

Demystifying the Bankruptcy Process - Part Five

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The COVID-19 pandemic created a lot of turmoil in every industry and every company. Stay-at-home mandates forced most retailers, restaurants, and event venues to close their doors without realistic prospects of a return to pre-COVID operations. The risk of dealing with a company in financial distress was at an all-time high. Understanding the bankruptcy tools available to a company that is on the path to or already in a court-supervised reorganization can help you in managing and reducing this risk.

Chapter 11 of the Bankruptcy Code governs the restructuring of businesses and individuals' assets and liabilities. The proceedings under chapter 11 bring all stakeholders to one forum and facilitates global resolution of claims and liabilities. It may have a different impact on the different stakeholders – secured and unsecured lenders, trade creditors, employees, and landlords.

What If You Are A Landlord?

If you find yourself a landlord of a company that filed for a Chapter 11 protection, you can enjoy some unique rights that put you in a better position than any other typical unsecured creditor. However, vigilance is essential because highly accelerated sales procedures and first-day motions may negatively impact the landlord's protections.

The financial risk to a landlord is somewhat different in two discrete time periods: 1) before the debtor's decision to assume or reject the lease and 2) after the debtor decides to reject the lease. In the first time period, the debtor tenant is typically still in possession and the landlord cannot re-let or market the space.

Pre-Assumption/Rejection: Thanks to the special protections for commercial real estate landlords under Section 365(d) of the Bankruptcy Code, between the date on which the petition is filed and the date on which there is a judicial order approving a rejection or assumption of the lease, a debtor tenant is required to timely perform all of its obligations under the terms of the lease.

Post-Assumption/Rejection: After the determination is made whether to assume or reject, landlords are subject to a risk of significant monetary loss if the debtor rejects the lease. The landlord's unsecured claim for termination damages is capped by Section 502(b)(6)(A) of the Bankruptcy Code, which limits a landlord's claim to the rent reserved for the greater of one year or 15 percent of the remaining term not to exceed three years. Even though most courts hold that a rejection can only occur with a formal court order, some courts have approved an effective date of the rejection can be earlier than the date of the order, making the rejection retroactive. This impacts a landlord's ability to collect rent and enforce the lease prior to a debtor's

decision to "assume" or "reject" the lease, described above.

Some other risks to keep in mind: 1) Pre-bankruptcy lease termination is difficult and may be set aside by the bankruptcy court. A lease termination fee may be viewed as a preference or fraudulent conveyance, and 2) the debtor is entitled to assume despite defaulting on the lease and despite any contractual clauses contrary to that. The Bankruptcy Court in effect provides a federal cure right and the debtor can assign the lease despite anti-assignment clauses.

In case you missed it, read [part one](#), [two](#), [three](#), and [four](#) here.

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