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Building Blocks

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Key Considerations for Attorneys Representing Landlords Dealing with a Commercial Tenant's Bankruptcy

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Commercial real estate landlords face various challenges when a tenant files for bankruptcy. A commercial landlord's ability to recover unpaid rent and other lease obligations hinges on a thorough understanding of relevant Bankruptcy Code provisions and practical strategies for navigating the complexities of commercial lease issues in tenant bankruptcies. The following provides a general overview of many of the issues facing commercial landlords when a tenant files for bankruptcy.

The Automatic Stay and Its Impact on a Landlord's Rights

The filing of a bankruptcy petition triggers an automatic stay under § 362 of the Bankruptcy Code,[1] which immediately halts most actions by creditors against both the debtor and the debtor's property. For landlords, the automatic stay has several consequences.

First, it prohibits landlords from taking any action to terminate the lease at issue, as of the debtor's bankruptcy filing. This means that "*ipso facto*" clauses in leases, which allow for automatic termination of a lease agreement upon a tenant's bankruptcy, are generally unenforceable.[2] Second, the automatic stay prevents landlords from taking any action to enforce its rights to, among other things, collect pre-petition rent or other lease obligations, including preventing eviction proceedings and suits for unpaid rent from proceeding. Landlords must seek relief from the automatic stay from the bankruptcy court pursuant to § 362 to pursue, or continue to pursue, these and any other nonbankruptcy remedies.[3]

Assumption and Rejection of Leases

Under § 365 of the Bankruptcy Code, a debtor may choose either to assume or reject the lease, with the latter effectively constituting a breach of the lease by the debtor/tenant.[4] In turn, assumption requires a debtor to cure any existing defaults and to provide adequate assurance of future performance. Rejection is a powerful tool that enables a debtor to unburden itself from an unprofitable or strategically detrimental lease, but it exposes the landlord to a claim for rejection damages.

Time Limitations for Assumption or Rejection

The Bankruptcy Code imposes a strict time limitation on a debtor's decision to assume or reject a nonresidential real property lease. A debtor generally has 120 days from the petition date to assume or reject, with a possible extension of 90 days, for a maximum of 210 days.[5] If a debtor does not assume or reject a lease, the lease is automatically rejected should time run out.

Despite the plain language of § 365(b)(4), certain courts have recognized that filing a motion to assume

1 11 U.S.C. § 362.
2 *See* 11 U.S.C. § 365(e)(1); *In re C.A.F. Bindery*, 199 B.R. 828, 832 (Bankr. S.D.N.Y. 1996) ("*ipso facto*" clauses unenforceable under Bankruptcy Code).
3 11 U.S.C. § 362(d).
4 11 U.S.C. § 365.
5 Specifically, pursuant to § 365(d)(4), a debtor must assume or reject a lease by the earlier of 120 days from the bankruptcy filing date or the date that the reorganization plan has been confirmed.

within the deadline is sufficient to prevent deemed rejection, even if the court has not yet issued an order approving the assumption.[6] Courts typically apply the deferential "business judgment test" to review a debtor's decision to assume or reject a lease.[7] In addition, a landlord can seek to compel a debtor to decide whether to assume or reject a lease.[8]

Rejection Damages

As previously noted, when a debtor tenant rejects a lease, the lease is breached, and the landlord is entitled to assert a claim for rejection damages with respect to the remaining amounts owed pursuant to the lease. This is treated as a pre-petition unsecured claim, without regard to unpaid post-petition amounts due, unless the lease was previously assumed.[9]

Section 502(b)(6) of the Bankruptcy Code caps a landlord's lease-rejection-damages claim against a debtor/tenant at the greater of one year's rent, or 15 percent of the unpaid rent for the remaining term, not to exceed three years of rent.[10] Courts in different jurisdictions have interpreted this § 502(b)(6) cap differently, leading to differing outcomes.[11] A landlord's rejection damages are to be reduced to the extent that it mitigates its losses by releasing the space.[12]

Pre- and Post-Petition Rent Claims

In addition to rejection damages, a landlord facing lease rejection may have claims for pre- and post-petition rent. In such a circumstance, unpaid pre-petition rent generally results in a separate unsecured claim that is not subject to the § 502(b)(6) cap,[13] while post-petition rent is treated as an administrative-expense claim entitled to priority over all pre-petition unsecured claims.[14]

Different Approaches to "Stub Rent"

Bankruptcy courts in different jurisdictions have adopted different approaches to interpreting the Bankruptcy Code's provisions related to the collection of so-called "stub rent" (*i.e.*, rent owed for the period from the petition date through the first date that rent is due under a lease). The inconsistencies among jurisdictions can significantly impact a landlord's entitlements in this regard. Two approaches taken with respect to the stub rent issue are the "billing date" (or "performance date") approach and "proration" approach.[15]

The billing-date approach focuses on the date rent was due. If due before the bankruptcy filing, the rent charge at issue is considered a prebankruptcy debt and generally cannot be collected from the debtor. Conversely, rent charges that become due after the bankruptcy filing are considered post-bankruptcy obligations and must be paid by the debtor.

On the other hand, the proration approach considers when a rent charge was actually *accrued*. If it accrued after the bankruptcy filing, even if it was billed or due before the filing, it might be treated as a post-petition obligation to the extent of such post-petition accrual. The specific jurisdiction, combined with the petition date relative to the lease's billing date (generally the first of the month), will dictate a landlord's right to timely payment of stub rent during the bankruptcy case.

In addition, depending on the jurisdiction, a landlord may separately be entitled to payment of stub rent as an administrative expense pursuant to § 503(b)(1) of the Bankruptcy Code.[16] However, there are two major drawbacks to relying on payment of stub rent as an administrative expense.

First, § 503(b)(1) requires that the potential administrative-expense payment of the stub rent at issue be for the "actual, necessary costs and expenses of preserving the estate." Consequently, the estate must have benefited from the lease for the landlord to obtain payment of an administrative-expense claim for such stub rent. If the tenant already vacated the space prior to the petition date, stub rent might not be available to a landlord.

Second, payment of administrative-expense claims often occurs at the end of a successful bankruptcy case. As such, a landlord relying on payment of stub rent as an administrative expense might not receive its stub rent payment on a normal rent cycle, and receipt of such payment will be dependent on whether the estate is administratively solvent at the conclusion of the bankruptcy.

The stub rent issue will typically arise for landlords in the context of a debtor's proposed post-petition financing, use of cash collateral and overall estate budgeting. It is highly likely that landlords will need to proactively assert their rights under the Code to obtain payment of stub rent. Understanding the approach to the stub rent issue within the applicable jurisdiction is critical for landlords seeking to evaluate their rights in a tenant's bankruptcy.

Real Estate Taxes

Similar to stub rent, the treatment of real estate taxes as pre- or post-petition charges will depend on a jurisdiction's adopted approach. Unlike rent, which is usually due on the first of the month, the due date and frequency of real estate tax bills can vary significantly. In proration jurisdictions, the analysis is straightforward. Real estate taxes accruing during the post-petition, pre-rejection period are considered post-petition charges that the landlord can collect, and the billing or due date of such taxes is irrelevant.[17] In contrast, in billing date jurisdictions, the due date of the real estate

6 *See, e.g., In re Simbaki Ltd.*, 520 B.R. 241, 246 (Bankr. S.D. Tex. 2014); *In re Rite Aid Corp.*, No. 23-18993 (MBK), 2024 WL 4715336, at *2 (Bankr. D.N.J. Nov. 6, 2024).
7 *In re IYS Ventures LLC*, 659 B.R. 308, 321 (Bankr. N.D. Ill. 2024).
8 Section 365(d)(2) provides that "on the request of any party to such contract or lease" a landlord "may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease."
9 11 U.S.C. § 502(g)(1).
10 11 U.S.C. § 502(b)(6).
11 *See, e.g., In re Cortlandt Liquidating LLC*, 648 B.R. 137, 140 (Bankr. S.D.N.Y. 2023), *aff'd*, 658 B.R. 244 (S.D.N.Y. 2024) (departing from precedent and applying "time approach"); *contra*, *New Valley Corp. v. Corporate Prop. Assoc. (In re New Valley Corp.)*, No. CIV. A. 98-982, 2000 WL 1251858 (D.N.J. Aug. 31, 2000).
12 *In re Crown Books Corp.*, 291 B.R. 623, 626 (Bankr. D. Del. 2003) (landlord's rejection damages reduced by amount of loss mitigated).
13 *In re Iron-Oak Supply Corp.*, 169 B.R. 414 (Bankr. E.D. Cal. 1994).
14 *In re Goody's Family Clothing Inc.*, 610 F.3d 812 (3d Cir. 2010).
15 *See In re GCP CT Sch. Acquisition LLC*, 443 B.R. 243 (Bankr. D. Mass. 2010) (citing relevant precedent).
16 *See, e.g., In re Goody's Family Clothing Inc.*, 610 F.3d 812 (3d Cir. 2010) (landlords entitled to "stub rent" as administrative expense).
17 *Nat'l Terminals Corp. v. Handy Andy Home Improvement Ctrs. (In re Handy Andy Home Improvement Ctrs. Inc.)*, 222 B.R. 149 (N.D. Ill. 1997) (lessee obligated to pay prorated portion of real estate taxes accrued during post-petition, pre-rejection period).

taxes under the lease is crucial in determining the landlord's entitlements.[18]

Timely Performance and the 60-Day Suspension Exception

While the general rule is that debtors must timely perform their post-petition lease obligations, § 365(d)(3) provides that a debtor, "for cause," "may" obtain bankruptcy court approval to suspend performance under a lease for the first 60 days of its bankruptcy case.[19] This exception was heavily relied on during the COVID-19 pandemic, enabling struggling retailers to defer lease payments while they negotiated rent reductions with landlords and strategically assessed (or triaged) their retail store footprints. In such scenarios, landlords should be prepared to vocally advocate for their right to payment immediately following the 60-day period, including by insisting that any deferred post-petition rent payments be fully accounted for in a debtor's budget.

Lease Assumption/Assignment and the "Shopping Center Exception"

As previously discussed, a debtor may assume a lease and assign it to a third party under § 365(f). This is the case even if the lease contains an anti-assignment provision. However, in order to assume or assign a shopping center lease,[20] § 365(b)(3) requires the debtor to provide adequate assurance of the assignee's financial condition and operating performance, that percentage rent will not decline substantially, and that the assignment will not violate other lease provisions or disrupt the tenant mix.

Going-Out-of-Business Sales

Debtors often utilize § 363 of the Bankruptcy Code to sell some, or substantially all, of their assets outside the ordinary course of business, free and clear of most liens and liabilities, either through public auctions or private sales.[21] However, retail debtors often seek court approval to hold "going out of business" (GOB) sales to liquidate inventory, as authorized under § 363(b)(1).

In motions to approve GOB sales, debtors usually seek court authority to retain a liquidator and sell inventory free and clear of liens, and will also seek waivers of lease restrictions that may prevent a sale. Signage limitations might be imposed by a bankruptcy court to address landlord concerns.

Treatment of Security Deposits and Letters of Credit

Security deposits provided by a tenant that has filed for bankruptcy are generally considered property of the bankruptcy estate. While landlords might be permitted to set off their claims against the security deposit, they must obtain relief from the automatic stay or obtain permission from the bankruptcy court to do so. The landlord should apply the deposit to its capped § 502(b)(6) rejection-damages claim, as it would be paid after other types of claims.[22] In contrast, letters of credit are generally not considered property of the estate and can usually be drawn on without bankruptcy court authority.[23]

Conclusion

While this article provides a general overview of certain key considerations for attorneys representing the interests of landlords in tenant bankruptcies, in order to do so effectively attorneys must obtain familiarity with jurisdiction-specific precedent and practice. Effective representation of landlords in tenant bankruptcies also involves analyzing lease provisions, assessing a debtor's financial condition and business prospects, evaluating potential claims and remedies, and proactively advocating for a landlord's rights throughout the bankruptcy process. abi

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18 *Centerpoint Props. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)*, 268 F.3d 205, 212 (3d Cir. 2001) (lease obligation to reimburse landlord for tax payments that arose post-petition and prior to rejection must be fulfilled in full).

19 11 U.S.C. § 365(d)(3).

20 Courts analyze various factors to determine whether a lease is a shopping center lease. *See In re Joshua Slocum Ltd.*, 922 F.2d 1081, 1087 (3d Cir. 1990) (describing factors).

21 11 U.S.C. § 363.

22 *Redback Networks Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 299 (B.A.P. 9th Cir. 2004).

23 *Sabratek Corp. v. LaSalle Bank NA (In re Sabratek Corp.)*, 257 B.R. 732, 735 (Bankr. D. Del. 2000).