

A COMMERCIAL TENANT FILES FOR BANKRUPTCY; WHAT NOW?

By David S. Klein

Imagine owning a fully occupied commercial building. One of your tenants has been paying rent and CAM fees without issue. Then the tenant is late on a payment, maybe two or three. One day you open up the mail to find a notice from a court you have never heard of that says the tenant has filed for bankruptcy, that an automatic stay is in effect, and that you are listed as a creditor in his bankruptcy estate. Obviously, this type of notice is not something you ignore. But what does all of this mean?

The Bankruptcy Code and the Automatic Stay

The United States Constitution authorizes Congress to enact “uniform Laws on the subject of Bankruptcies throughout the United States.” The bankruptcy code is therefore a set of federal laws and rules, which apply, for the most part, uniformly in bankruptcy courts across the country. At the moment the tenant files bankruptcy, something called the automatic stay takes effect. In most instances, an order from the bankruptcy court is not needed; it is simply the filing of the bankruptcy which triggers the automatic stay. The automatic stay generally prohibits the commencement, continuance, enforcement, or appeal of actions and judgments, against a tenant for the collection of a claim that arose prior to the bankruptcy filing. You must stop anything that could even slightly be considered a collection action. For example, do not send a letter to the tenant about its failure to allow you access to the premises, do not call the tenant to ask why it has not tendered March rent, and absolutely do not file an eviction or other state court action against the tenant. If you have knowledge of the automatic stay, anything deemed a collection action could subject you to damages, including the payment of the tenant’s attorney fees. And what about that provision of the lease that says the tenant is in default if it files for bankruptcy? The bankruptcy code treats that type of provision as an unenforceable event of default. However, do not worry too much, because there are protections for developers, owners, and property management companies that are forced to deal with a tenant that files for bankruptcy. Below is a general discussion about scenarios frequently encountered when a tenant with a commercial lease files for bankruptcy.



A Pre-Petition Expired Lease Where the Tenant is No Longer in the Premises

If the lease expired prior to the tenant filing for bankruptcy and the tenant is no longer in the premises, you are in the best position. The bankruptcy code provides commercial landlords with an exception to the automatic stay which allows you to take action against a tenant "under a lease of nonresidential real property that has terminated by the expiration of the stated term of the lease before the commencement of or during a case under [the bankruptcy code] to obtain possession of such property." This means that you may take possession of the premises without having to move for relief from the automatic stay. As discussed in more detail below, you may, however, need to ask the court for permission if the tenant left personal property in the premises.

A Pre-Petition Terminated Lease Where the Tenant Remains in the Premises

If you terminated the lease prior to the tenant filing bankruptcy but the tenant remains in the premises, you are in a good position. The best practice is to file a motion with the bankruptcy court asking that the automatic stay be lifted so you may exercise your state law remedies against the tenant. If the court grants the motion, then you may send the tenant a letter demanding immediate possession of the premises and file an eviction. Once you receive an order from the court, you may contact the sheriff to arrange for the tenant's personal property to be removed from the premises. You do, however, need to be aware of any liens against the tenant's personal property. You also need to determine if the personal property is part of the bankruptcy estate. Usually a call to the tenant's bankruptcy attorney or the bankruptcy trustee will resolve these issues. But you may need to ask the court for additional permission to remove the tenant's property if its attorney or the trustee will not allow you to do so.

Assuming or Rejecting an Unexpired Lease

If the lease is still in effect at the time the tenant files for bankruptcy, the situation is a bit more complicated. If the tenant filed a chapter 7 or chapter 11 bankruptcy (only individuals may file a chapter 13 bankruptcy, so a discussion about that type of filing is generally not relevant in the context of a commercial lease), the tenant (in a chapter 11) or a trustee (in a chapter 7 or chapter 11) has 120-days to accept or reject a lease, subject to the court's approval. The court may allow an additional 90 days for the decision to be made, but only if good cause is shown. You should never assume that a tenant or trustee will automatically reject the lease. For example, if the premises is profitable, the trustee may want to sublease the premises, or the tenant in a chapter 11 case may want to sell its leasehold interest to another party in order to fund a reorganization plan. The decision differs from case to case.

If the tenant or trustee rejects the lease, or fails to meet the 120-day deadline to assume or reject the lease, then he must immediately surrender the premises to you. If the tenant or trustee fails to do so, a motion to compel rejection or a motion for relief from the automatic stay may need to be filed with the Court.

If the tenant or trustee assumes the lease, he or she must cure all defaults or at least provide adequate assurances that the defaults will be promptly cured. The tenant or trustee must also provide the Court with adequate assurance that he or she will perform all future obligations under the lease.

Regardless of the decision at the end of the 120-day period (or longer if the tenant or bankruptcy trustee asks the court for more time), the lease must not go into default post-petition. If the tenant defaults, then you may file a motion for relief from the automatic stay.

Unpaid Rent and Other Fees

As discussed above, if the tenant or trustee assumes the lease, unpaid pre-petition rent and other fees must be remedied. However, if the lease is rejected, unpaid pre-petition rent and other fees, as well as damages related to the rejection of the lease, become a general unsecured claim in the bankruptcy. This means in a chapter 7 case that you will receive a fractional distribution from the trustee who will liquidate the tenant's assets. If the tenant has no assets, then you will not receive a distribution and the unpaid pre-petition rent and other fees are discharged. In a chapter 11, the tenant may propose a repayment of those amounts.

Post-petition unpaid rent and other fees generally become an administrative priority claim, which is paid before the general unsecured claims. The administrative claim is generally limited to scenarios where it can be shown that the bankruptcy estate benefitted from the use of the premises. Regardless of whether you have a general unsecured claim, an administrative priority claim, or both, it is important to be aware of the deadline to file your proof of claim.

Security Deposits

If you are holding a security deposit, do not automatically apply it to unpaid rent and other fees. Instead, the bankruptcy code treats a landlord as holding a secured claim to the extent of its security deposit. You must move for relief from the automatic stay before applying the security deposit to unpaid rent and other fees owed by the tenant. If the security deposit exceeds the amount of unpaid rent and other fees, then you may be compelled to turn over a portion of the security deposit to the bankruptcy estate.

Conclusion

When a tenant files bankruptcy, a number of unfamiliar laws and rules immediately come into play. It is important that you react promptly to any type of notice received from a bankruptcy court. In addition, a business cannot represent itself in bankruptcy court, so the filing of any motions must be handled by an attorney.

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