

### Tenant Bankruptcies: What Commercial Landlords Need To Know

04.17.2000

In this economic boom time, it is admittedly unusual to see business professionals discussing bankruptcy issues. Yet even during this time of obvious economic prosperity, the Central District of California Bankruptcy Court (which covers Orange, Los Angeles, Riverside, and San Bernardino counties) recently reported that debtors filed more than 100,000 bankruptcy petitions during 1999 alone. All signs indicate that bankruptcy filings by lessees of commercial real property will be even more numerous in 2000. Commercial landlords need to be wary and, more importantly, need to be informed of the rights and obligations created by the Bankruptcy Code. This article provides a brief summary of two of the issues that commonly affect commercial landlords when their tenants file for bankruptcy.

#### 1. Collecting Pre-Petition Rent & Evicting The Tenant.

The filing of a bankruptcy petition creates an "automatic stay" which precludes creditors, including landlords, from enforcing their rights and remedies against the tenant/debtor. The automatic stay is created without notice or hearing, and at least initially, creditors have no opportunity to challenge its issuance. The scope of the automatic stay is fairly immense. Regardless of how far proceedings against the debtor have proceeded, at the point a bankruptcy petition is filed, those proceedings must halt.

The automatic stay precludes the commencement or continuation of all legal action against the debtor, bars landlords from taking any act designed to obtain possession of property within the bankruptcy estate, and impedes any act intended to create, perfect, or enforce a lien against the debtor's assets. Beyond this, Bankruptcy Courts often extend the stay to preclude landlords from taking any steps against guarantors, sureties, or other co-obligors under the lease. Further, the automatic stay requires the immediate cessation of even informal collection activities adverse to the debtor; even telephone calls, demand letters, and the exercise of setoff rights must cease. Even where a landlord has, pre-petition, prosecuted an unlawful detainer action, obtained a judgment against the debtor, and sent the authorities to eject the tenant, the tenant's decision to file for bankruptcy will generally preclude eviction of the tenant absent court intervention.

Moreover, landlords who knowingly violate the automatic stay can be held liable for damages and even cited for contempt. Where creditors knowingly ignore the automatic stay, debtors may recover, among other things, possession of assets seized in violation of the automatic stay, the attorneys' fees incurred by the debtor in seeking such recovery, interest on the money so expended, and even punitive damages designed to deter a given creditor from ignoring the stay in the future. Courts regularly apply these precepts to landlords who knowingly violate the automatic stay.

Owing to this, it is important that commercial landlords proceed cautiously after gaining knowledge of a tenant's bankruptcy. The Bankruptcy Code specifically allows landlords to seek relief from the automatic stay in order to proceed against guarantors, collect rent, and even evict debtor/tenants under certain circumstances. The key is to obtain approval from the Bankruptcy Court before undertaking such steps. While the facts of any given case can vary the result, competent creditor attorneys routinely gain such approval, often on an expedited timetable.

## **2. Collecting Post-Petition Rent & Getting New Tenants.**

Leases are often a debtor's most valuable asset -- the debtor's clients know where the debtor conducts its business and, if the debtor were to relocate, that move may cause serious problems for the debtor. In recognition of this, the Bankruptcy Code generally allows debtors to preserve their leases after filing a bankruptcy petition. Moreover, because certain leases are intrinsically valuable (i.e., below market leases, leases in under-developed areas, leases in specialty developments) the Bankruptcy Code can allow tenant/debtors to transfer their leases to non-debtor entities, often without the landlord's consent. The upshot of all this is fairly simple -- unwary landlords may find themselves stuck with undesirable new tenants, while savvy landlords can often avoid that circumstance. As is always the case, the key issue is knowing your rights and staying involved in the tenant's bankruptcy case.

In bankruptcy parlance, tenant/debtors must decide if they wish to "assume or reject" the leases to which they are a party. Leases which the tenant/debtor assumes remain in full effect after the bankruptcy filing; rejected leases do not. Yet, in order to assume most commercial leases, a debtor must first cure all pre- and post-petition defaults thereunder. Because of this, Bankruptcy Courts recently recognized that under certain circumstances, debtors may not be able to assume certain leases. Under one fact pattern, where a lease required a tenant/debtor to operate its business during certain hours, the tenant/debtor's failure to comply with that requirement was deemed to be a non-monetary default which could not be cured. Accordingly, the debtor/tenant under such circumstances was precluded from assuming its lease, absent the landlord's decision to waive the non-monetary and incurable default. Knowing this precept may allow a commercial landlord to, at best, preclude assignment of the lease to an undesirable new tenant or, at worst, provide the landlord with additional bargaining strength as it negotiates a new lease with the debtor.

The Bankruptcy Code also strictly regulates when and how debtors may assume or reject leases. In most Chapter 7 and 11 cases, if the debtor neither assumes nor rejects its commercial leases, those contracts are ordinarily deemed rejected after 60 days, unless the Court extends the time for assumption/rejection of the lease at issue. Importantly though, the Bankruptcy Code does not require commercial landlords to sit idly by while their tenants reorganize their businesses. In fact, the Bankruptcy Code specifically allows landlords to petition the Bankruptcy Court for an order compelling debtor/tenants to assume or reject a particular lease by a date certain. Further, the Bankruptcy Code awards landlords an "administrative priority" for rental obligations (including CAM's and related charges) accrued after the tenant files for bankruptcy. In fact, a landlord may even seek payment of the debtor's post-petition rental obligations in cases where general unsecured creditors will receive nothing. Again, for commercial landlords the key is knowledge of the law and active involvement in the tenant's bankruptcy case.

As noted above, commercial landlords need not be victims when their tenants file for bankruptcy. Within the tenant's bankruptcy case, pro-active landlords can take steps to collect post-petition rent, preclude assignment of their leases, and, under certain circumstances, even eject their debtor/tenants. Unfortunately, the size of this

column precludes me from discussing the multitude of other options available to commercial landlords when their tenants file for bankruptcy. The Bankruptcy Code can protect commercial landlords, not just tenants. The key is understanding your rights.

© 2000 Sheppard, Mullin, Richter & Hampton LLP.

## Attorneys

Aaron J. Malo

## Practice Areas

Bankruptcy and Restructuring