

Client Alert for Commercial Landlords: “Control The Space” and Pre-Bankruptcy Contractual Termination of Lease

20 Apr 2020

Mitchell B. Weitzman

When the economy weakens, as with the unprecedented effects of the current COVID-19 pandemic, certain office and retail tenants will be unable to satisfy their lease obligations, vacate or file bankruptcy. Landlords should anticipate the consequences of these developments and some may choose to be proactive rather than reactive, and one way is to consider sending notices of default and termination prior to a tenant's filing of a bankruptcy petition. Retail landlords, particularly, often wish to “control the space” for optimal tenant mix and leasing of a project. A pre-petition contractual termination of a lease gives the landlord an argument in bankruptcy court that the tenant's lease did not become part of the “bankruptcy estate” as of the petition date, and thus may not be assumed or assigned under Section 365 of the Bankruptcy Code. If a bankruptcy judge agrees, the landlord has moved one step closer to controlling its space. The bankruptcy courts will apply state law on the question of whether a landlord has effectively terminated the lease prior to the bankruptcy filing. Some states give tenants a right to redeem. Some leases expressly grant a right to redeem, and others contain express waivers of a right to redeem. Some states consider whether a state court has ruled on possession prior to a bankruptcy filing. These factors and others will determine if a landlord's pre-petition termination of lease was complete and effective under state law.

Some leases require a written notice and opportunity to cure, before a default arises. If so, a termination notice must follow that process. Other leases provide that non-payment of rent when due, with no notice required, is an immediate default which allows a landlord to exercise its remedies, including the landlord's contractual termination.^[1] Most commercial leases contain “savings clauses,” which expressly reserve full rent or damages resulting from a tenant's breach, notwithstanding a landlord's issuance of a notice of termination. A landlord must carefully review the lease before issuing a termination notice, to insure that such notice will not cancel future obligations contrary to the landlord's intention. In addition, before issuing such notices, landlords should review other pertinent documents, including guaranties, waivers or subordinations granted to tenant lenders, franchise riders, and the like. Often landlords have granted substantial rights to lenders and franchisors of their tenants in the event of default or termination.

If a bankruptcy judge determines that a commercial lease has become part of the bankruptcy estate, the debtor will have 120 days from the petition date to assume, or assume and assign, a lease (or earlier upon an order confirming a plan), with an option to extend that period for 90 days for cause, with further extensions available only by landlord consent, under Section 365(d) of the Bankruptcy Code. If not timely assumed, the lease is deemed “rejected” under the Bankruptcy Code. Often the decision to assume or reject a lease is contained in a bankruptcy plan of reorganization or Chapter 13 plan. In addition, upon rejection of a lease, a landlord is entitled to file a proof of claim for lease rejection damages subject to the statutory cap set forth in Section 502(b)(6) of the Bankruptcy Code.

If a debtor or trustee has retained its leasehold interest and the option to seek an order approving assumption of the lease, it must demonstrate to the bankruptcy court an ability to promptly cure any pre-petition rent default and perform its obligations prospectively, under Section 365(b)(1) of the Bankruptcy Code. Shopping center tenants who wish to assume and assign a lease have additional burdens, to show that a proposed assignee's business will not violate an existing lease provision on use, radius, location, and exclusivity or restrictive covenants within other leases or a master agreement at the shopping center, will not disrupt the tenant mix at the retail project, will not result in a substantial decline in percentage rent, and that the financial condition and operating performance of the assignee shall be similar to

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debtor's, under Section 365(b)(3) of the Bankruptcy Code. Landlords will have the opportunity to contest these motions, and often they are unhappy with bankruptcy judges' rulings because a landlord's view of the suitability of an assignee may not match the larger view of a judge. For instance, bankruptcy judges often have a broad view of an existing use clause. A pre-petition notice of termination is a landlord's attempt to avoid this somewhat uncertain process in bankruptcy court and to control its space.

If a lease has become part of the bankruptcy estate, the debtor will be required to satisfy its post-petition obligations (including payment of rent) pending its decision on assumption or rejection, under Section 365(d)(3) of the Bankruptcy Code. If it fails to do so, a landlord may file a motion for relief from the automatic stay under Section 362 of the Bankruptcy Code to obtain approval to seek possession under state law. Section 365(d)(3) also provides that the court may extend, for 60 days, any debtor obligations during the initial 60 days of a bankruptcy. In addition, upon rejection, the debtor or trustee is required to surrender the premises under Section 365(d)(4) of the Bankruptcy Code.

Crucially, any action against the tenant during a bankruptcy requires bankruptcy court approval through a lift-stay motion and order, and this extends to a debtor's failure to surrender the space following rejection of the lease or despite receiving a pre-petition termination of the lease. Taking action against a debtor without bankruptcy court approval violates the automatic stay under Section 362 of the Bankruptcy Code resulting in sanctions imposed by the bankruptcy court.

This summary is not intended to contain legal advice or to be an exhaustive review. If you have any questions regarding this article, please contact [Mitchell Weitzman](#) at Jackson & Campbell, P.C.

[1] Many force majeure provisions provide that payment of rent is not suspended due to listed events.

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TAGGED: bankruptcy, commercial lease agreements, commercial leasing, COVID-19, Section 365 of the Bankruptcy Code