



COLORADO REAL ESTATE JOURNAL

THE COMMUNICATION CHANNEL OF THE COMMERCIAL REAL ESTATE COMMUNITY

MARCH 20, 2013 – APRIL 2, 2013

A landlord's guide to bankruptcy

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

In Part 1 of this commercial landlord's guide (published in the March 20-April 2 issue of CREJ), I addressed some of the issues faced by a landlord when a commercial tenant files bankruptcy. In this second part, I will discuss the requirements for a tenant to assume a commercial lease in a bankruptcy case, the effect of assumption or rejection of a lease 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.

■ **Conditions for Tenant's Assumption of the Lease; Effect of Assumption.** If a tenant decides to *assume* (i.e., to affirm) a commercial lease, and there is an existing default under the lease (excluding defaults related to the tenant's insolvency or its filing of a bankruptcy petition), the tenant must do these three things:

1. Cure the default(s), or provide adequate assurance of a prompt cure;
2. Compensate the landlord for any "actual pecuniary loss" (i.e., out-of-pocket damages) caused by the tenant's defaults under the lease; and
3. Provide adequate assurance that it will be able to perform its obligations arising under the lease in the future.

For leases of real property in a shopping center, the Bankruptcy Code states specifically how the third requirement above, "adequate assurance of future performance," must be satisfied. The shopping center tenant must not only demonstrate its ability to pay rent in the future, but must also show that:

- the tenant's payment of percentage rent under the lease, if



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center; and

- the tenant's assumption of the lease will not disrupt any tenant mix or balance in the shopping center.

Once the applicable conditions are satisfied and the bankruptcy court approves the tenant's assumption of the lease, the lease becomes an ongoing obligation of the bankruptcy estate. Amounts due under the assumed lease are considered *administrative expenses* of the bankruptcy case, which are paid ahead of unsecured claims and must be paid in full, in cash, upon the confirmation of any plan of reorganization.

■ **Tenant's Rejection of the Lease, and Its Effect.** 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 future obligations to perform under the lease, and the landlord's claim for "lease rejection damages" will be treated as a general unsecured claim in the bankruptcy case (except to the extent of any security deposit held, or other

any, will not decline substantially;

- the tenant's assumption of the lease will not breach any "radius, location, use, or exclusivity provision" contained in the lease, or in other leases in the shopping

property pledged by the tenant prebankruptcy to secure its obligations under the lease).

The Bankruptcy Code caps the amount of the landlord's lease rejection damages claim at the sum of 1) the amount of unpaid rent due under the lease on the date of the bankruptcy petition, plus 2) rent under the lease for the greater of one year, or 15 percent (not to exceed three years), of the remaining lease term. The landlord has an obligation to mitigate its damages claim by seeking to re-lease the premises, as it does under state law.

■ **Horse Trading: Assumption of the Lease "As Modified."**

The Bankruptcy Code says only that the tenant may assume the lease in its existing form, or reject it altogether. There is no provision in the code allowing the tenant to assume part of the lease and reject the rest. In reality, however, a commercial tenant in bankruptcy will sometimes negotiate with the landlord by offering to assume the lease if certain modifications are made (e.g., lowering the rent or reducing the size of the leased premises), and threatening to reject the lease without those modifications.

■ **Tenant's Right to Assign Its Interest Under the Lease.**

Commercial leases frequently contain provisions that prohibit the tenant from assigning its interest under the lease or require the landlord's approval for any assignment. Once the tenant files bankruptcy, those provisions are no longer enforceable. The tenant in bankruptcy can assign a commercial lease notwithstanding those provisions, so long as the tenant 1) first assumes the lease and 2) provides "adequate assurance of future performance" by the assignee. In the case of shopping center leases, the more

specific requirements for "adequate assurance of future performance," discussed above, must be satisfied when considering the proposed assignee as the tenant. Thus, for example, a tenant may not assign its shopping center lease to King Soopers if there already is a grocery store in the shopping center whose lease contains an exclusivity provision.

Once the Bankruptcy Court approves the tenant's assignment of a lease, the bankruptcy estate will incur no obligations under that lease in the future. The landlord may require a deposit or other security for the new tenant's performance, to the same extent that it would have required such a deposit or security at the outset of a lease to a similar tenant.

■ **Establishing the Landlord's Claim in Bankruptcy.** If the tenant assumes its lease, any existing defaults must be cured and the bankruptcy estate must timely perform its obligations going forward. Therefore, the landlord will not have a claim in the tenant's bankruptcy case. If the tenant rejects its lease, the landlord must promptly file a *Proof of Claim* in the bankruptcy case for the damages caused by the rejection. The amount of that claim will be capped, as explained above.

In the event that the tenant defaults in payment under the lease after the bankruptcy case is filed, either (a) before assumption or rejection, or (b) after assumption, the amounts due from the tenant are administrative expenses. Those administrative expenses should not be included in the landlord's Proof of Claim. Instead, the landlord should seek payment of the administrative expenses by filing a separate motion in the bankruptcy case.▲