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Tenant Bankruptcies

Stephen Lasser · Tuesday, June 26th, 2018

An issue that commercial landlords frequently have to address is tenants falling behind in their rent payments and then filing for bankruptcy protection. Once a tenant declares bankruptcy, an "automatic stay" goes into effect, which makes it illegal for the landlord to pursue eviction and collection efforts against the tenant except through the channels available through the tenant's bankruptcy court proceeding. This is problematic because the landlord loses rental income and is also prevented from evicting the tenant and re-letting the space to a solvent tenant. As a result, it is critical for landlords to take proactive measures prior to a faltering tenant declaring bankruptcy, as well as taking aggressive measures within the bankruptcy proceeding to minimize the potentially negative effects of bankruptcy.

Security Deposit Management

Standard commercial leases contain provisions that require tenants to deposit money with landlords as security for the tenant's performance of the terms and conditions of the lease, including the payment of rent. The amount of security deposits vary, but they are usually equivalent to several months' rent. Although security deposits are seemingly simple safeguards, unfortunately, they are sometimes not utilized to their maximum effect.

First, it is critical that at the time of a lease renewal that the amount of the security be increased to be commensurate with a multiple of the new presumably increased monthly rent and that such increased amount is actually collected. A security deposit collected 5, 10 or 20 years ago will probably not offer a landlord adequate protection for a current rent default.

In addition to making sure that security deposit amounts are up to date, it is also critical that landlords do not delay in applying security deposits against rent arrears. Although a landlord may hope that a tenant in arrears will eventually get current in its rent payments again, if a landlord delays giving notice to the tenant that it is applying the tenant's security against a tenant's rent arrears and fails to make such application prior to the tenant declaring bankruptcy, then the security deposit will become part of the bankrupt tenant's bankruptcy estate and might not ever be collected by the landlord. This is because many commercial tenants who declare bankruptcy owe debts to other creditors such as lenders or equipment lessors who are typically secured creditors and would receive repayment priority over landlords whose rent claims are typically unsecured. Unfortunately, in many bankruptcies there is not enough money to pay the debts of unsecured creditors after the secured creditors have been paid. As a result, it is a good practice for landlords to ensure that tenant security deposits are always kept current and that landlords do not delay in

applying security deposits against rent arrears in order to protect themselves.

Using Letters Of Credit Instead Of Cash Security Deposits

Letters of credit are an attractive alternative to cash security deposits that landlords can use to secure a tenant's payment obligations under a commercial lease. The main benefit to landlords is that if a tenant declares bankruptcy, the proceeds of a letter of credit do not become part of the tenant's bankruptcy estate, and the landlord can collect these funds without violating the automatic stay.

A letter of credit is typically a short two or three page agreement whereby the issuing bank agrees to pay an amount specified in the letter of credit to the beneficiary (landlord) upon a default by the applicant (tenant) under the lease between landlord and tenant, and the landlord subsequently delivering a payment demand known as a "draft" to the issuing bank.

From a landlord's perspective, one downside of using a letter of credit is that it may take more than a week for an issuing bank to release funds in contrast to a cash security deposit held in an account controlled by the landlord, which would be more easily accessible. In addition, issuing banks can be extremely particular and demanding in regard to the manner and format in which the draft and related documents must be presented by landlord in order to draw on a letter of credit. However, as long as a landlord or its legal counsel is experienced and meticulous when attempting to draw on a letter of credit, the potential inconvenience should be more than offset by the bankruptcy protection that a letter of credit can provide.

Expedited Lease Rejection

Once a commercial tenant declares bankruptcy, the court appointed bankruptcy trustee has 120 days to decide whether to accept or reject or the lease which leaves the space in a no-man's land in the interim because the landlord cannot legally relet the space until the lease is rejected. However, unless the tenant filed a Ch. 11 reorganizational bankruptcy and intends to continue to operate its business out of the space on an ongoing basis or the trustee believes that the lease is valuable and could be sold in order to generate income for the bankruptcy estate to pay off other debts, in most cases the lease will eventually be rejected by the trustee.

As a result, it is usually a good strategy for landlords to have their legal counsel promptly contract the bankruptcy trustee and tenant's bankruptcy counsel to try to obtain an expedited rejection of the lease in less than 120 days. This voluntary lease rejection would be embodied in a written agreement, which would have to be approved by the trustee, and whereby the tenant will also surrender possession of the leased space to the landlord, so the locks to the space can be changed and the space can be relet. This agreement would also address the disposal of any other property left in the space, which might be encumbered by the liens of other creditors. If a landlord fails to take proactive steps to expedite a lease rejection, such landlord may be sitting with a fully or partially empty space for a long time.

Landlord's Unpaid Rent Claims

In addition to attempting to expedite the rejection of a bankrupt tenant's lease and the surrender of the leased space back to the landlord, landlord's legal counsel should also submit a proof of claim with the bankruptcy court for all unpaid pre-bankruptcy petition rent and post-bankruptcy rent owed by the bankrupt tenant to the landlord. Pre-petition unpaid rent would be classified as

unsecured debt, which is given the lowest payment priority in bankruptcy. Generally, a landlord's claim for post-petition rent that accrued prior to the lease rejection would be considered an administrative claim under the Bankruptcy Code, which would be given higher payment priority than unsecured debt, but would still be behind secured creditors. Lastly, landlord's legal counsel could file a proof of claim for an unsecured claim for "rejection damages" for the balance of the rent that would have been due under the lease "post rejection" in an amount equal to the greater of one year's rent or fifteen percent of the rent due for the balance of the lease (not to exceed three years).

In conclusion, there are many proactive measures that landlords can take prior to and after a commercial tenant declares bankruptcy in order maximize the collection of rent and expedite the vacatur and reletting of the bankrupt tenant's space.

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