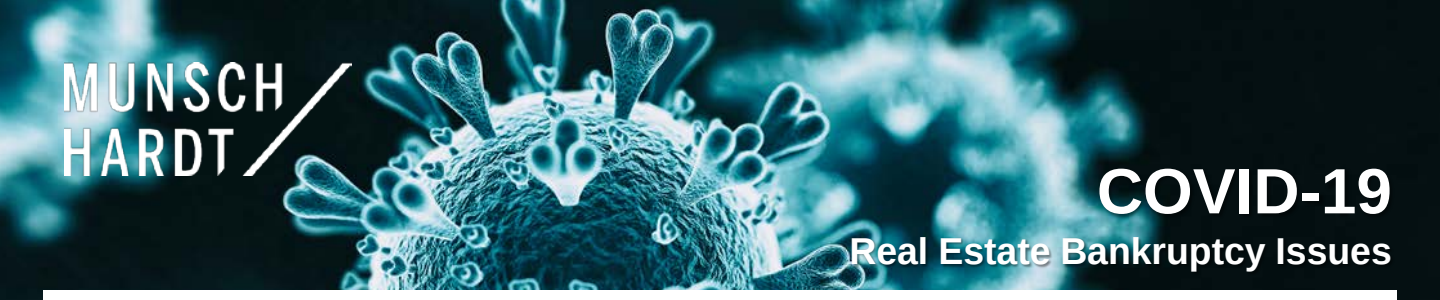

Tenant Bankruptcy Issues Facing Landlords in Today's Economic Climate

The events of the past month have shifted the power dynamics between commercial landlords and tenants. With non-essential businesses across the country closed, landlords may soon find themselves in the difficult position of managing tenant bankruptcies that would have been unimaginable a few weeks ago. There are several land mines landlords must negotiate in a tenant's bankruptcy, especially with regard to the recovery of damages.

Leases Included in the Bankruptcy Estate.

Section 365 of the Bankruptcy Code governs issues related to unexpired leases. Once the bankruptcy case commences the bankruptcy estate is created. Within the bankruptcy estate, "all legal or equitable interests of the debtor in property as of the commencement of the case" (11 U.S.C. § 541(a)(1)) fall within the bankruptcy estate. It is important to note that leases terminated prior to the commencement of the bankruptcy case do not fall within the bankruptcy estate. Therefore, if a landlord anticipates one of its tenants will file for bankruptcy and the tenant has otherwise defaulted under its lease, and the landlord wants possession of its property free and clear of the tenant's bankruptcy, the landlord should terminate the lease prior to the tenant's bankruptcy filing.

Automatic Stay.

The Bankruptcy Code provides for an "automatic stay" upon creation of the bankruptcy estate. During the automatic stay neither the landlord nor the tenant may terminate the lease. At this point most landlords look to their lease agreements to review the tenant default provisions. Many leases still contain provisions that state the tenant is in default upon filing for bankruptcy. The Bankruptcy Code states that these "*ipso facto*" clauses are not enforceable, and therefore, the landlord cannot terminate the lease due to the tenant's filing for bankruptcy.

Assumption or Rejection of Lease.

During the bankruptcy case the Bankruptcy Code grants the trustee or debtor in possession (either, "Debtor") three options in dealing with the unexpired lease. The Debtor may: (1) assume the lease; (2) assume and assign the lease to a third party; or (3) reject the lease. Each option has its own pitfalls and issues, but it is important to note that the Debtor must assume or reject the lease agreement in its entirety. The Debtor cannot hand pick the provisions it wants to keep and wants to reject. If the Debtor elects to assume the lease, the Debtor must cure its pre-petition and post-petition defaults. This requirement includes both monetary and non-monetary defaults. If the Debtor is in default, the Debtor must prove it can provide adequate assurance of future performance, and the burden is on the Debtor to demonstrate to the bankruptcy court that it can adequately perform. If there are outstanding liabilities and defaults under the lease, the landlord should consider working with the Debtor to reach an agreement that allows the lease to be assumed.

Damages Upon Lease Rejection.

The landlord will be open to the most exposure if the Debtor rejects the lease. Section 502(b)(6) of the Bankruptcy Code provides a statutory cap on the amount of damages a landlord can claim from the rejection of a lease. Section 502(b)(6) states that the landlord's damages are limited to the following: (1) the rent reserved in the lease without acceleration for the greater of one year or 15% (not to exceed three years) of the remaining term of the lease, calculated from the earlier of either the petition date or the date the landlord repossessed or the tenant surrendered the premises; or (2) any unpaid rent due under the lease on the earlier of either the petition date or the date the landlord repossessed or the tenant surrendered the premises. The biggest issue that arises is the landlord's ability to collect for damages to the premises. The courts are split on their interpretation of the language contained in Section 502(b)(6). The majority of courts

have found that a landlord's claim for breach of repair and maintenance obligations are not capped by Section 502(b)(6). These courts claim that due to the plain language of the statute, the cap only applies to damages related to the rejection of the lease and not to damages related to the tenant's breach of its repair and maintenance obligations. On the flip side, the minority holds that certain lease obligations, such as maintenance, insurance, and taxes, are subject to the cap contained in Section 502(b)(6). The Ninth Circuit Court of Appeals most recently addressed this issue in a 2017 decision clarifying the court's holding in In re *El Toro Materials Co.* (50 F.3d 978, 981 (9th Cir. 2007)). In *In re Kupfer*, the court established a clear test and limited the purview of the statutory cap to "damages resulting from termination of the lease" (Section 502(b)(6)). Per *Kupfer*, Landlords can recover for damages to the premises under the "simple test." The simple test asks: "Would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than reject it?" (852 F.3d 852, 858 (9th Cir. 2016)). If the landlord would still have the claim if the tenant assumed the lease, then the claim is not subject to the statutory cap.

Security Deposits:

The Fifth Circuit found a way for landlords to protect themselves via the use of a letter of credit. In *EOP-Colonnade of Dallas Ltd. Partnership v. Faulkner (In re Stonebridge Technologies, Inc.)*, 430 F.3d 260 (5th Cir. 2005), the landlord obtained a letter of credit as well as a cash security deposit to secure the tenant's obligations under the lease. During the bankruptcy case the Debtor rejected the lease. Instead of filing a claim in the bankruptcy case the landlord drew down on the letter of credit. The letter of credit was far in excess of the amount of damages the landlord would have otherwise received. The Fifth Circuit found that the landlord could collect the higher amount under the letter of credit. The court reasoned that because the agreement between the bank and the landlord was separate from the agreement between the tenant and the bank, the landlord could draw upon the letter of credit. Therefore, if a landlord is nervous about additional security a letter of credit may alleviate some of those concerns.

Although landlords cannot control whether or not their tenants file for bankruptcy, knowledge of the potential issues can enable landlords to prepare for the worst and protect their interests. By carefully negotiating lease provisions and working with tenants once they enter bankruptcy, landlords can protect themselves from the negative effects of having a lease rejected by the tenant.

Munsch Hardt Kopf & Harr is continually monitoring leasing developments related to COVID-19 and will send out additional information as pertinent updates occur. In the interim, please contact one of our leasing attorneys if you have any questions or need additional information.

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