

## LANDLORD RIGHTS IN A TENANT'S BANKRUPTCY

Lets assume that the landlord has executed a carefully crafted commercial lease with the tenant, covering a variety of topics. Typically the items covered in a lease will include the term of the lease, the use to which the premises may be put, that the lease may not be assigned without the specific written consent of the landlord, and laying out various conditions to the assignment, as well as damages and other rights to which the landlord is entitled in the event that the tenant fails to pay rent or comply with certain other provisions of the lease. It will often also contain a clause that it will be a breach of the lease in the event that the tenant files a bankruptcy.

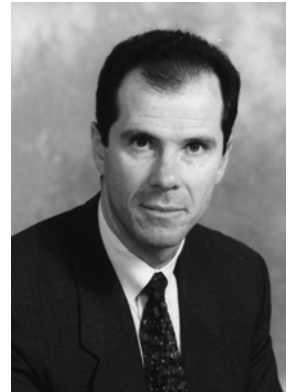
Under California law, if a tenant fails to pay rent and the landlord gives to the tenant the appropriate notice required under the lease (under California law at minimum a 3-day notice to pay rent or quit), then in the absence of the tenant paying the rent within the specified period, the lease is terminated and the landlord has the right to begin eviction proceedings. Under these circumstances the landlord is entitled to recover damages from the tenant, which generally under California law will be the difference between what the landlord is able to re-let the premises for and the contracted rent with the tenant. Lets assume in our case that the tenant has failed to pay rent for 30 days, that the landlord has given a 3-day notice to pay rent or quit, and the landlord is preparing to initiate the unlawful detainer process. Lets assume however that the tenant has previously sought the advice of bankruptcy counsel

and the tenant files a Chapter 11 bankruptcy prior to the expiration of the 3-day notice. In this event, the landlord becomes subject to a multitude of rights of the tenant under the Bankruptcy Code.

### Automatic Stay

The Bankruptcy Code provides that the filing of a petition in bankruptcy operates as a stay against the commencement or continuation of any action or proceeding against the tenant that could have been commenced before the bankruptcy case or, any act to obtain possession of property of the bankruptcy estate. This prevents the landlord from exercising his right pursuant to the 3-day notice to enforce the terms of a lease, whether the landlord merely wants to obtain possession of the property, or in addition obtain any monetary award to which the landlord may be entitled in terms of the lease agreement.

The automatic stay will however only bar the landlord from exercising its rights to possession if the lease is indeed property of the bankruptcy estate of the tenant. If the lease terminated by the expiration of the stated term of the lease before the bankruptcy case, then the landlord is not barred by the automatic stay and usually can proceed to obtain recovery of the property. What occurs however, is the result in the more common situation when the stated terms have not expired, but



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rather the lease has been terminated pre-bankruptcy for other reasons, such as non-payment of rent and the service and expiration of the 3-day notice. As to this latter group, the landlord is still required to obtain relief from the automatic stay to obtain possession of the property. Significantly however in this case, the tenant cannot further delay the landlord by “assuming” the lease in the bankruptcy (see below).

The key question thus becomes: When is a lease properly terminated under California law? Under California law a lease terminates on the day that the landlord files his unlawful detainer action in State court following a properly given 3-day notice to pay rent or quit, together with an election by the landlord declaring the lease forfeited, coupled with the tenant’s failure to timely cure the default. Even then however, a tenant in bankruptcy may still seek to avoid this result by asserting that the tenant is entitled to a relief from forfeiture. California law provides that even though a lease has been terminated, a court may relieve a tenant from the forfeiture of termination in cases of hardship.

Thus, on the one hand, a landlord who properly serves a 3-day notice to pay rent or quit which includes a declaration electing forfeiture of the lease upon default by the tenant, shifts the burden to the tenant to justify relief from forfeiture after the tenant files bankruptcy. If however repossession has not been completed, the tenant may still seek to reverse that process by reason of California anti-forfeiture law.

### **Tenant’s Rights To Assume Or Reject The Lease Agreement**

Assuming that the lease agreement is part of the tenant’s bankruptcy estate, then one of the basic powers of a tenant in bankruptcy is to assume or reject the lease agreement.

If the tenant elects to assume the lease, all rents and charges which accrue subsequent to the date of the request to assume become an administrative claim against the tenant’s bankruptcy estate. These claims are entitled to a priority payment status senior to all other pre-petition unsecured creditors of the tenant. Thus the result of assumption of a lease by the tenant is significant and ought not to be lightly undertaken.

The Bankruptcy Code requires that a tenant must assume or reject a lease within 60 days of the bankruptcy filing. Courts will sometimes extend that period beyond the 60 days in complicated cases, provided that the tenant pays all post petition rents.

In the event of a rejection, then the landlord will have two sets of claims: first, an administrative claim for the period of time during which the tenant occupies the premises from the date of bankruptcy through the date on which the lease is rejected; and second, the landlord will be entitled to an additional general unsecured claim which is limited to the greater of one year’s rent under the lease or 15% of the rent reserved for the remaining term of the lease (not to exceed three years). Thus, notwithstanding the landlord’s extensive damage claims under the lease under California law, the Bankruptcy Code limits those claims to the amount stated above. Not only does the Bankruptcy Code limit the claim, but the claim is also treated as a general unsecured claim. Thus it will be lumped in with other general unsecured creditors to which the tenant owes money. It is not unusual in a Chapter 11 case for general unsecured creditors to be paid pennies on the dollar. Thus, a landlord whose lease agreement is rejected by a tenant will not only have its claim limited to the term stated above, but the net claim will only be paid pennies on the dollar thus drastically reducing what the landlord would otherwise have been entitled to recover as a result of a tenant’s breach outside of a bankruptcy.

Courts have applied a “business judgment” test to a tenant’s decision to assume or reject a lease. The tenant’s decision however must be approved by the Bankruptcy Court, which will more often than not defer to the tenant’s decision.

Assuming that the tenant meets the business judgment test, there are various other standards that the tenant must meet in the event that there was a pre-petition default under the lease agreement. The tenant under these circumstances may not assume the lease agreement unless the tenant: (a) cures the default under the lease or provides “adequate assurance” that the default will be promptly cured; (b) compensates or provides “adequate assurance” that the tenant will

compensate the landlord for any loss arising from the default; and (c) provides “adequate assurance” of future performance.

Note that these additional obligations of the tenant only apply in the event the tenant has defaulted under the lease agreement prior to the filing of the bankruptcy. If the tenant has not defaulted, then provided the tenant meets the business judgment test, it may assume the lease.

Since tenants who are in bankruptcy often do not have the financial wherewithal to immediately cure any pre-petition default, tenants often request the Bankruptcy Court to approve “adequate assurance” of cure of the default as opposed to an immediate payment thereof. There is no specific definition of the term “adequate assurance”. It’s meaning is left to be developed on the facts and circumstances of each case. The cases range from holding that a tenant’s duty to cure should occur within 15 days to 3 years. In any case, the immediate cure of pre-petition rent arrearages usually is not required. Notwithstanding the apparent liberality with which courts have dealt with the prompt cure requirement, a tenant’s request for a lengthy period within which to cure pre-petition arrearages must be supported by evidence that the landlord will in fact receive the money when promised. This, for example, could be provided by a guarantee by a financially capable party.

In the event that the tenant is a lessee of a shopping center, then the Bankruptcy Code more specifically defines “adequate assurance” to mean that the tenant provide to the landlord the following: (a) adequate assurance of the source of the rent; (b) that any percentage rent due under the lease will not decline substantially; (c) that assumption is subject to all the provisions of the lease including radius, location, use and exclusivity provisions; and (d) that assumption will not disrupt any other tenant mix or balance in the shopping center.

A shopping center itself is not specifically defined, but case law has stated that whether or not the location is within a shopping center includes consideration of factors such as whether all leases are held by a single

landlord, the presence of a common parking area, the existence of a master lease, the existence of fixed hours during which all stores are open, the existence of joint advertising, the existence of percentage rent provisions and the contiguity of the stores.

### **Assignment Of Leases**

Provided that the tenant assumes the lease, the tenant is entitled to assign the lease to a third party, notwithstanding any language in the lease agreement which precludes the assignment. The purpose of this is to prevent anti-alienation or other clauses in the lease from defeating a tenant’s ability to realize the full value of its interests in its assets. These restrictive provisions are called *ipso facto* clauses such as when they restrict the use of leased premises or attempt to capture some or all of the profits on assignment. Thus for example, a provision in a lease that requires, as a condition to assignment, that the lessee pay to the landlord any key money that the tenant receives upon assignment, is not enforceable. In the case of shopping center leases however, because of the language cited above, these clauses may have more meaning.

So too, lease agreement provisions which provide that a lease will be breached in the event of bankruptcy, insolvency or other financial conditions of the tenant are not enforceable under the Bankruptcy Code, since they are also regarded as *ipso facto* clauses. The scope of this provision is wide and includes not only defaults triggered by a bankruptcy filing, but also defaults triggered by events or conditions which are likely to occur or exist around the time that a bankruptcy case is filed. For example, a default measured by the tenant’s financial condition will not preclude the lease from becoming part of the tenant’s bankruptcy estate.

In summary, it is evident that if a tenant files a bankruptcy, the tenant has a multitude of rights to which the landlord is subject, which otherwise would not come into play outside of a bankruptcy.

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