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Tenant's Rights After Landlord's Bankruptcy: An Important Question During Tough Economic Times

As our sagging economy has impaired commercial real estate, evidenced most clearly in the dramatic declines in the stock prices of publicly traded REITs and real estate operating companies. The possibility of commercial landlords filing for bankruptcy has increased substantially. A bankruptcy filing by a commercial landlord creates thorny issues, and a commercial tenant should be aware of its rights in that event. Unfortunately, the scope of the tenant's rights is limited, and not surprisingly, a tenant is often dealing with the proverbial "lesser of two evils." Nonetheless, a commercial tenant is well advised to consider the issues in advance if it gets wind of a possible bankruptcy filing by its landlord, in an effort to minimize its out-of-pocket expenses as well as to ameliorate the effects of the possible disruption to its business.

At the outset, we note that this article is directed primarily to tenants of office and industrial properties. A retail landlord's bankruptcy, as well as the relationship between retail landlords and retail tenants generally, involves unique issues and corresponding legal rights. While much of this article is relevant to retail tenants, those unique issues and corresponding legal rights involve additional complexity that we will not address in this article.

Special Purpose Bankruptcy Remote Entities

As a preliminary matter, tenants can derive some comfort from the fact that commercial real estate is less likely to be exposed to bankruptcy nowadays because properties are now often owned by special purpose bankruptcy remote entities, commonly referred to as "SPEs." SPEs are entities that are formed for the purpose of avoiding insolvency. They are the product of mortgage securitization and are intended to protect the holders of the securities from having the underlying mortgages compromised by a landlord bankruptcy.

However, if a landlord is an SPE, the landlord could be exposed to the risk of bankruptcy if the income source for the SPE (i.e., the rental income from the property) is affected by increasing vacancies and defaults. Such exposure is more foreseeable in a single-tenant property than a multi-tenant property. If the situation does arise, it is likely that the lender (e.g., the servicer for the securitized mortgage) will take over the property without a landlord bankruptcy, and the rights of the tenants will be determined by the subordination provisions of their leases. At least that is the intended result. Since mortgage securitization has proved to have more problems than many realized, it will be interesting to see if the SPE structure can achieve this result.

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Bankruptcy's Effect upon Existing Leases

If a landlord is not an SPE (or if the SPE structure does not achieve its intended result) and a bankruptcy filing occurs, all of the landlord's property becomes part of an estate to be administered for the benefit of the landlord's creditors. This includes a landlord's rights under unexpired leases. Following the bankruptcy filing, the landlord remains as "debtor in possession," or a trustee is appointed to act on behalf of the bankruptcy estate, depending in part on whether the bankruptcy is a reorganization or a liquidation. (We will generally refer to the landlord for the remainder of this article, but a bankruptcy trustee has the same

rights and may be acting for the bankruptcy estate in many instances.) Once the filing occurs and the bankruptcy estate is created, the landlord has the option of assuming (and perhaps assigning to a third-party purchaser) or rejecting any unexpired leases.

If a lease is assumed, the lease continues in full force and effect, and the tenant retains all of its rights under the lease. The landlord is entitled to assume the leases and assign them in connection with the sale of underlying

located (e.g., the tenant might operate a business not sufficiently “upscale” for the landlord’s future plans, might have densely populated space that strains the building’s systems, or might be experiencing financial difficulty itself).

If a lease is rejected, the tenant has the right to remain in possession of the leased premises or, if the rejection gives rise to a right of termination under the terms of the lease or applicable state law, to treat the lease as terminated. In addition, the rejection is deemed to be a

leasehold—typically from the proceeds of the sale.” However, “adequate protection” may not fully compensate a tenant for all of its out-of-pocket costs.

Tenant Options If a Lease Is Rejected

Under the Bankruptcy Code, a rejection of the lease constitutes a breach, and the lease can be treated as terminated by the tenant if the terms of the lease or applicable state law gives rise to a termination right as a result of such breach.³ Finding an express termination right in the lease or under state law is uncommon, however. Consequently, a tenant is in a state of theoretical ambiguity following rejection. Fortunately (for the tenant), the rejection almost invariably equals termination because the landlord has affirmatively indicated that it wants the tenant out of the property and is unlikely to fight a tenant’s claim of a deemed termination. Nonetheless, a tenant would be well advised to secure a written termination agreement to confirm that it is not exposed to any alleged liabilities following the rejection of its lease.

If the tenant does not want to treat the rejection of the lease as a termination, the Bankruptcy Code allows the tenant to remain in possession of the leased premises, in which case the tenant must continue to pay rent in accordance with the terms of the lease.⁴ If the tenant elects to stay in possession of the leased premises after the landlord rejects the lease, the landlord may not evict the tenant unless the tenant defaults in the performance of its obligations under the terms of the lease.

In the event of a rejection, the right to remain in possession is the only protection provided to a tenant under the Bankruptcy Code, and the rights of a tenant who remains in possession under a rejected lease are unclear. The Bankruptcy Code allows the tenant to retain all of its rights that are “in or appurtenant to

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property. Prior to assuming the lease, however, the landlord must cure any defaults outstanding under the lease, and must provide “adequate assurance” of its ability to perform its obligations under the lease following assumption.¹ A bankrupt landlord is often willing to assume a lease to keep the rent stream flowing. However, if a tenant is paying below-market rent, the landlord is more likely to reject the lease in an effort to re-lease the space and secure a higher rent (though probably not in the current market where all paying tenants are appreciated, even if their rent is potentially below market). Furthermore, even if the rent is market or above market, there are other considerations that might influence a bankrupt landlord to reject a lease.

For example, the lease might cover only a small portion of the building, or a lease might break up potentially large blocks of contiguous space that would be more profitable to lease in their entirety. In either case, a landlord may believe the property is more valuable if it is available for a larger user. Alternatively, the tenant may not fit the landlord’s desired profile for the building due to a change in the tenant’s circumstances or a change in the area in which the building is

breach of the lease as of the date of the bankruptcy filing, so the tenant becomes an unsecured creditor of the bankruptcy estate to the extent of any damages that arise from the breach.

A final possibility arising from a landlord bankruptcy filing is the ability of the landlord to sell the property free and clear of any interest in the property (including tenants’ interests under leases).² In such an event, the property may be sold subject to or free and clear of tenants’ leasehold interests. It is vital that a tenant promptly review any proposed sale documentation impacting its lease to ascertain the intention of the landlord and its proposed purchaser. Each affected tenant will be entitled to “adequate protection” of its interest under Section 363(e) of the Bankruptcy Code, and there may be room for negotiation with the landlord and/or the purchaser. In *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC, In re Qualitech Steel Corporation*, 327 F.3d 537 (7th Cir. 2003), the court held that “[a]dequate protection’ does not necessarily guarantee a lessee’s continued possession of the property, but it does demand, in the alternative, that the lessee be compensated for the value of its

the real property,” including rights such as “any right of use, possession, quiet enjoyment, subletting, assignment or hypothecation.”⁵ With respect to other rights under the lease (such as the landlord’s obligation to repair and maintain the property, to provide building services, and to rebuild in the event of casualty), whether or not they are “in or appurtenant to the real property” is a factual question for the bankruptcy court to determine based upon the underlying lease and applicable state law.

In a multi-tenant building, remaining in possession under a rejected lease would be risky because the tenants rely on the landlord to be responsible for rights that may not be considered “in or appurtenant to the real property.” In contrast, in a single-tenant building where the lease is often a triple net lease, the tenant could become responsible for some or all of these obligations and remaining in possession would be less problematic. To the extent a landlord is not required to perform its obligations under a rejected lease, the Bankruptcy Code provides that the tenant’s sole remedy against the nonperforming landlord is to offset damages against the rent payable under the lease after the date of the rejection of the lease.⁶ As the offset is limited to the total future rent payable, this would likely be an incomplete remedy for a tenant in a multi-tenant building. However, this remedy could be sufficient in the single-tenant, triple net lease context. A tenant may need rights in addition to offset rent to effectively use the offset right, and those rights might be limited to those provided by the underlying lease and applicable state law. The Bankruptcy Code does not clearly identify a right of self-help in such instances, but such right may be implied by a bankruptcy court to allow the tenant to make use of the offset right. For example, if a roof developed a leak, a court may allow the tenant to repair the leak and offset the cost of repair against the rent rather than having to wait for the leak to cause damage and

then offset rent on account of the damages caused.

Similarly, if a landlord fails to fulfill certain obligations that the bankruptcy court finds are continuing obligations of the landlord after filing for bankruptcy (as opposed to claims accruing prior to filing) and the lease or applicable state law provided the tenant a termination right due to the landlord’s failure to perform the obligations, the tenant may be able to terminate post-rejection if the tenant determines that continued occupancy is not viable. However, a court could find that an express termination right did not survive rejection or that such termination right is precluded by the right of the tenant to offset rent. When determining its course of action, each tenant must carefully consider the risks associated with the landlord’s failure to comply with its obligations under the rejected lease and the significance of any claims accrued prior to the landlord filing for bankruptcy. A tenant must consider factors such as whether the tenant or the landlord has repair and maintenance obligations under the lease,

was held in escrow or commingled with the landlord’s operating funds. Most leases and states allow commercial landlords to commingle security deposits, in which case they are likely to be included in the bankruptcy estate. A tenant trying to recover a commingled security deposit would likely be treated as an unsecured creditor. However, if a cash security deposit is held in escrow or otherwise segregated so that it is identifiable, then it is less likely to be considered part of the bankruptcy estate. If the landlord does not have a possessory interest in the cash, there is a greater chance that the tenant could recover the security deposit.

Unlike a cash deposit, a security deposit in the form of a letter of credit should not be subject to a fact-specific analysis because the landlord only has a right to draw under the letter of credit if the tenant fails to perform under the lease. The landlord has a possessory interest in the letter of credit, but has no right to the proceeds absent a tenant default. Further, the tenant does not have to recover the letter of credit in the same way it has to recover a cash security deposit. Consequently, if the lease

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the extent of such obligations, the condition of the property as a whole, the term of the lease, the availability of alternative space, potential relocation issues, and allocation of responsibility for building and utility services.

Security Deposits

Another important issue for a tenant is whether its security deposit will become part of the bankruptcy estate. If the security deposit is a cash deposit, a bankruptcy court will undertake a fact-specific analysis and examine whether the cash

expires or is validly terminated without a tenant default, the letter of credit should lapse in accordance with its terms or be surrendered by the bankrupt landlord in accordance with the lease.

Prospective Protections

Landlord bankruptcy is rarely considered a significant issue when a lease is initially negotiated. As the foregoing suggests, there are limited steps that a tenant can take to protect its rights during the original negotiation of the lease. However, provisions purporting to give

tenants specific rights conditioned upon or triggered by the landlord's bankruptcy or insolvency (often called "ipso facto clauses") are unenforceable in bankruptcy. Protective provisions that do not link a tenant's rights to an event of bankruptcy or insolvency may also be unenforceable despite a bankruptcy because bankruptcy courts will look closely to determine whether cleverly worded contract language is merely a veiled ipso facto clause. Although they may be unenforceable, it is worth adding protective provisions that define not only the landlord's obligations to repair, provide services, and rebuild, but also the tenant's right of self-help and termination in the event of the landlord's failure to satisfy such obligations as rights "in or appurtenant to the real property." A tenant might also want to include negotiated language in the lease, reserving its rights to terminate the lease where the bankrupt landlord rejects its lease. Finally, a tenant could try to protect its security deposit by negotiating for the option to furnish the security deposit either in cash or by a letter of credit. Due to the administrative issues associated with creating and maintaining a separate account for the individual tenant, a landlord is not likely to agree to such a provision.

Subleases

Commercial subtenants face a more difficult position in the event of a landlord or sublandlord bankruptcy. If the landlord files for bankruptcy and the lease is rejected, the subtenant will have no rights under the Bankruptcy Code vis-à-vis the landlord or its sublandlord (the prime tenant). In that event, the subtenant is dependent upon the

actions of its sublandlord. If its sublandlord terminates the lease, then the sublease would likely be terminated as well. If, on the other hand, its sublandlord does not terminate following the rejection of the lease, the subtenant may be obligated to remain in space that no longer has all of the benefits under the lease that the subtenant bargained for.

In addition, a subtenant faces the risk that its sublandlord could declare bankruptcy. In that event, the sublandlord has the right to reject both the lease and the sublease, which will severely limit the rights of the subtenant. If the lease is rejected, it is almost certain that the sublease will be rejected as well, and the subtenant will have no rights under the Bankruptcy Code vis-à-vis the landlord. The subtenant will retain its unsecured claim against the sublandlord for damages arising from the deemed breach of the lease, but that is likely to be a hollow comfort. If the subtenant has obtained a nondisturbance agreement from the landlord at the inception of the sublease (which is generally difficult to achieve), then the subtenant may have the right to remain in possession of its space under the terms of the lease or the sublease. Such rights would depend upon the terms of the nondisturbance agreement.

Conclusion

A landlord's (or sublandlord's) bankruptcy and the rejection of a lease (or sublease) provide the tenant with limited options. Unfortunately, the outcome for a tenant (or subtenant) is uncertain and its rights, to the extent available, will often be determined by a fact-specific

analysis conducted by a bankruptcy court. A tenant (or subtenant) should closely monitor, and be prepared to act quickly following, any landlord (or sublandlord) bankruptcy filing in an effort to minimize its out-of-pocket expenses and ameliorate the effects of the possible disruption to its business.

endnotes

- 1 11 U.S.C.A. § 365(b)(1)(C) (West 2008).
- 2 *Id.* § 363(f).
- 3 *Id.* § 365(h)(1)(A)(i).
- 4 *Id.* § 365(h)(1)(A)(ii).
- 5 *Id.* § 365(h)(1)(A)(ii).
- 6 *Id.* § 365(h)(1)(B).

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