Important Q & A for Commercial Tenants Whose Landlords Seek Bankruptcy - Part One

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Introduction

In the wake of the pandemic, and its impacts on how and where employees work and how businesses use their leased properties, bankruptcy courts have seen a dramatic rise in the number of commercial landlords seeking bankruptcy protection from creditors. If a commercial landlord files for bankruptcy, tenants of the bankrupt landlord will face a series of immediate issues, the resolution of which can significantly impact the tenant's present and future business.

This article offers a series of important business and legal questions and answers on issues your company will likely face if your commercial landlord seeks bankruptcy during the term of your company's lease along with factors to consider as your company determines how to respond to such bankruptcy cases.

Should Your Business Continue to Pay Rent and Fees?

Unfortunately for commercial tenants, a commercial landlord's bankruptcy does not change the tenant's obligation to timely pay its rent. Similarly, a bankruptcy does not modify the tenant's obligation to pay other fees (such as the tenant's share of costs for common area maintenance, utilities, and taxes), if such costs were the tenant's obligation before the bankruptcy filing.

Can a Tenant Pursue Pre-Bankruptcy Claims Against its Landlord?

One of the most important effects of filing a bankruptcy case is that the party seeking bankruptcy receives an "automatic stay" of any claims, lawsuits, or collection proceedings pending at the time of the filing. The stay does not terminate the claims, but it does obligate claimants to pursue their claims in the bankruptcy case only.

Unfortunately, if the tenant's claim is unsecured, pursuing the claim in the bankruptcy court will often result in a small recovery or perhaps no recovery at all, since it will be paid only after payments to your landlord's lenders and other secured creditors.

What Happens to the Tenant's Security Deposit?

Under most commercial leases, the tenant remains the owner of funds paid to the landlord as a Security Deposit. and the tenant has a right to be reimbursed its Security Deposit after the lease terminates, less deductions for tenant damage to the property and similar costs.

Because ownership of the Security Deposit remains with the tenant during the lease, the Deposit does not become an asset of the bankrupt landlord's estate. If your landlord files for bankruptcy, you should seek agreement with the landlord that your deposit is an asset outside the bankruptcy case and will be returned after the end of your lease. If your landlord does not agree to those terms, you should file a claim in the bankruptcy case seeking return of the deposit.

What Should Tenants do if their Landlord Assumes or Assigns their Lease?

Another right granted to parties filing for bankruptcy is a right (typically within 210 days after the bankruptcy case is filed) to assume, assign or reject existing contracts, including commercial leases.

If your landlord "assumes" your lease, the landlord must then perform its obligations for the remainder of your lease term. In addition, you have a right to demand from your landlord "adequate assurance" that the landlord will be able to perform its obligations once the lease is assumed.

In some circumstances a commercial landlord may "assume and assign" the lease to a third party (often to facilitate a sale of the building containing the leased premises), which means that the third party then becomes responsible to perform the landlord's obligations. In those circumstances, a tenant can also demand adequate assurances of the third party's ability to perform the landlord's lease obligations.

What Should Tenants do if their Landlord Rejects Their Lease?

If, after filing for bankruptcy, your landlord "rejects" your lease, the landlord will have no further obligation to perform its lease obligations. In that situation the tenant will have two basic options:

- The tenant can choose to stay for the balance of the lease term and any available extensions of the term, although doing so will be without landlord services. The tenant will also be required to pay its regular rent and fees, but will be able to make a claim against the landlord for the value of the services not provided after the rejection.
- The tenant can treat the landlord's rejection as a breach of the lease and choose to move out of the leased premises. If the tenant incurs financial injury as a result of the rejection and move, it can file a claim against the landlord to recover its damages, although the claim would need to be filed in the landlord's bankruptcy case.

What Steps Should a Tenant Take if their Bankrupt Landlord Sells the Property "Free and Clear"?

In some situations, a landlord in bankruptcy may attempt to sell the property to a third party "free and clear" of any liability or responsibility for claims of tenants. In that circumstance, there is a division of opinion in the bankruptcy courts about whether the rights of a tenant to remain in the leased premises following a lease rejection, are also available to the tenant after a free and clear sale.

Given the uncertainty of tenants' rights after a sale "free and clear," tenants should carefully monitor their landlord's bankruptcy case to assure that they have advance notice of the proposed sale and be ready to assert their rights in the bankruptcy case. Also, early notice of a proposed sale will offer the tenant an opportunity to engage with the proposed purchaser to discuss and agree on terms of a lease post-sale.

For additional assistance in managing issues that arise when commercial landlords file for bankruptcy, please contact Scott Hogan or another member of Foster Swift's Finance & Bankruptcy practice team.