

LEASING: BANKRUPT TENANTS - Strategies for Landlords

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The filing of a bankruptcy by a tenant in possession of a commercial property under an unexpired lease often can be a curse to the landlord but, surprisingly, also can be a blessing. Finding the proverbial silver lining requires prompt action, sound strategic thinking, and vigilance of the process.

TYPES OF BANKRUPTCY PROCEEDINGS

LIQUIDATION. Chapter 7 of the Bankruptcy Code provides for liquidation of assets and is available to any person or business. Chapter 7 provides for the orderly liquidation of assets for the benefit of creditors in return for forgiveness of debts. However, certain debts are nondischargeable, such as child support, student loans, and debts incurred by fraud.

REORGANIZATION. Reorganizations are available to any person or business under Chapter 11, and to wage earners under Chapter 13, of the Bankruptcy Code. The debtor is allowed to keep its assets provided it pays its creditors more than the creditors would have received under a Chapter 7 liquidation. The debtor submits a plan and, if approved, the debts are modified in amount and time of repayment. Typically, the creditors are divided into classes, and the treatment of each class of is outlined in the debtor's plan. In Chapter 13 cases, an appointed trustee reviews the plan and comments on its fairness and compliance with the Bankruptcy Code. In Chapter 11 cases, a disclosure statement and plan are prepared and transmitted to all creditors and they have the opportunity to vote on acceptance or rejection of the plan.

THE AUTOMATIC STAY

Upon filing of a petition in bankruptcy, collection efforts must cease. This includes not only actions to collect the debt directly, but also actions to improve the creditor's position, such as obtaining of additional liens, security agreements, and perfection of interests in the debtor's property. This prohibition against further collection efforts is called the "automatic stay" and is governed by 11 U.S. Code section 362. In essence, the automatic stay prohibits a creditor from taking any action against the debtor (and, in Chapter 13 filings, against a co-debtor) to collect its debt or to obtain any additional interest in any property of the bankruptcy estate. Violations of the automatic stay, if intentional, are punishable by the bankruptcy court. Violations of the automatic stay which are unintentional are void and without any effect.

As a result of the automatic stay, once a bankruptcy petition has been filed the creditor may not undertake to obtain a judgment against the debtor, garnish any funds, levy against any property, commence any lawsuit outside of bankruptcy court in order to quantify its debt or attempt to collect the debt, engage in any self-help, or set off or otherwise attempt to collect against the debtor (or any co-debtor in Chapter 13 cases) or any property owned by the debtor. Because the debtor is deemed to have a property interest in the lease, landlords may not seek to recover their property without approval of the bankruptcy court.

A creditor may obtain relief from the automatic stay by filing a motion and proving to the satisfaction of the bankruptcy court that its interests are not being adequately protected by the bankruptcy proceeding, and that the property sought is not necessary for the debtor's reorganization.

FIRST DAY MOTIONS

The filing of a bankruptcy often spawns a number of motions and a flurry of preliminary activity. It is not uncommon to have emergency motions (motions on shortened notice), filed with an actual hearing held within a matter of days. Many creditors often are surprised to receive a notice of a motion after the hearing has already taken place.

Landlords must be vigilant as to any action which may affect their rights and obligations. While many of these motions primarily deal with administrative issues, some motions can include such significant matters as debtor-in-possession financing, authorization to pay certain vendors, lease rejection procedure motions, and motions to extend the time to assume or reject leases. Although many courts will approve such motions subject to the right of an affected party to object at a later date, courts are reluctant to reverse relief granted which the court thought was appropriate in the first place.

Landlords are well advised to immediately engage counsel to attend hearings on these preliminary motions and to object to such motions where appropriate. An example of a rather common preliminary motion is one where the debtor in possession seeks financing which allows the lender to have a lien on the debtor's leasehold interests. If granted, the landlord could well find itself in a much less desirable position.

TAKE A LOOK AT YOUR ATTORNEYS' FEES CLAUSE

In a lease's boilerplate, a landlord and tenant agree that the victor in arbitration or litigation recovers its attorneys' fees. Routinely, a landlord could not recover its attorneys' fees from a tenant in bankruptcy -- not because the tenant lacked the funds, but because the federal courts in California would not allow the recovery.

In 2007, the U.S. Supreme Court overruled this unfair precedent. So, a landlord who successfully pursues a lease assumption or rejection or who successfully litigates an effort to evict a tenant in bankruptcy court may be entitled to claim its attorneys' fees.

PRE-BANKRUPTCY, PRE-SURRENDER RENT

The landlord is entitled to a claim for unpaid pre-bankruptcy, pre-surrender rent. This element of damages accrues only up until the earlier of the bankruptcy filing or the surrender of the leasehold.

The date of surrender is determined by state law. In California, surrender requires the landlord's acceptance. Acceptance can be inferred from landlord's conduct that is inconsistent with continued possession by the tenant. A landlord's issuance of a "Notice of Belief of Abandonment" constitutes acceptance of the debtor's offer of surrender under California law. It is likely that service of a 3-Day Notice with an election to terminate the lease constitutes an acceptance of a prior surrender offer. An unlawful detainer judgment may be a binding judgment with respect to surrender and pre-surrender damages

EXECUTORY CONTRACTS

The Bankruptcy Code allows a bankruptcy debtor to assume or reject any executory contract. An “executory contract” is a contract in which the parties have not yet finished performance. An unexpired lease is an executory contract.

With an unexpired lease, a debtor has two choices:

- Reject the lease, which would be deemed a breach of the lease and would allow a claim for damages by the landlord (subject to administration by the bankruptcy court); or
- Assume and assign the lease, discharging any further claim (allowed only if the debtor is current under the lease and the debtor is able to give adequate assurance of future performance by the assignee).

An unexpired commercial lease is deemed rejected if not assumed within 60 days of the filing of bankruptcy. However, prior to 2005, extensions of the 60 days typically were granted if the debtor kept the rent current. And, under Chapter 11 a debtor had until confirmation of a plan to decide to assume or reject an unexpired residential lease.

As of 2005, an unexpired commercial lease is deemed rejected if not assumed within 120 days of the filing of bankruptcy (or confirmation of a plan, if earlier). The bankruptcy court can extend this time period for an additional 90 days for a total of 210 days. Thereafter, only the landlord can authorize further extensions.

Shopping center owners lobbied for this 210-day cap, based upon their experience with retailers that hinder the landlord’s ability to pursue financing opportunities with the uncertainty of a bankrupt tenant.

DAMAGES AVAILABLE TO LANDLORD FOR REJECTION OF A LEASE

Rejection of a lease constitutes a breach, entitling the landlord to a claim for damages.

- The claim is limited to the damages which would otherwise be allowable under applicable state law
- The Bankruptcy Code provides a ceiling for the amount of that claim

Under California law, prospective damages are measured by a hypothetical offset. The court offsets the present “worth... of the unpaid rent which would have been earned” after the lease termination, against “the amount of such rental loss... which could reasonably have been avoided.” Civil Code section 1951.2(a)(2),(3). The tenant has the burden of proving the amount of mitigation the landlord might have achieved.

Hypothetically, where the lease is below market, the landlord ordinarily will have no prospective damages. An exception would be a case in which the lease was only slightly below market and the costs of reletting (such as broker’s commissions, make ready expenses) would exceed the “profit” in the new lease. If the landlord

nonetheless suffered some loss, compensation might be awarded under Civil Code section 1951.2(a)(4): “Any other amount necessary to compensate the landlord for all the detriment proximately caused by the lessee’s failure to perform his obligations under the lease...”

STATUTORY CEILING ON LANDLORD CLAIMS FOR PROSPECTIVE DAMAGES

“A landlord’s claim “for [prospective] damages resulting from the termination of a lease of real property” shall be limited to “the rent reserved under such lease, without acceleration for the greater of [a] one year, or [b] 15 percent, not to exceed three years, of the remaining term of such lease” ‘ measured from the earlier of the bankruptcy filing or the surrender of the leasehold.”

U.S.Code §502(b)(6)

DEFINITION OF “RENT RESERVED”

The requirements to qualify as “rent reserved” have been established by published decisions of the bankruptcy court:

“We hold that the following three-part test must be met for a charge to constitute “rent reserved” under §502(b)(6)(A):

- The charge must: (a) be designated as ‘rent’ or ‘additional rent’ in the lease; or (b) be provided as the tenant’s/lessee’s obligation in the lease;
- The charge must be related to the value of the property or the lease thereon; and
- The charge must be properly classifiable as rent because it is a fixed, regular or periodic charge.”
See *In re McSheridan* (1995).

Examples:

- “Rent reserved” ordinarily includes “triple net” charges such as taxes, insurance and CAM charges.
In re McSheridan (1995).
- “Rent reserved” includes amortized improvement costs. *In re Blatstein* (1997)
- Rent recapture (free rent, recaptured in the event of a default) did not constitute “rent reserved under the lease.” *In re Smith* (2000).
- Service charges, reletting costs and liquidated damages are not included in rent reserved. *In re Fifth Avenue Jewelers* (1996)
- Attorneys’ fees are not “rent reserved.” *In re Pacific Arts Publishing* (1996).

There are a number of court cases that have produced interesting results:

- In one case, the tenant executed a promissory note to its landlord in connection with the lease, and the lease characterized payments on the promissory note as “further rent.” The Ninth Circuit held that the note payments were included among the obligations which must be performed post-petition pursuant to §365(d)(3) and hence were entitled to administrative claim status. Arguably the

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promissory note payments would also constitute “rent reserved” under the *McSheridan* test. *In re Cukierman* (2001).

- Applying a somewhat different test, one court allowed utility charges incorporated in the lease as “rent reserved,” but rejected charges which would arise only upon certain contingencies, such as attorneys’ fees. *In re Conston Corporation* (1991).
- A prior state court judgment does not have the effect of a binding judgment so as to override the §502(b)(6) cap. *In re Fifth Avenue Jewelers* (1996). (Note the extraordinary analysis in *Fifth Avenue Jewelers* (1996): If the date of surrender is the same as “termination of the lease,” nothing can be allowed on account of the “rent reserved” after the date of surrender, because there is no rent due under a lease after it has been terminated. Applying this analysis, the cap applies only in bankruptcy rejection cases, because in those cases the rejection has retroactive effect; there will be rent reserved under the lease following the date on which the petition was filed.)
- The statutory cap applies only to post-termination damages and “only includes damages anticipated to result from a tenant’s failure to fill out the lease term. It does not address damages wholly collateral to the termination event – such things as waste, destruction or removal of leasehold property.... Damages caused by a tenant’s failure to properly repair and maintain the premises are not subject to [the statutory cap] since that is a separate obligation imposed on a tenant....” See *In re Bob’s Sea Ray Boats* (1992).

IS THE CAP 15% OF THE MONTHS REMAINING, OR OF THE RENT REMAINING?

There is a question as to whether this 15% cap refers to 15% of the months remaining on the lease, or 15% of the rent remaining to be paid.

MINORITY RULE – 15% of the months remaining on the lease.

The minority of courts have concluded that Congress intended that the phrase “remaining term” be a measure of time, not rent. See *In re Iron-Oak* (1994). One argument in favor of this position is that the phrase “without acceleration” is meaningful only if the measurement is of time, not rent.

To apply this minority rule interpretation, multiply the remaining months of the lease by 15%, then add up the rent which will accrue over those next months (giving effect to escalators and scheduled free or reduced rent which will arise during those months.)

MAJORITY RULE – 15% of the total rent to be paid over the remaining term of the lease.

The majority rule avoids the anomalies in the minority rule when rent fluctuates over the lease term. See *In re Gantos* (1995); *In re New Valley Corporation* (2000).

To apply this majority rule interpretation, add up all rent due during the remaining term of the lease and multiply by 15%.

POST-BANKRUPTCY DEVELOPMENTS

Prior to 2005, the statutory cap on damages does not apply where the lease has been assumed.

Where a lease is assumed and thereafter is rejected, the landlord will hold an administrative claim for rejection damages. As of 2005, that claim is limited by a statutory cap of 2 years of rent following rejection or turnover of the premises.

Payment of post-bankruptcy administrative rent does not affect or reduce the landlord's rejection damages claim. See *In re Atlantic Container Corporation* (1991).

SECURITY DEPOSITS

The statutory cap established governs the landlord's claim, not merely its unsecured claim. The security deposit or other collateral must be applied to the claim as capped. The landlord will not be permitted to offset his actual damages against his security deposit and then make a claim for the balance under the cap. Rather, his security deposit will be applied in satisfaction of the claim that is allowed under the cap. See *Odden v. Tonto Realty Co.* (1944).

As a result, a landlord who holds a security deposit in excess of one year's rent must expect to surrender that excess if the tenant files bankruptcy.

To be deemed a security deposit, the collateral must have been provided by the tenant to secure performance of the tenant's obligations under the lease. A cash security deposit is merely a type of collateral provided by the tenant.

GUARANTEES

In general, a third-party guarantee and a pledge of a third party's assets to secure such a guarantee will not be affected by the statutory cap and the tenant's bankruptcy case. This is because a guarantee is a separate and independent obligation, not (necessarily) affected by a change in the obligation of the primary obligor.

The bankruptcy of the primary obligor cannot affect the obligation of the guarantor. In the context of a real property lease and the application of the §502(b)(6) cap to a rejection damages claim against the tenant's bankruptcy estate, the landlord may pursue a guarantor for a debtor's lease obligations notwithstanding the trustee's rejection of the lease or a cap on rejection damages.

The guarantee and any collateral pledged to secure it must be separate and distinct from the lease obligation. Collateral pledged by a third party to secure the tenant's lease obligation may well be subject to the §502(b)(6) limitation since, arguably, the collateral secures only the amount the court determines the tenant must pay. Likewise, a guarantee which is sharply limited to "amounts which the tenant must pay," such as reimbursement or indemnity insurance policies, may be subject to the §502(b)(6) cap.

In order to avoid §502(b)(6) cap problems, a third party must incur a separate and independent obligation to the landlord, and that obligation must be secured by the third party's property.

LANDLORD STRATEGIES

LANDLORD STRATEGY: ASSIGNMENT OF LEASES

“Notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law that terminates or modifies, or permits a party other than the debtor to terminate or modify, such contract or lease or a right or obligation under such contract or lease on account of an assignment of such contract or lease, such contract, lease, right or obligations may not be terminated or modified under such provision because of the assumption or assignment of such contract or lease by the trustee.”

U.S.C. §365(f)(3)

The courts have identified an express congressional policy to permit such sales as one of the “rehabilitative policies of the Bankruptcy Code.” See *In re Standor Jewelers West, Inc.* (1991).

The debtor’s interest in its leases are often called “designation rights.” Often the designation rights carry more value than the rest of the debtor’s business.

As of 2005, a debtor may assign its designation rights even if it has defaulted under a non-monetary provision of its lease, even if that default cannot be cured.

Landlords have fought the result by challenging the assignment, challenging the assignee and challenging the assignor.

LANDLORD STRATEGY: USE OF “BONUS RENT” CLAUSES

A leading strategy for landlords is to block the assignment indirectly by reducing the economic benefit of the assignment to the assignor.

A common mechanism is the use of lease provisions which require a sharing of “bonus rent.” These clauses provide that if the lease is assigned by the tenant, the landlord will share in any additional consideration paid for the lease (“bonus rent”). Landlords argue that the sharing bonus rent clauses should be given effect because they apply to all assignments without regard to the existence of a bankruptcy case.

However, the Courts have consistently invalidated sharing bonus rent clauses. Sharing bonus rent clauses are analyzed in terms of §365(f)(3) (which overrides all provisions which “modify” a lease “on account of an assignment” of the lease.) Sharing bonus rent clauses come into effect only “on account of an assignment” of the lease, and have the effect of “modifying” the rent payable under the lease, contrary to the statute. The fact that they apply to “all assignments” is irrelevant for the purposes of §365(f)(3).

LANDLORD STRATEGY: RESTRICTIVE “USE” CLAUSES

Leases often provide for very restrictive “use” clauses, especially in retail centers. A number of courts have noted that the practical effect of a highly restricted use clause is to prohibit assignment of the lease. Case law applied a “balancing test” to use clause restrictions, weighing the landlord’s business interests against the estate’s desire to realize value for its assets. Where the use restriction appeared to the bankruptcy court to be

arbitrary -- as it often did -- it was invalidated. The “inherent power” of bankruptcy courts to deny enforcement of certain lease provisions was established in *Queens Boulevard Wine & Liquor Corp. v. Blum* (1974). “The bankruptcy court does have discretionary power to authorize some deviation in the use of premises where there is no demonstrable economic detriment to the landlord.” See *In re Mr. Grocer, Inc.* (1987).

Retail center landlords sought and obtained special legislation in 1984 and 2005, §365(b)(3), and (f)(1), designed to moderate this case law. See the box describing the special rules applicable to retail centers.

Outside of retail centers, use restrictions have limited practical effect. They remain the subject of a balancing test. “Where the benefit to the debtor outweighs the potential harm to the lessor, the court may exercise its equitable power to deny enforcement of a clause that would have severe negative consequences on a Chapter 11 debtor’s ability to reorganize.” *In re Tobago Bay Trading Company* (1990). In *Tobago* the Court authorized a “going-out-of-business sale” in a shopping center, notwithstanding a lease prohibition against such sales). Outside of a retail center, a landlord typically will have little economic justification for caring about the precise manner in which the tenant will use the premises, and hence the landlord will ordinarily lose the balancing test.

A landlord’s concerns might be given greater weight if the proposed use was inherently objectionable (e.g., a fireworks manufacturing plant, an adult theater).

Various lease provisions can have the effect of limiting the tenant’s ability to assign or, rather, of limiting the universe of potential assignees. Examples include limitations on hours of operations, required hours of operations, minimum sales revenues clauses, radius clauses, nameplate clauses, and use clauses. All such clauses should be subjected to a “balancing test” which weighs the landlord’s legitimate economic interests against the bankruptcy estate’s desire to realize value from an asset. The most deference likely is to be shown to the landlord where the lease has a “percentage of revenues” rent clause and the assignee’s ability to generate comparable/appropriate revenues is dubious. Again, however, different rules apply in retail centers.

LANDLORD STRATEGY: PROHIBITIONS ON “GOING DARK”

Often, leases have clauses which prohibit the tenant from suspending business operations -- “going dark” -- for more than a very limited period of time. These provisions may also be phrased as a “continuous use” covenant.

There is substantial business justification for such clauses. Percentage rent will not be paid while a tenant is “dark,” and “dark” premises have higher rates of vandalism, increased insurance costs and lower property values. In the shopping center context, all tenants share an interest in prohibitions on going dark.

Such clauses are likely to be subjected to a balancing test. In one case, the Court permitted lease termination for violation of implied prohibition on “going dark” because percentage rent was a material portion of landlord’s consideration under master lease; the sublessee’s bankruptcy did not excuse breach. See *EMRO Marketing Company v. Plemmons* (1988)

A landlord may have a claim against the estate for consequential damages for going dark.

SPECIAL RULES APPLICABLE TO RETAIL CENTER LEASES

Retail center landlords sought, and in 1984 and 2005 obtained, special amendments to the Bankruptcy Code to moderate the impact of the case law on tenants in retail centers.

Lease Restrictions:

- Any lease assignment shall be “subject to all the provisions [of the lease]” including “radius, location, use or exclusivity provisions” and shall not breach those provisions of any other lease.
- The debtor is prohibited from conducting a new or different business, or from assigning the lease to a lessee that would conduct its business in a manner inconsistent with the existing permitted use or existing tenant mix or theme of the shopping center.
- Assignment cannot “disrupt the tenant mix or balance.” For example, in one case the court, in applying these special rules, found that the assignment of a lease from upscale anchor Jordan Marsh to Mervyn’s would disrupt the tenant balance and mix. See *In re Federated Department Stores, Inc.* (1991).

Adequate Assurances of Future Performance:

- Assignment cannot result in a “substantial” decline in percentage rent. §365(b)(3)(B).
- “Adequate assurances” are tested by reference to the tenant’s financial condition at lease inception.

WHAT IS A RETAIL CENTER?

A 14-criteria test has been proposed in *In re Joshua Slocum* (1990) and other recent cases to determine whether a group of stores can be described as a “shopping center”:

14 Criteria to Determine a Retail Center

1. A combination of leases;
2. All leases held by a single landlord;
3. All tenants engaged in the commercial retail distribution of goods;
4. The presence of a common parking area;
5. The purposeful development of the premises as a shopping center;
6. The existence of a master lease;
7. The existence of fixed hours during which all stores are open;
8. The existence of joint advertising;
9. Contractual interdependence of the tenants as evidenced by restrictive use provisions in their leases;
10. The existence of percentage rent provisions in the leases;
11. The right of tenants to terminate their leases if the anchor tenant terminates;
12. Joint maintenance / trash removal;
13. The existence of a tenant mix; and
14. The contiguity of the stores.

PROOFS OF CLAIM AND CREDITORS COMMITTEES

Creditors in bankruptcy cases are given the opportunity to file a form which sets forth their claim. That form is called a "Proof of Claim". The first notice of filing in Chapter 7, Chapter 11 and Chapter 13 cases establishes a deadline by which proofs of claim must be filed. Failure to file a proof of claim in the case by the deadline waives any right to share in the distribution that may occur.

The proof of claim not only sets forth the amount of the claim, it also provides information regarding any security and the type of claim that is being asserted. In addition, any documents (security agreement, invoices or other proof of the amount owed and security) should be attached to the proof of claim form filed in the court.

In Chapter 11 cases, the debtor's schedules provide for the amount and treatment of the claims. If no proof of claim is filed by a creditor, the creditor will be deemed to have the amount and type of claim set forth in the debtor's schedules. However, if the creditor files a proof of claim which varies from the amount or type of claims set forth in the schedules, the creditor's sworn proof of claim is deemed to control unless it is objected to, a hearing is held and the court determines otherwise. It is always advisable to file a proof of claim.

Certain types of creditors (unsecured) are often asked in Chapter 11 cases if they would like to be a member of a creditors committee. This committee's function is to provide oversight of the debtor and to protect the committee's members' interest. A committee may hire its own attorney or accountant, which the debtor must pay. A committee's voice is generally very influential in Chapter 11, and membership on a committee can be a most rewarding experience.

CLASSIFICATION OF CLAIMS.

The Bankruptcy Code classifies the types of claims:

- **Secured**--those claims for which a creditor has collateral to assure payment;
- **Priority**--those claims for which no specific security has been granted, but for which the Bankruptcy Code provides for a "priority" payment prior to payment to general unsecured creditors; and
- **Unsecured**--claims for which no security or priority is held.

SECURED CLAIMS.

The secured creditor is treated as secured only to the extent of the value of its collateral. If a debt is greater than the value of the collateral, the secured claim is limited to the value of the collateral and any excess debt is treated as an unsecured claim. Under-secured creditors (those whose debt exceeds the value of their collateral) are not entitled to a statutory or contract interest on the secured portion of their debt, but are entitled to be paid the present value of their secured claim. This means that these creditors are entitled to be compensated for the time value of the amount of their security interest at a "reasonable interest rate."

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PRIORITY CLAIMS.

The assets remaining after the payment of secured claims are distributed according to priorities established by section 507 of the Bankruptcy Code. The most common priorities are:

- **Administrative Claims.** These liabilities arise during the bankruptcy and are deemed by the court to be beneficial and necessary for the preservation of the estate;
- **Involuntary Case Claims.** Claims that arise between the filing date of an involuntary bankruptcy petition and the entry of an order for relief after a hearing on whether the involuntary bankruptcy is proper;
- **Wage, Salary and Commission Claims.** Limited to \$4,000 per individual earned within 90 days of the date of the filing of the bankruptcy; and
- **Employee Benefit Plan Claims.** Limited to \$4,000 per employee earned within 180 days of bankruptcy.

GENERAL UNSECURED CLAIMS.

Any non-exempt assets remaining after the payment of secured claims to the extent of their security, and all priority claimants to the extent of their priority, under the Bankruptcy Code are liquidated and the proceeds distributed to the unsecured creditors on a pro rata basis.

It is important to note that a single claim may have both a secured and unsecured component, or may be granted a priority only to a certain dollar limit.

THE TRUSTEE'S "STRONG-ARM" POWERS.

Under the Bankruptcy Code the Trustee (or the debtor in a Chapter 11) holds the rights of a hypothetical lien creditor as of the date of filing. This means that any lien that has not been perfected may be challenged by the Trustee. Any amounts recovered by the Trustee as a result of a challenge to a lien constitute more money available for priority and unsecured creditors. Even such technical defects as the expiration of a financing statement are likely to result in a determination by the court that the secured creditor is, in fact, unsecured. The debtor and the Trustee carefully review financing statements, security agreements and related documents for defects. The lesson is that a creditor should be sure that it properly files its financing statements, that it polices its collateral, and that it diaries and renews its financing statements prior to their expiration. Often, a creditor realizes too late that its "security interest" never attached to the collateral. For example, a liquor license cannot be encumbered by a lien, but the cash proceeds from the sale of the license can be.

ADEQUATE PROTECTION.

Assets subject to a security interest are often necessary for the operation of a debtor's business. However, as an asset ages, it can depreciate in value or usefulness. The Bankruptcy Code recognizes the inequity in allowing a debtor to continue using the asset and allows secured creditors to be compensated for this use or to be "adequately protected" from the expected depreciation.

Adequate protection is the assurance that the secured creditor's position or security interest will not erode during the time the debtor is in bankruptcy but has not yet completed the plan confirmation process. A creditor's secured position can erode in two ways: (a) While the collateral remains approximately the same value, the debt becomes larger (due to accruing interest,) and threatens to exceed the value of the collateral; and (b) through a decrease in the value of the collateral, the debt threatens to exceed the value of the collateral.

As a result of these possibilities, the Bankruptcy Code requires that the debtor protect the secured creditor against the loss of its secured position. This protection may be granted by:

- Making payments to the secured creditor (e.g., a payment equal to accruing interest and depreciation caused by use);
- Through the granting of liens on additional unencumbered collateral so that a decrease in the value of the current collateral or an increase in the amount of the loan and interest will not leave the creditor unprotected;
- By proving to the court that the value of the collateral is sufficiently in excess of the amount of the loan such that the creditor is in no danger (the "equity cushion"); and/or
- By granting to the secured creditor a special bankruptcy priority in the event that it is not fully paid out of the collateral.

The exact protection afforded to the secured creditor is usually a matter of negotiation between the debtor and the creditor.

PREFERENCES.

Bankruptcy is designed to provide that creditors of the same type or kind be paid in similar proportions. As a result, the Bankruptcy Code contains provisions which provide that certain payments made to creditors within 90 days before the date of the filing of bankruptcy (one year for payments to insiders) are recoverable by the Trustee or the debtor acting as Trustee (in a Chapter 11.) These funds are then redistributed under the priorities set forth in the Bankruptcy Code. As a result, any payment that a creditor receives within 90 days of bankruptcy is subject to review to determine whether it is preferential.

In order to be deemed a preferential payment, a payment must be on account of an antecedent debt (not an equal exchange for current services,) it must be paid at a time when the debtor is insolvent, and it must allow the creditor receiving the payment to receive more than it would in a Chapter 7 liquidation. If any one of these standards are not met, then the Trustee may not recover the alleged preferential transfer.

Payments to secured creditors (unless they are severely undersecured) typically are not deemed to be preferential. In addition, payments made to trade creditors within the terms of their invoice are usually deemed to be payments in the ordinary course of business and not preferential. They are not deemed to be payments on account of an antecedent debt. However, payments, even a few days beyond the time period

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permitted in the creditor's documents, are suspect and subject to recovery by the Trustee. Again, policing the timing of the debtor's payments to a creditor, as well as the collateral, can avoid the problem of repayment of preferential transfers to the Trustee. An important lesson is to immediately deposit payments.

CONCLUSION

A landlord has a number of available strategies in the event a commercial tenant files bankruptcy. While the landlord must be cognizant of the automatic stay and assure that it does not take any actions which would violate the stay, the landlord is much better situated than other creditors in a bankruptcy filing. In order to take advantage of these strategies, however, the landlord needs to act promptly and remain diligent throughout the process.

Before rushing to avail itself of its many remedies, a landlord is well advised to take sufficient time to develop a primary objective. Is it preferable to remove the tenant at the earliest possible stage, regardless of any financial recovery? Such an objective would be appropriate with a troublesome tenant who overburdens the property, and to whom the landlord wishes it had never leased the premises in the first place. Conversely, if the tenant either occupies a significant portion of the space within the building, or has been a desirable tenant up to the filing, the landlord may prefer to employ strategies more calculated to recover as much rent as possible.

Regardless of the objective, the landlord should know that it has rights and remedies when one of its tenants files bankruptcy. While this article has highlighted and discussed a number of these remedies, it is not meant to be a replacement for seeking professional legal advice, as the bankruptcy process is complex. A proper and timely response to a bankruptcy filing can enable a landlord to enhance its position, whereas the failure to do so can lead to disastrous consequences.

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