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## A landlord's guide to bankruptcy

*\*EDITOR'S NOTE: This is the first of a two-part article on tenants and bankruptcy.*

Many Colorado landlords have confronted the issues that arise when a commercial tenant files, or threatens to file, a bankruptcy case. It is important for landlords to know the effects of a tenant's bankruptcy filing on each party's rights and obligations under the lease. What follows is a summary of those effects, and a brief guide for landlords to use in navigating a commercial tenant's bankruptcy case. In this issue, I will discuss some bankruptcy basics, the tenant's deadline to "assume" or "reject" the lease, and the tenant's obligation to pay rent during the bankruptcy case. In the next issue of CREJ, I will address the conditions for a tenant to assume its lease, the effect of assumption or rejection by the tenant, the tenant's right to assign its interest under the lease and how to establish the landlord's claim in the tenant's bankruptcy case.

**■ Chapter 7 and Chapter 11 of the Bankruptcy Code.** When a tenant company files a Chapter 7 bankruptcy petition, it has chosen to liquidate its business. A Chapter 7 trustee is promptly appointed to take possession and/or control of all of the debtor's property on behalf of the "bankruptcy estate," for the benefit of its creditors. The bankruptcy estate becomes the owner of that property, and the trustee is responsible for liquidating the property and distributing the proceeds to the tenant's creditors according to the priority established in the U.S. Bankruptcy Code.

When a tenant company files a Chapter 11 petition, it intends to reorganize its business in some manner. Reorganization can take many forms, including varying



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combinations of (a) restructuring debts (e.g., by changing the amount, maturity, amortization and/or interest rate); (b) selling some or all of the debtor's property; (c) raising new equity capital; (d) borrowing additional money; and (e) in some instances, liquidating some or all of the debtor's operations and property within Chapter 11. In most Chapter 11 cases, no trustee is appointed; the debtor continues to operate its business as the *debtor in possession*.

**■ Automatic Stay.** Regardless of the type of bankruptcy petition filed, an automatic stay becomes effective immediately upon filing of the petition. The automatic stay prohibits creditors and other parties from taking any action to collect amounts owed by the debtor prior to the bankruptcy filing. The prohibited actions include the filing of lawsuits or liens, attempts to enforce pre-bankruptcy judgments against the debtor, and communications with the debtor seeking to collect prebankruptcy debts.

Of particular importance to landlords, the automatic stay in a tenant's bankruptcy prohibits:

- attempts to collect rent owed for periods prior to the bankruptcy filing;
- the setoff of a security deposit against amounts due under the lease; and
- attempts to recover possession of the leased premises, through the state court eviction process or otherwise.

A landlord may be able to obtain *relief from stay* by asking the bankruptcy court to terminate or modify the automatic stay to permit certain actions against the tenant or affecting the leased premises. That kind of relief must be requested by a formal motion, and notice must be given to all creditors and other parties to the bankruptcy case.

Your lease probably includes a provision that says that the filing of a bankruptcy petition by the tenant is a default, entitling the landlord to various remedies (termination of the lease, acceleration of rent obligations, recovery of the premises and the like). That provision is unenforceable against the tenant once the tenant files a bankruptcy petition. (Landlords continue to include that provision because if the bankruptcy case is dismissed, the provision is enforceable under state law.)

**■ Tenant's Decision to Assume or Reject; Deadlines.** A tenant in bankruptcy may either assume (i.e., affirm) or reject a lease of commercial real property. Either decision by the tenant requires notice to all creditors and approval by the bankruptcy court. If any party objects to the tenant's decision, the court will evaluate whether that decision is a reasonable exercise of business judgment by the tenant.

If the tenant assumes the lease, it must first satisfy certain conditions laid out in the Bankruptcy Code (more on that in the next issue of CREJ). Once assumed, the lease becomes an ongoing obligation of the bankruptcy estate, and can be enforced against the tenant under state law like any other lease.

If the tenant *rejects* the lease, the rejection is treated as a breach of the lease immediately before the date of filing of the tenant's bankruptcy petition. The tenant must surrender the

leased premises immediately upon rejection, unless the court orders otherwise. The bankruptcy estate will have no ongoing obligations under the lease, and the landlord's claim for damages will be treated as a general unsecured claim in the bankruptcy case (except to the extent of any security deposit held, or other property pledged by the tenant prebankruptcy to secure its obligations under the lease). The amount of the landlord's claim for lease rejection damages also is subject to limits imposed by the Bankruptcy Code (again, more on that in the next issue).

The commercial real estate tenant must make its decision to assume or reject the lease within 120 days of filing its bankruptcy petition. The bankruptcy court may extend that 120-day period once, within the original 120 days, for up to 90 additional days. Any further extensions of the decision period require the written consent of the landlord. If the tenant fails to file a motion to assume or reject a commercial lease within the applicable deadline, it is *deemed rejected* and the tenant must surrender the leased premises immediately.

**■ Tenant's Obligation to Perform During Decision Period.** The Bankruptcy Code requires the tenant to timely perform all of its obligations under the lease, including the payment of rent, that arise from the date the bankruptcy petition is filed until the lease is assumed or rejected. Importantly, this does not include payment of amounts that became due before the tenant filed its bankruptcy case. The court may postpone the tenant's time to perform obligations arising within the first 60 days of the bankruptcy case, but the tenant's time to perform those obligations cannot be postponed beyond the 60th day.▲