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PERSPECTIVE

Remember, landlords are sacred cows in bankruptcy

By M. Jonathan Hayes

We have been getting a lot of calls recently as you might expect from distressed small businesses. The “free” government money is starting to run out and panic is setting in. The potential client explains that things are getting better and they just need a little more time to get back up to speed; they would like to know their options.

It’s unfortunate how many of these calls in the last year or two have been driven by employee litigation. The potential client, the small business owner, has been sued by a group of employees claiming they didn’t get the proper lunch breaks and that sort of thing. The client either can’t afford the defense or has spent a lot of money defending themselves and lost. Now the employees are trying to collect.

But the most common complaint is the landlord. These days the callers tell me they are a few months behind on the rent. Often they can’t afford the rent “and all the other charges” anymore anyway. They need a reduction in the rent but “the landlord won’t be reasonable.” Sometimes they need less space or other concessions. But the landlord is threatening to evict them which will “kill the business,” force them to lay off employees. Their lawyer told them to call me to see if bankruptcy might help.

Well, sorry but probably not. There are very few options for the small business dealing with the landlord in bankruptcy other than to do what the lease says — or move. The debtor’s lease in a bankruptcy case is an executory contract. It is an asset and a liability

at the same time. Possession of the space has value but the terms of the lease remain fully enforceable, whether in a bankruptcy case or otherwise.

In bankruptcy, irrespective of the chapter, the lease must be assumed or rejected. Section 365. That’s the choice. In Chapter 11, a lease of non-residential real property must be assumed or rejected within 210 days. Section 365(d) (4). The deadline can be extended for 90 days “for cause,” but if it is not assumed by the debtor within 210 days, it is rejected “and [the debtor] shall immediately surrender the [property] to the lessor.” Section 365(d) (4) (A). Prior to Dec. 27, 2020, the deadline was 120 days but Congress temporarily extended it from 120 days to 210 days. The additional time allowed will “sunset” on Dec. 27, 2022 and revert back to 120 days.

Now the bad news. If the debtor chooses to assume the lease, the debtor must, as part of the assumption, cure all financial defaults — “promptly.” Section 365(b) (1). The debtor must also provide “adequate assurance of future performance under the lease.” Section 365(b) (1) (c). So the four or five months (or more) the debtor is behind on the lease must be paid in full in order to assume the lease. The idea of promptly gives a little wiggle-room on when the cure payment is required but the debtor should not assume that the past due rent can be paid over time as part of the plan.

The debtor can certainly negotiate and try to get better terms, in essence modify the lease, but the bankruptcy court cannot make the landlord be “reasonable.”

What about the rent that comes due after the case is filed? The

Bankruptcy Code requires the debtor to “timely perform all the obligations” under the lease beginning the day the case is filed. Section 365(d) (3). If the case is filed on the 15th of the month, the debtor should pay half a month’s rent immediately, and next month’s rent on time. This obligation can be excused for 60 days “for cause,” but I sure wouldn’t count on getting that. The past due rent owing when the case was filed can wait until the motion approving the assumption of the lease but the debtor should not get further behind with the administrative, i.e., post-petition rent.

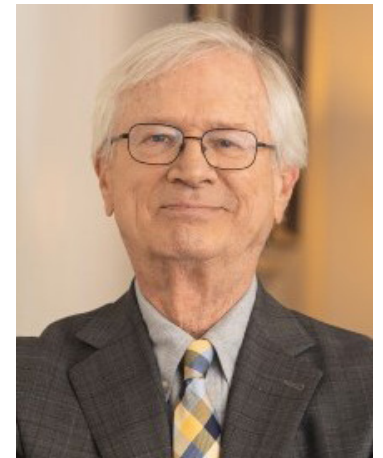
What if the lease expired before the Chapter 11 is filed? This happens under California law when the debtor is served with a three-day notice to pay rent or quit. If the rent is not paid and the time runs, there is no more lease under California law. There may be a right to relief from forfeiture but short of that, there is nothing to assume or reject. The bankruptcy court cannot fix that. What if the lease expires by its terms after the Chapter 11 is filed? Again, there is suddenly nothing to assume or reject. There is no lease and no right to possession of the property. Bankruptcy cannot bring it back without consent of the landlord.

Can the lease be sold, or can it be assumed but by another entity? Generally speaking, yes. But to be sold or transferred the lease must be assumed first, then assigned. And again, in order to assume, the debtor must not only promptly cure but give “adequate assurance of future performance.” If the lease is to be assigned after assumption, the new tenant must give adequate assurance of future performance. Section 365(f).

So what if the debtor decides to reject the lease? Besides the obligation to immediately surrender possession, rejection constitutes a breach of the lease and the landlord has a claim for damages. The amount of damages is whatever the landlord would be entitled to under non-bankruptcy law. The landlord is required under California law to mitigate its damages and that would factor into the amount of the claim in bankruptcy. In addition, the Bankruptcy Code limits the claim to “the greater of one year, or 15 percent, not to exceed three years” rent. Section 502(6). This is called the “Landlord’s Cap.” But there is a new unsecured claim for “rejection damages” which must be dealt with in the plan, along with the rest of the unsecured claims.

There is a little good news I suppose. The language in the

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typical lease that provides that the lease automatically ends on filing a bankruptcy petition is completely unenforceable. Section 365(e). Also, if the debtor is behind on the rent and files Chapter 11, the unlawful detainer stops until the landlord can get relief from stay from the bankruptcy judge. This is likely to take two months or so. This will

give the debtor time to move if that's the plan. But the rent that should have been paid for the two months postpetition is an administrative expense which must be paid in full if a Chapter 11 plan is to be confirmed.

Landlords have historically been overbearing knowing that they have the upper hand. They get their space back or payment

in full according to all the terms including the fine print in the lease (and attorney's fees of course). The bankruptcy will at least provide the beleaguered small business person some time to negotiate and maybe get a better deal but really not more than that. Many of the new clients I have spoken to the last few months have told me that

the landlord has been working with them and accepting late payments and lack of performance generally. But the potential client typically hopes the bankruptcy judge will make the landlord give them a better deal, a "more reasonable deal," a new lease. Well, that won't happen. Landlords are sacred cows in bankruptcy. ■