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Property & the Law

By Richard Levy Jr.

Owners Can Minimize Tenant Default Risks

The roadside warning sign, "Reduce Speed–Dangerous Curves Ahead," is all too familiar. Similar caution is equally prudent for commercial landlords, who face potentially risky roads when leasing property to tenants: How can a landlord minimize the financial risk of a tenant's default? If the tenant becomes a debtor in bankruptcy, and elects to reject the lease, how can the landlord maximize recovery of the lost rent?

The landlord's economic security and ultimate recovery will be improved by credit enhancements obtained from third parties.

A tenant's bankruptcy raises special concerns for the landlord. Will it perform the lease during the bankruptcy case? Will the tenant survive long enough to reorganize? How long can the tenant put the property on hold without specifically agreeing to assume or reject the lease? Can it sell the lease, even if there are restrictions on the assignment of the lease or use of the premises? Can the landlord liquidate any security deposit or pursue a guarantee to minimize its loss?

Federal Bankruptcy Code provides some technical answers. There are specific time limits during which a tenant may keep the lease without formally assuming or rejecting it, but it must perform the post-petition obligations of the agreement during that period and may obtain extensions beyond the statutory time limit only with the landlord's approval. With certain exceptions, the tenant can sell the lease, even in the face of anti-assignment or use restrictions. Of course, if the debtor-tenant assumes (or assumes and assigns) the lease, the landlord is entitled to be paid for all monetary defaults through the time of assignment and to receive adequate assurances of future performance from the assignee. A property owner should almost always be able to take advantage of security deposits, letters of credit or other credit enhancements given to back the tenant's obligations.

If the tenant-debtor rejects the lease, the landlord may recover possession of the property, re-lease it to a new tenant and assert general unsecured claims in the bankruptcy for unpaid pre-bankruptcy rent and post-rejection future rent. The landlord can also assert administrative expense claims for unpaid post-bankruptcy obligations due through the time of the rejection. Unsecured claims typically recover only partial distributions ratably with all other general unsecured claims, as they are the lowest ranked creditor claims and are only entitled to payment from the residual proceeds of the bankrupt entity's assets. Thus, unless the estate is solvent, general creditors rarely recover their allowed claims in full.

However, the amount of the landlord's claim for future rent, known as "rejection damages," is statutorily capped at the greater of one year, or 15% not exceeding three years, of the remaining lease term. If the landlord holds a security deposit or letter of credit furnished by the tenant, it may realize the full value of the deposit proceeds. The face amount of the capped unsecured claim normally will be reduced dollar for dollar by that recovery. A cash security deposit or other collateral furnished by the tenant remains property in which the bankruptcy estate retains an interest until the bankruptcy court authorizes liquidation of the collateral. This, in turn, requires prior authorization by the court.

In contrast, a letter of credit furnished by the tenant's bank, a deposit paid from a third party or a guarantee collateralized by a third party is not estate property. It can be readily accessed by the landlord upon occurrence of a default, which may, under the lease documents, include the tenant's bankruptcy filing. Thus, the landlord's economic security and ultimate recovery will be materially improved through credit enhancements obtained from third parties.

Landlords whose obligations from tenants are not secured by assets of the tenant should proceed with care before filing a proof of claim in the tenant's bankruptcy case if the lease is rejected. Such a filing constitutes an affirmative submission to the bankruptcy court's jurisdiction to adjudicate all aspects of the debtor-creditor relationship and will trigger the statutory cap on the landlord's lease rejection damages.

Nothing in this discussion should dampen a landlord's enthusiasm for any credit enhancements it can obtain to protect itself. While the landlord's road in a tenant's bankruptcy case may not be free of difficult turns, the careful structuring of lease documents and the judicious use of security devices for the lease obligations should enable the landlord to more quickly resume normal speed. —RENY

The views expressed in this article are those of the author and not Real Estate Media or its publications.

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