlying lease obligation), but the landlord must keep this deadline in mind in reviewing its options. If the landlord is faced with a factual scenario (e.g., the loss of a potential replacement tenant) which demands a definitive answer to the assumption/rejection question prior to the end of any applicable time period, the landlord has the option to petition the bankruptcy court to compel the Debtor to either assume or reject the lease immediately. Filing such a motion to compel can be an effective tool in the landlord’s negotiations with tenant. Keep in mind that the Debtor tenant can only assume the lease if it “cures” all applicable defaults under the lease or the landlord waives the defaults. Thus, the filing of a bankruptcy petition can enable the landlord to force the tenant to bring the lease current if the tenant wishes to remain in the leased premises.

During the course of the bankruptcy, the landlord should monitor the case to make certain that the Debtor is in compliance with its post-petition obligations. The

bankruptcy code requires the Debtor to timely perform its obligation under the lease. In the event the Debtor fails to do so, the landlord is accorded administrative expense priority for rent and other sums due during such post-petition period. However, careful attention must be paid to the overall status of the bankruptcy case. It is a hollow victory for the landlord to be accorded administrative expense priority status for rental payments only to find that the bankruptcy estate is administratively insolvent, unable to pay even the priority claims.

Finally, one item of utmost importance for the landlord is filing its proof of claim. In almost all Chapter 7 liquidation proceedings, the landlord's proof of claim is simple-it is the sum of (a) the landlord's pre-petition claim for accrued rent, CAM charges, taxes, etc. and (b) the landlord's claim arising from the rejection of its lease (discussed in more detail below). Filing the proof of claim in Chapter 11 proceeding can be more complex as it will depend on whether the landlord's lease is assumed or rejected. If the lease is assumed, the Debtor must cure all defaults under the lease. This includes all amounts due and owing both pre-petition and post-petition. The prudent landlord should file a timely proof of claim even if it believes the Debtor will assume its lease to make sure the amount is paid.

Filing a proof of claim when a lease is rejected is a more difficult situation. In either a Chapter 7 or Chapter 11 proceeding, the rejection of a lease by the Debtor constitutes a breach of the lease as of the commencement of the bankruptcy case. Consequently, the landlord has a claim in the Debtor's bankruptcy case for the "breach." Under North Carolina law (subject to the landlord's duty to mitigate its damages), the landlord would have a claim for the balance of the rent due under the breached lease. For example, if there were seven years remaining on the lease term with an annual rental of \$10,000.00, the landlord would have a claim based on the lease rejection in the amount of \$70,000.00. However, the Bankruptcy Code provides a "cap" on the amount of a claim arising from the rejection of a lease at "the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of the lease."

One item gaining popularity as a possible mechanism to avoid the "cap" on lease rejection damages is the use of a tenant letter of credit (in lieu of a tenant security deposit). The complete analysis is more detailed than this article permits, but the simplified answer is that the landlord's rights under a letter of credit, when properly documented in both the letter of credit and the lease, is not a claim against the debtor that is subject to the "cap." Rather it is a claim against the issuer of the letter of credit, presumably a lending institution that is a non-bankrupt party. While not a guaranteed result (some courts are reluctant to permit this result), the use of the letter of credit is an opportunity that landlords should explore as the lease is being drafted and signed. This will probably not be a desirable option with small, local tenants; but, when dealing with larger or more national tenants, the landlord would be remiss if it ignored this possible protection.

The issues surrounding a lease of non-residential real property where the tenant seeks bankruptcy relief are both numerous and, at times, complicated. These issues become even more complicated when, in a Chapter 11 bankruptcy proceeding, the tenant

attempts to renegotiate or modify its lease with the landlord. Having an informed attorney can help the landlord with options, deadlines, claim amounts and assessment of recovery, and greatly increases the ability of the landlord to make decisions in its best interests.

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