

IN PRACTICE

## REAL ESTATE

### Commercial Property Leases in Bankruptcy: Common Landlord and Tenant Issues

When a commercial tenant or their landlord files for bankruptcy protection, questions quickly arise, such as if and how a landlord may evict the tenant, and how to measure damages. The Bankruptcy Code and related case law address these points.

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As the commercial real estate market undergoes seismic shifts resulting from the rise of online retailing, the COVID-19 pandemic, the growth in work-from-home options for employees and employers, and the continuing evolution of how we do business as a nation, companies may find themselves in situations where their tenant or their landlord has filed for bankruptcy protection. Questions then quickly arise, such as if and how a landlord may evict a bankrupt tenant, whether a bankrupt tenant may remain as a lessee and continue to occupy the premises, and how to measure damages for a landlord in this situation, both before bankruptcy and going forward post-petition. The Bankruptcy Code and related case law address these points.

Under the Bankruptcy Code, a debtor has the right to elect to assume or reject executory contracts, such as unexpired leases for real property. 11 U.S.C. §365. A debtor with operations in multiple locations may, if approved by the Bankruptcy Court, assume leases for locations where the lease

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is affordable (in the case of a tenant debtor) or profitable (in the case of a landlord debtor), and where it makes business sense to continue the lease. The debtor may reject leases for those locations where that is not the case.

#### Commercial Tenant Bankruptcies

Generally, to assume an unexpired lease, the debtor—i.e., a debtor-in-possession (“DIP”) or Chapter 7 or Chapter 11 Trustee—must cure any default in the lease (such as unpaid rent through the time of lease assumption), or provide adequate assurance that such default will be cured, as well as provide adequate assurance that the tenant will perform its future obligations under the lease. 11 U.S.C. §365(b). Whether “adequate assurance” is provided is determined by the Bankruptcy Court, with guidance on interpreting the broad provisions of the Bankruptcy Code provided mainly by a patchwork of case law.

For example, adequate assurance of future performance of a lease in a shopping center includes assurance of the source of rent and other consideration due under the lease; that any percentage rent due under the lease will not decline substantially; that the assumption or assignment of the lease will not disrupt any tenant mix or balance in such shopping center; and other requirements. 11 U.S.C. §365(b)(3). If the debtor-tenant intends to assume and then

assign the leased space, assurances need to be provided to prove that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease. *Id.*

Notably, ipso facto clauses, i.e., commonly found provisions in leases that purport to terminate the lease upon a tenant’s filing for bankruptcy protection, are generally unenforceable and cannot be used to justify a lease default by the tenant or to force the removal of the tenant due to the bankruptcy filing. Accordingly, a tenant-debtor that cures a payment or other default under the lease and provides adequate assurance of future performance may remain in possession during the lease term if the tenant continues to meet the lease obligations post-petition.

If a tenant-debtor elects to reject the lease, the landlord may assert a claim in the bankruptcy case for unpaid rent. The rejection of the commercial lease is deemed to be a breach of the lease occurring immediately before the filing of the bankruptcy petition. 11 U.S.C. §365(g). The landlord’s claim may consist of three components:

- (i) The unpaid rent due prior to the date of the bankruptcy filing (11 U.S.C. §502(b)(6)(B)), which is generally treated as

an unsecured claim that shares a pro rata distribution with other general unsecured claims, plus

(ii) Any unpaid rent from the date of the bankruptcy filing through the date of the lease rejection, which may be entitled to administrative priority (i.e., a payout at a greater rate and up to 100% of the claim if the estate is administratively solvent and if the rent is deemed to be an actual and necessary expense of preserving the estate under 11 U.S.C. §503(b)), plus

(iii) A claim for the balance of rent due under the term of the lease; this amount is generally treated as an unsecured claim sharing a pro rata distribution with other general unsecured claims, and is capped under 11 U.S.C. §502(b)(6) at the greater of the rent due for one year or 15%, not to exceed three years, of the remaining term of the lease.

The purpose of the cap on the landlord's claim for the remainder of the rent due under the lease is to balance the interests of landlords and other unsecured creditors by allowing the landlord "to receive compensation for losses suffered from a lease termination while not permitting a claim so large as to prevent general unsecured creditors from recovering from the estate." *Solow v. PPI Enterprises* (In re PPI Enterprises (U.S.)), 324 F.3d 197 (3d Cir. 2003).

### Commercial Landlord Bankruptcies

Although a debtor-landlord may reject a commercial lease, the tenant is entitled to remain in possession for the balance of the term set forth in the lease and any renewal or extension period if the tenant continues to pay the rent due under the operative lease documents. The practical effect of the landlord's rejection of the lease is that it enables the landlord to essentially walk away from its obligations to maintain and service the property, including providing such things as utilities, repairs, maintenance, and janitorial services. The tenant may offset against future rent any damages caused, after rejection, by the debtor's nonperformance under the lease. 11 U.S.C. §365(h). See also *IDEA Boardwalk v. Polo North Country Club* (In re Revel AC), 2016 Bankr. LEXIS 3805 (Bankr. D.N.J. 2016); *Megafoods Stores v. Flagstaff Realty Assocs.* (In re Flagstaff Realty Ass'n.), 60 F.3d 1031 (3d Cir. 1995).

Even a sale of the property in bankruptcy is generally held to be subject to the tenant's leasehold and statutory rights under §365(h) to remain in possession because the purchaser steps into the shoes and assumes the rights and obligations of the debtor-landlord. See *IDEA Boardwalk*, 2016 Bankr. LEXIS 3805 at \*11 (ruling that the purchaser of Atlantic City casino property was enjoined from interfering with the tenant's ability to avail itself of its rights under the lease) and \*\*16-19 (holding that the sale of the property under Bankruptcy Code §363 (11 U.S.C. § 363) did not trump the rights afforded to the tenant under Bankruptcy Code §365(h) (id. at \*\* 16-19)). The debtor-landlord cannot use its statutory right to reject the lease to oust the tenant from the premises, even where the landlord alleges that the tenant is paying below-market rent under the lease. See, e.g., *In re Doggy Care of Jersey City*, Chapter 11 Case No. 17-30869 (JKS) (Docket No. 39-2). Rather, "[t]he primary function of rejection is to 'allow a debtor-landlord to escape the burden of providing continuing services to a tenant' [and] rejection 'relieves the estate from covenants requiring future performance, such as the provision of utilities, repairs, maintenance, and janitorial services by the debtor'". *IDEA Boardwalk*, supra, 2016 Bankr. LEXIS 3805 at \* 19 (quoting *Flagstaff Realty*, supra, 60 F.3d at 1034).

All of these landlord-tenant bankruptcy issues should be in the forefront for landlords and tenants in determining rights, obligations, and strategies when a bankruptcy involving a commercial property is filed. The Bankruptcy Code and the Bankruptcy Court set deadlines for the elections to assume or reject a lease, and for the filing of related claims, of which parties on both sides of the leasehold relationship should take heed. Knowledge of rights and obligations, foresight in planning, and flexibility will help parties navigate these issues and optimize their positions in the event that bankruptcy pervades the landlord-tenant relationship. ■