



Issues Affecting Tenants in **BANKRUPTCY**

By Angeline V. Kell

When tenants file for bankruptcy, landlords must become aware of their own best interests. While a landlord should contact an attorney for legal advice, this article points out issues to attend to.

The Automatic Stay Bars All Actions under 11 U.S.C. § 362

When a tenant files bankruptcy, it triggers the automatic stay. In bankruptcy, the tenant is referred to as the debtor. According to the Bankruptcy Code, any attempt by a creditor, such as a landlord, to enforce, collect, or recover a claim from the debtor is stopped by the automatic stay. Further, any act to obtain possession of property of the bankruptcy estate or exercise control over property of the estate is stayed. In other words, a creditor could face penalties for enforcing, collecting, or recovering past due rents

or possession of the lease space by lock-out or filing an eviction proceeding.

Time to Assume or Reject the Lease

Sections 502 and 365—and sometimes Section 503—govern leases also known as executory contracts in bankruptcy.¹ Section 365 requires that the debtor formally accept or reject the lease within 120 days after the date of filing bankruptcy. That means that a debtor may decide to either reject a lease or executory contract or assume it in full and usually assign it to the reorganized entity. Bear in mind that a debtor may also file motions to extend the time to assume or reject leases. The 120 days may turn into 180 days if the court grants an extension.

Rejection of Leases

Once a debtor rejects the lease, the landlord has an unsecured pre-petition

or pre-bankruptcy claim for the default and breach. Sometimes the landlord may also have a post-petition administrative expense priority claim for amounts accruing after the bankruptcy filing if a debtor is still in the leased premises. In this situation, the landlord may file a proof of claim, which is a damage claim in bankruptcy court.

Section 502(b)(6)(b) controls the rejection damages. Under that section, rejection summary of damages are calculated as follows: the outstanding amount of rent due at the time of the bankruptcy filing is added to the greater of two options. The greater of the rents owed as of the time of the bankruptcy filing for a period of a year or 15 percent of the rents not to exceed three years following the filing of the bankruptcy. Most courts mandate that the landlord subtract the security deposit from the calculation.

Recently, debtors have been rejecting leases upon filing the initial petition or moving to reject the lease *nunc pro tunc*, which actually means “now for then.” It applies retroactively. For instance, in the U. S. Bankruptcy Court for Delaware², *In re Restaurants Acquisition I, LLC* the Chapter 11 debtor moved to reject multiple leases upon filing bankruptcy.³ The debtor operated a chain of full-service restaurants known as the Black-Eyed Pea or Dixie House Restaurants.

By rejecting the abandoned leases on the petition date or commencement of bankruptcy, the debtor prevented any post-petition administrative expense claims by the landlords. The debtor’s quick rejection also prevented it from paying the landlord its monthly rent under Section 365(d)(3). Unfortunately, when that occurs, landlords have little to no recourse. In most bankruptcies involving reorganization, landlords will receive 10 percent of unsecured claim for rents owed.

Nevertheless, once the lease is rejected, the leased premises are no longer property of the estate. Namely, the landlord may lease the space without requesting permission from the bankruptcy court. If the order granting rejection also covers the property left in the leased premises or the debtor abandons the property, the landlord may proceed to sell it under Texas law.

Assumption of Leases

Section 365 controls the assumption of executory contracts and leases in bankruptcy. If there has been a default, the Bankruptcy Code imposes certain requirements on the debtor. First, the Bankruptcy Code requires the debtor cure of all defaults or provide adequate assurance of prompt cure of the defaults. Second, the Bankruptcy Code requires payment to the landlord for actual pecuniary loss resulting from these defaults or adequate assurance of prompt compensation. Finally, the Code requires adequate assurance of future performance under the lease as well.

In other words, if the debtor assumes the lease, the debtor must continue to make all the monthly rent payments according to the terms of the lease. The debtor must also cure all pre-petition payment defaults. The monthly rent payments must also include common area

maintenance or CAM charges. However, allowable CAM charges under Texas law may differ in bankruptcy.

The Bankruptcy Code does not define the term “adequate assurance.” Consequently, the bankruptcy courts tend to analyze the proposed “adequate assurance” to the facts of each case. It has been held by 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.

Alternative Assumption of the Lease

Alternatively, a debtor may enter into a settlement that assumes the

lease but does not require payment in full of all pre-petition rent. The settlement may also propose a lower monthly rental rate. These settlement assumptions are not found in the Bankruptcy Code. However, they may offer a better solution for both parties. It may be in the landlord's best interest to accept a lower monthly rent and an assumed lease than an unsecured claim and have an empty space.

Instead of receiving an unsecured claim for 10 percent of the pre-petition rent, the landlord could receive a lower monthly rental fee and maintain an occupied leased premises. In addition, the landlord has the right to file an administrative expense claim for any defaults after the lease is assumed under Section 365(g)(2). Nevertheless, if the lease is later assigned to the reorganized debtor, the landlord may not obtain any past due payments from the pre-reorganized debtor prior to confirmation.

It is best to **CONSULT YOUR ATTORNEY** when a tenant files **BANKRUPTCY**. As you can see, there are **MANY TRAPS** that may incur liability for the landlord.

Not long ago, one of my clients chose to enter to a settlement containing an assumed lease with the debtor. The landlord received exponentially more rent than it would have if the debtor rejected the lease. Although, according to the Bankruptcy Code, the debtor had to cure all pre-petition defaults, that option would have forced the debtor to reject the lease. The rejection would have only provided 10 percent of the unsecured claim paid last to the landlord. As a result, the settlement agreement provided a good deal for both parties.

Stub Rent

Some debtors assume that they must only pay rent that occurs after the filing of bankruptcy. This may be a problem if the debtor files after the first of the month or in the middle of the month. This is the position of the courts in the Southern District of Texas. Stub rent, or rent that accrues after the debtor files bankruptcy but before the next monthly payment is due is not allowed in the Southern District of Texas as displayed in *In re Simbaki* in 2015.⁴ Conversely, other courts in the Second and Ninth Districts hold that the debtor must prorate the monthly rent or pay a portion of the rent due to the landlord.

Conclusion

It is best to consult your attorney when a tenant files bankruptcy. As you can see, there are many traps that may incur liability for the landlord. While a landlord may only receive an unsecured claim when a lease is rejected, there are alternatives. The attorney may be able to assist the landlord in receiving a modified assumed lease and secure more money than he/she would have otherwise received. **N**

¹ Sometimes Section 503 is involved.

² It applies retroactively. It actually means now for then.

³ Case No. 15-12406 (KG); *In re RESTAURANTS ACQUISITION I, LLC*, ("Black Eyed Pea" or "Debtor"); *In the United States Bankruptcy Court for Delaware*

⁴ *In re Simbaki*, 2015 WL 1593888 (Bankr. S.D.Tex. 2015).

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Womac Law is an aggressive commercial-based law firm providing a broad range of legal services to companies and individuals on a statewide basis. The firm specializes in commercial landlord/tenant lease negotiations, real property transactions, and litigation. The firm's client base consists of real estate management and brokerage companies, as well as others owning real estate. Brian D. Womac has been licensed as an attorney in Texas since 1985 and has been board certified in commercial real estate law since 1991.