Bankruptcy and your Tenant

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The rise of filing for bankruptcy is upon us and we are seeing more and more bankruptcy filings by tenants. So, what happens when your tenant files for bankruptcy? The following is a general guideline of the procedures and timelines of the bankruptcy proceedings and some of the problems which may arise from your tenant filing for bankruptcy.

Once your tenant files a bankruptcy petition, an automatic stay is triggered. Pursuant to the Bankruptcy Code, the landlord is now considered an unsecured creditor on any past due rents owed at the time of the bankruptcy filing. After the bankruptcy filing, any attempt by the landlord to enforce, collect or recover on the lease or premises is stayed. Therefore, there can be no lock out, no demand for payment and no filing of a lawsuit to recover rents or possession of the premises. Likewise, a landlord is prevented from leasing the premises to another tenant until the lease is rejected or abandoned by the bankruptcy trustee or debtor.

Upon your notice of the filing, a Notice of Appearance and Request for Notices should be filed immediately so that you are kept apprised of the proceedings. This is accomplished by your attorney filing the appropriate paperwork, making the appearance and requesting notices be sent to the attorneys' office.

In regards to your lease, the Bankruptcy Code requires that the tenant formally accept or reject the lease within the earlier of 120 days after filing or date of entry of the tenant's order confirming the reorganization plan. If your tenant does not formally assume the lease and cure all defects/defaults within this period, the lease is automatically deemed rejected. The old rule of a 60 day deadline to assume or reject the lease is gone. The most recent revisions to the Bankruptcy Code extended that deadline. If you require anything faster than the new timeline, you will have to file a Motion for Relief of Stay requesting the court to allow the landlord to take action on the lease or premises or secure an agreement with the bankruptcy trustee to abandon the premises.

With regards to the unexpired lease, the bankruptcy treatment of a lease contract usually takes one of three possible forms. These are assumption, rejection and assignment. If the trustee or tenant in possession assumes a lease, the tenant's rights under the lease continue as property of the estate and the tenant's obligations under the lease become obligations of the estate. A later breach of an assumed lease creates an administrative expense which is a priority claim under the bankruptcy pay back plan. In this situation, if there are funds to pay back the debtor's debt, the landlord would be entitled to an administrative expense which is an expense paid before the unsecured and most secured claims. Under the assumed lease situation, the landlord is under no obligation to renegotiate the terms of the lease making it possible for the tenant to use bankruptcy to effect a modification of its obligations under the lease.

If however, the tenant chooses to reject the lease, such rejection constitutes a breach and this breach is deemed to have occurred prior to the filing of the bankruptcy. In this situation, the landlord will only have a general unsecured claim for the damages set out below.

Finally, if the lease has value but the debtor is not in a position to assume the lease, the bankruptcy trustee may assign the lease. Like an assumption, all defaults have to be cured, adequate security for future performance must be shown, and the landlord is not obligated to renegotiate the terms of the lease. The assignment usually takes place with the landlord's participation.

Under today's bankruptcy laws, the tenant is given wide latitude when deciding to assume or reject an unexpired lease. The prevailing standard by which the Bankruptcy Court decides whether to grant or withhold approval of the assumption or rejection of a lease by the tenant is the "Business Judgment Rule." Although the Bankruptcy Code does not define the Business Judgment Rule, case law has described it as a "lax standard" and has further stated that such decision to assume or reject a lease should only be disturbed if the tenant's actions are in bad faith or a gross abuse of its managerial discretion.

If there has been a default on the terms of the lease, the Bankruptcy Code imposes certain requirements on the tenant or bankruptcy trustee handling the estate relating to the current default and with respect to the future performance obligations under the unexpired lease. As to the tenant's defaults, the Bankruptcy Code requires the tenant or trustee to first cure all defaults or provide the landlord adequate assurance for the prompt cure of any outstanding defaults. This may mean securing an additional security deposit or guaranty. Second, the Bankruptcy Code requires compensation for actual pecuniary loss resulting from these defaults or adequate assurance of prompt compensation. Finally, the Bankruptcy Code requires adequate assurance of future performance under the lease.

The term "adequate assurance" is not defined in the Bankruptcy Code. As such, the courts tend to tie the holding of "adequate assurance" to the facts of each case. It has been held by recent case law that each case must rest on a pragmatic analysis taking into consideration the landlord's rights and expectations as they existed prior to the filing of the bankruptcy proceeding. Therefore, the standard of defining what qualifies as adequate assurances in order for the tenant to assume the lease will vary on a case by case basis.

Once the lease has been rejected as outlined above, the next stage comes into play. Usually within three (3) to six (6) months after filing bankruptcy, the Bankruptcy Court sets a "Bar Date" for a creditor to file a Proof of Claim relating to any pre-petition damages.

A Proof of Claim can only reflect an amount for damages which have accrued prior to the date of the filing for bankruptcy. However, if the lease has been rejected, the landlord can also include a claim for lease rejection damages. These damages are calculated as the greater amount of one year of rent from the date of filing bankruptcy or 15 percent of the rent remaining, not to exceed three (3) years. In rare occurrences, the tenant may dispute the Proof of Claim and file an objection to the Proof of Claim. This is usually done within one (1) year after the "Bar Date."

The types of bankruptcies which you may encounter are as follows:

1. Chapter 7 No Asset – no need to file a Proof of Claim
2. Chapter 7 Asset- requires a Proof of Claim
3. Chapter 11 (offered to businesses for reorganization) – requires a Proof of Claim
4. Chapter 13 (offered to individuals for reorganizations)- requires a Proof of Claim

At some point in the bankruptcy, the tenant will ask for confirmation or approval of its "Plan for Reorganization." If you are a large creditor, you may be elected to sit on the board approving and denying the plans offered. The bankruptcy process in general is often simply a waiting game. The timeline for when a creditor can be paid varies greatly and is very indefinite. Once the Plan for Reorganization is approved, it usually takes several years to get paid and the amount a creditor will be paid is very speculative as well. Most landlords, being in the unsecured category, get only a fraction of what is owed and are paid back over years.

You should know that Chapters 11 and 13 reorganizations are sometimes the means by which a business or individual in trouble may continue to operate and revitalize itself while also paying creditors and keeping workers employed. These types of bankruptcies are welcomed over the Chapter 7 filings due to the survivability of the tenant. After the Chapter 7 filing, you have no tenant for your lease space or to pursue for the rents owed.

Under the Chapter 11 and 13 bankruptcies, the Bankruptcy Code provides for the tenant to continue to manage the business as a debtor in possession unless the conduct of current management or the interests of creditors, equity security holders and the estate necessitates the appointment of a trustee. And the trustees can create serious problems for all caught in their cross hairs.

During the waiting game, over zealous trustees may create some other surprises for landlords. Even if the tenant was current on all of its obligations under the lease and payments were made pursuant to the lease at time of the bankruptcy filing, a problem could arise relating to rental payments made within ninety (90) days prior to filing bankruptcy. Section 547 of the Bankruptcy Code states that the trustee may avoid any transfer (payments) of an interest of the debtor/tenant in property –

1. to or for the benefit of a creditor;
2. for or on account of an antecedent debt owed by the debtor before such transfer was made;
3. made while the debtor was insolvent;
4. made -
    i. on or within ninety (90) days before the date of the filing of the petition; or
    ii. between ninety (90) days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
5. that enables such creditor to receive more than such creditor would receive if -
    i. the case were a case under Chapter 7 of the Bankruptcy Code;
    ii. the transfer had not been made; and
6. such creditor received payment of such debt to the extent provided by the provisions of the code.

So, not only are you facing past due rents owed and possibly a claim for future rents, a landlord may find itself faced with a trustee now attempting to recover any checks paid to the landlord for the ninety (90) days prior to filing bankruptcy. You may be asking whether this can really be the law.

One of the first issues to consider is when was the payment actually made. If rental payments are made by a check from the tenant, is the date of the check or the date the check clears the landlord's account the relevant date? Unfortunately, case law is fairly inconsistent. A tenant could deliver a rental check 93 days prior to filing bankruptcy, but if the check doesn't clear the landlords account until eighty-nine (89) days prior to the bankruptcy filing, then is that amount subject to future avoidance? Texas law and some courts have held the relevant date being that of the delivery of the check and not the date the check was paid. There are cases on both sides of this issue. Some other courts have held that the date the check clears the account should be the cut off date. The United States Bankruptcy Court for the Northern District of Dallas ruled that the court employs the date of delivery of the check, not the date of deposit or date the check was paid, when characterizing the payment. This court noted that those Texas Court of Appeals who have considered the issue are unanimous in concluding that a 'date of delivery' rule should apply to check payments for purposes of §547 (c).

The US Court of Appeals for the Fifth Circuit similarly held that the time of delivery of a check is the time of transfer for purposes of §547(c)(2). The court explained that both houses of Congress in the compromise bill stated payment of a debt by means of a check is equivalent to a cash payment, unless the check is dishonored. Payment is considered to be made when the check is delivered for purposes of sections 547(c)(1) and (2). The court noted that treating payment by check as a credit transaction would discourage creditors from continued dealings with troubled businesses for fear that payments could later be avoided. The court further noted that in ordinary commercial transactions, payment by a check which is subsequently honored is considered to be a cash payment.

Preferential transfers may not be avoided 11 U.S.C. 547 (c)(2) which provides that the Trustee may not avoid under this section a transfer:

1. to the extent that such transfer was-

    A. intended by the debtor and the lcreditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given by the debtor; and

    B. in fact a substantially contemporaneous exchange;

2. to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business, and such transfer was-

    A. made in the ordinary course of business; or

    B. made according to ordinary business terms;

The Bankruptcy Code gives the trustee certain powers to recover and void payments to a creditor ninety (90) days before the bankruptcy filing. However, the trustee may not avoid transfers given to creditors which in turn provided new services or value to the tenant. Several recent cases have held that rental payments to a tenant occupying rental property met the exception to the rule and precluded the trustee from avoiding those payments. Courts have gone as far as disallowing an action to avoid payment for copiers which were never opened nor used. The court held that there was an opportunity and intent to use it providing a material benefit to the debtor. However, if your tenant had vacated the property but was making payments prior to bankruptcy, you may find a bankruptcy trustee filing an action to avoid those payments made within the ninety (90) days of the filing. Your defense would be the Bankruptcy Code which clearly states the tenant's estate is liable for rentals up to lease rejection, regardless of the use or occupancy of the premises.

In closing, this office recommends monitoring the bankruptcy proceedings by filing a Notice of Appearance of Counsel and Request for Notices and Proof of Claim. The filing of these documents guarantees all notices of bankruptcy filings and procedures. A meeting of creditors is usually set up within the first few months of filing bankruptcy and will give you a better sense of what is likely to occur down the road. **N**

WOMAC & ASSOCIATES is an aggressive commercial based law firm providing a broad range of legal services to companies and individuals on a state-wide basis. Brian D. Womac specializes in commercial landlord/tenant negotiations and litigation. The firm's client base consists of corporations, partnerships, construction companies, lending institutions, insurance companies, investors, management and leasing companies and many other businesses owning real estate. Brian D. Womac has been licenses as an attorney in Texas since 1985 and founded WOMAC & ASSOCIATES in 1987. Mr. Womac has been board certified in commercial real estate law since 1991, and has personally handled over 2,500 commercial landlord/tenant litigation matters in Harris County.