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# You Are a Landlord and Your Tenant Is Financially Stressed - What Should You Do?

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*Tenant bankruptcy cases significantly impact landlords. In this article, the authors explore some of the issues that arise when a tenant is financially stressed and the potential mitigating actions from the perspective of the landlord.*

In the current economic environment, many commercial tenants are experiencing severe financial distress. This leads to an increasing risk of tenants filing bankruptcy, which will impact landlords on several levels. Even before a tenant files bankruptcy, the tenant's financial distress itself gives rise to various legal considerations that can affect the landlord's loss exposure.

Prior to the bankruptcy filing, a number of matters - including tenant delinquencies, rent deferrals and abatements, lease transfers and assignments, the status of lease guarantees and security deposits, and the status of insurance maintained by the tenant with respect to its premises, as well as the tenant's overall level of distress - require careful consideration by a landlord in order to help avoid or mitigate the landlord's risks of (i) exposure to loss, and (ii) encountering complications in its attempts to quickly assert control over the tenant's leasehold interest.

After the bankruptcy filing, the landlord must proceed with caution in connection with enforcing its rights. The Bankruptcy Code (the Code) imposes an immediate "automatic stay" in favor of any debtor, which is essentially an injunction intended to protect a debtor and its property against any action that may be taken by a creditor without obtaining prior bankruptcy court authorization. The automatic stay applies both in situations where the debtor itself (e.g., a tenant) files a "voluntary" bankruptcy or another party files an "involuntary" bankruptcy against the debtor. In order to proceed against a debtor that is subject to a stay, relief from the stay - which may only be granted by the bankruptcy court itself - must be obtained prior to the taking of any action by a creditor. Violations of the stay are subject to a contempt action before the bankruptcy court.

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Leases are considered "executory contracts" for purposes of the Code since material performance is due by the parties on both sides of the agreement. The Code contains special provisions relating to the treatment of leases in bankruptcy. While as a general matter debtors must perform their lease obligations that arise after bankruptcy, debtors may have flexibility to take advantage of somewhat more relaxed compliance oversight during the early stages of a bankruptcy case (barring rapid creditor landlord intervention). Note that it is not recommended for a landlord to unilaterally take self-help measures once a bankruptcy is filed.

There are instances where leases that are of value to a debtor are ultimately "assumed" in a bankruptcy.[1] In such an event, all existing defaults under such lease will need to be cured and all outstanding rent must be paid in full to the landlord. However, it is more often the case that the relevant lease is of little or no value to a debtor, in which event the debtor may seek to "reject" the lease.

Frequently, the debtor's ability to reject a lease in a bankruptcy leaves the affected landlord in an unpredictable and risky situation. There are certain proactive steps that landlords should consider taking in situations where a tenant may be headed for, or imminently preparing to file, bankruptcy. While every situation is unique (and the particular level of distress that the applicable tenant is experiencing will certainly impact the nature of the actions that can be taken to mitigate losses and enhance recoveries), there are certain recurring issues that often arise in these situations that a proactive landlord can anticipate and thereby attempt to minimize the resulting adverse financial consequences. This article will explore some of these issues and potential mitigating actions from the perspective of the landlord.

## STAYING INFORMED ABOUT TENANT DISTRESS

In many situations, the landlord may not fully appreciate the extent of a tenant's financial distress. Late or missed rent payments are often the first indicator that a tenant is experiencing difficulty. However, this might not occur until the tenant is already in bankruptcy, at which point the landlord must immediately begin to monitor the bankruptcy case because matters can occur quickly and may, absent vigilance, impact the landlord's ultimate recovery.

While some leases contain financial reporting requirements that may provide insight into a tenant's financial status, these provisions often require only annual reporting, so they can become quickly outdated (and tenants may also not report the full extent of their precarious financial situation). Other lease provisions may give the landlord the right to request (or require the delivery of) current financial information from the tenant. As an initial matter, landlords should strive at all times to stay informed regarding the current financial status of their tenants,[2] since receiving an early warning on distress may enable the landlord to pursue certain remedies prior to the occurrence of a bankruptcy (which remedies would otherwise likely be subject to the automatic stay after the bankruptcy).

## TERMINATION OF THE LEASE MAY BE HELPFUL

If a tenant is not already in bankruptcy, then, upon learning that a tenant is experiencing


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financial distress, an initial course of action for the landlord to consider is whether it has the ability to terminate the lease by its terms (in a manner that makes such termination irrevocable) before the bankruptcy case is filed. This requires careful consideration not only of the business impact of such termination, but also of the specific terms of the lease and underlying state law. Otherwise, once the bankruptcy case commences, (i) the lease (if it is still in the phase where existing pre-bankruptcy tenant defaults can potentially be cured) remains in place without any right for the landlord to terminate (absent specific bankruptcy court approval), and (ii) the landlord and all other creditors are, at least temporarily, stayed from taking any actions to enforce rights or remedies that would have been available pre-bankruptcy.

In evaluating the decision whether to terminate a lease pre-bankruptcy, the actual lease terms are controlling as to (among other things) the nature of the circumstances that would allow the landlord to terminate and how to effectuate such a termination.[3]

In addition, many leases contain notice and cure rights in the event of certain tenant defaults and/or a provision stating that a termination notice only becomes effective after a certain number of days pass following the delivery of the notice to the tenant. If the tenant files bankruptcy either during the pendency of a tenant cure period or during the period between the delivery of the termination notice and the date it becomes effective pursuant to the terms of the lease, then the termination will not be considered effective and the lease will still be considered in effect. From the perspective of avoiding entanglement in bankruptcy, if a lease termination is not clearly, fully and finally effective before a bankruptcy case is filed, then any further landlord acts to implement termination would be deemed to be a violation of the automatic stay.

In short, the timing of the delivery of a termination notice and the provisions of the lease governing its effectiveness should be taken into account when considering this option.

## ACCELERATION OF RENT CONSIDERATIONS

Any attempts by a landlord to accelerate rent under a lease following a bankruptcy filing are also barred by the automatic stay. As such, any acceleration of rent under a lease must be implemented and become effective before the bankruptcy is filed.

Additionally, (i) in some jurisdictions, the termination of a lease can operate to cut off all future obligations of the tenant thereunder, so local counsel should also be consulted to understand the mechanics of lease termination in the applicable jurisdiction, and (ii) local counsel should also be consulted with respect to the applicable jurisdiction's mitigation of damages requirements (including to understand the landlord's obligations under such circumstances and to frame any potential future damages claim or proofs of claim that may ultimately be pursued in bankruptcy court).

## NEGOTIATION WITH THE TENANT

If the landlord does not pursue lease termination, then it may want to consider engaging the tenant in discussions regarding how the lease will be treated in the bankruptcy. With respect to more marginal leases, the tenant


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will likely be desirous of reducing damages claims under the lease and, therefore, a consensual, early exit from the lease might be beneficial to both parties. Assuming that both parties are in agreement, one potential approach could be to enter into a surrender agreement, whereby:

(i) The tenant agrees to vacate the premises;

(ii) The parties agree to liquidate the remaining amounts owed by the tenant under the lease to a fixed sum, and

(iii) The landlord retains and applies the entire security deposit. As consideration for such a lease surrender, the landlord will often agree to waive some or all claims against the tenant.[4]

Again, the bankruptcy court and other creditors will typically review this type of arrangement carefully, whether the same is implemented before or after the bankruptcy filing. If any surrender agreement or similar arrangement is effectuated (i) after the bankruptcy filing, then it will need express bankruptcy court approval, and (ii) before the bankruptcy filing, then after the filing the bankruptcy court can still evaluate whether the overall agreement resulted in a “transfer” of value away from the debtor tenant to the landlord in a manner that could be subject to “avoidance” by the court under various sections in the Code. Generally, any agreement that purports to transfer new value to the landlord with respect to the period prior to bankruptcy (i.e. value that goes beyond the amount of any existing deposits held by the landlord) could trigger increased scrutiny from other creditors and should be thoroughly evaluated by the landlord.

## ACTING ON SECURITY DEPOSITS OR OTHER PAYMENT ASSURANCES

As a general matter, when entering into a lease, a landlord will often seek to (i) achieve “secured” status as to any cash security (or other advance) deposits that it holds under the lease, or (ii) otherwise obtain reasonable assurances or collateral for a tenant’s obligation to make all required payments under its lease (such as letters of credit or third-party guarantees).

If a landlord learns of a potential upcoming bankruptcy filing with respect to a tenant, then, to the extent permitted by the terms of the applicable lease, the landlord should consider applying any cash security deposits it is holding to amounts due under the lease (including acting to trigger any acceleration of rent pursuant to the terms of the lease and in accordance with applicable law).

If the application of a cash security deposit or acceleration of rent does not fully and irrevocably occur before the bankruptcy filing, then the bankruptcy filing itself will automatically stay landlord’s ability to apply the cash security deposit or accelerate the rent (absent the express approval of the bankruptcy court). With respect to a security deposit that is in the form of a letter of credit or a third-party guaranty, because each such instrument is a third-party obligation that is independent of the debtor tenant, the filing of a bankruptcy by (or with respect to) the tenant should not, in and of itself, ordinarily interdict the landlord’s ability to draw on the letter of credit or seek to collect under the guaranty (unless the issuer of the letter of credit or the guarantor is also subject to a bankruptcy filing).


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## CONFIRM INSURANCE STATUS ASAP

Another important initial item from the landlord's perspective is to make sure that the tenant does not allow the applicable property, casualty and other insurance to lapse (which could lead to the existence of a gap in coverage if a casualty or other covered event occurs). As part of the termination process, a landlord should also review the status of the existing insurance and confirm that (if the tenant is responsible for obtaining and maintaining such insurance) (i) the landlord is appropriately named on the applicable policies as a loss payee or co-insured, and (ii) such insurance coverage will not lapse due to a bankruptcy filing.[5] The bankruptcy courts and the U.S. trustee monitoring the bankruptcy will react swiftly to complaints made by creditors (or other affected parties) if there are lapses by a debtor tenant in maintaining proper insurance. As is the case with virtually all proactive action by a landlord, if a tenant allows its insurance to lapse in breach of a lease and then becomes subject to a bankruptcy, then the landlord will need to act within the bankruptcy process in order to remedy this matter (and other similar types of matters).[6]

## SECURING THE PREMISES

A distressed tenant may leave the demised premises unoccupied or in an abandoned state. In such a scenario, whether prior to or during a bankruptcy, the landlord should consider arranging for security to ensure that the premises is secure. However, this does not mean taking over the debtor tenant's leasehold or acting to control its property, unless (i) before the bankruptcy, the same is permitted by the applicable lease, or (ii) during the bankruptcy, the same is specifically authorized by the bankruptcy court.

## WILL THE LEASE BE ASSUMED, REJECTED OR ASSUMED AND ASSIGNED IN THE BANKRUPTCY?

As noted earlier, leases are considered "executory contracts." The Code gives debtor tenants the opportunity to either assume, reject or assume and assign leases,[7] even if the lease provisions say otherwise. While there are some limited exceptions to a tenant's right to assign its lease in bankruptcy (e.g., in the case of shopping center leases), landlords are often hindered in their ability to oppose assignments by tenants since a debtor's decision to assume, reject or assign a contract in bankruptcy is subject to a business judgment standard. In any event, the landlord should try to assess how the leased premises fits into the debtor's business and otherwise contributes to the debtor's overall profitability. These decisions are present in virtually all tenant bankruptcy cases.[8] As a practical matter, unless a lease is a cornerstone asset that is essential to the business of the debtor tenant, the landlord may need to provide the tenant with incentives (including economic concessions) in order for the tenant to agree to assume the lease and cure defaults.

Note that the Code imposes certain time limits on when the debtor tenant must decide to assume, reject or assume and assign its lease (which can vary depending on the nature of the lease or asset-type). And while the terms of a lease may provide for "automatic termination" or other consequences in the event of a bankruptcy, these "ipso facto" provisions are nullified and rendered void under the Code.


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## RENEGOTIATING THE LEASE TERMS

As previewed above, the Code's provisions regarding assumption, rejection or assignment of leases (as well as the cap on available damages for rejection of a lease) provide substantial incentives for fostering renegotiation of the terms of a lease with a debtor tenant since the tenant can seek to reject the lease if, in its business judgment, the existing lease terms are too burdensome or unprofitable to assume from the tenant's perspective. Renegotiation may be an especially attractive option in situations where the space demised under the lease cannot be re-leased easily or quickly (in which case renegotiating the lease terms may be the most effective way to avoid vacancy at the property and further loss of rental income).[9] Lease amendments or modifications can be effectuated both before and after the bankruptcy is filed, but once the filing occurs the applicable lease transaction would require the prior approval of the bankruptcy court. Additionally, pre-bankruptcy agreements must be carefully crafted to avoid undermining any protections or rights that the landlord already possesses pursuant to the existing terms of the lease. Although it is not common for these types of pre-bankruptcy transactions to trigger the Code's avoidance provisions on account of a transfer of value from a debtor tenant to the landlord, they are still subject to review after the fact in the bankruptcy to ensure that the value exchanged is not "unreasonable" or too one-sided in favor of the landlord.

## MY ONLY CONCERN IS MY LEASE - NOT THE REST OF THE CASE

Bankruptcy cases are generally filed to implement a holistic restructuring of the debtor's asset mix and debt structure, with the intention of erasing debts in order to right-size the debtor's balance sheet and discard unprofitable assets. The cases are multi-faceted and can have wide-ranging effects (especially if an affected landlord is not vigilant in monitoring the ongoing developments in the case). Bankruptcy can also be used to attempt to relieve owners or other involved parties from loss exposure. It is important for a creditor landlord to engage legal counsel to monitor the bankruptcy case in order to (i) ensure that the case does not override the landlord's existing rights in the leasehold and associated third party guarantees, and (ii) evaluate whether there are other potential sources of value recovery for creditors that should be preserved. This often involves a cost-benefit analysis by the landlord as to whether active involvement in the case is warranted. The courts are increasingly placing the burden of imposed harm to rights on affected creditors who do not actively protect their rights in the bankruptcy (particularly in situations where creditors were given the opportunity to object to the granting of debtor relief that adversely affects the creditors' interests).

## MY LEASE WAS REJECTED - IS THERE ANYTHING ELSE TO DO?

Landlords whose leases are rejected are often left with a significant unsecured rejection claim in the bankruptcy. The actual amount of the claim is calculated based on the terms of the lease; however, the amount of damages collectible by a landlord as a result of the termination of a lease is statutorily capped at the greater of rents due for (i) one year, and (ii) 15% of the remaining lease term (not to exceed three years). In addition, landlords may also be able to pursue other residual claim recoveries in the bankruptcy case, including


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(potentially) the full balance of the lease claims against non-debtors under guarantees or letters of credit.

## CONCLUSION

The existence of a distressed tenant is always unwelcome news for the landlord. However, there are steps that may be taken by the landlord to attempt to minimize the resultant financial loss and disruption. Every situation related to a filing (or potential filing) of bankruptcy is different and fact-specific, so any landlord that is faced with the prospect of a tenant bankruptcy should always consult with an attorney that is knowledgeable about both the relevant lease and the potential impact of the bankruptcy on the landlord's rights.

## NOTES:

[1]The "assumption" of a lease in bankruptcy essentially means that the parties elect to keep the lease in effect and continue to perform thereunder. On the other hand, the "rejection" of a lease in bankruptcy essentially means that the parties elect to void the lease and thereby relegate all claims by landlord for damages under such lease to the status of unsecured claims.

[2]To that end, landlords should consider whether they have the right under the applicable lease to require the tenant to deliver current financial reporting information upon demand.

[3]Note that termination rights may be subject to numerous factors, including (i) matters that are solely bilateral between landlord and tenant (e.g., failure to pay rent or other required amounts, or other nonmonetary defaults), and (ii) external matters (e.g., obtaining the approval of a lender, governmental authority or other third party where applicable).

[4]As part of this process, the landlord should consider, among other things, its expectations of recovery of amounts owed under the lease from other third parties, as well as what any residual unsecured claim might be worth in a bankruptcy case. Typically, unsecured creditors do not see a significant return in bankruptcy cases, although each situation is different.

[5]This is applicable and important even if the tenant has pledged its insurance coverage to the tenant's lender.

[6]Note that this is the case even if the landlord is the named insured or an additional insured on such policies, because insurance policies procured by the debtor comprise property of the bankruptcy estate.

[7]If a lease is (1) "assumed" by the debtor, then the lease remains ongoing for the duration of the bankruptcy; (2) "rejected" by the debtor, then the lease will be terminated; and (3) "assumed and assigned" by the debtor, then the lease will continue with the assignee serving as the new tenant thereunder.

[8]Note that while a bankruptcy filing will essentially excuse the debtor's performance of certain pre-filing obligations, it does not affect the debtor's obligations to perform and pay amounts due under the lease for the post-bankruptcy period. Generally speaking, debtor tenants are required to pay rent for the post-bankruptcy period (subject to certain qualifications and provisions of the Code).

[9]For example, this was one of the main areas of focus in the WeWork restructuring.


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