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In the Wake of COVID-19: Protective Actions Retail Tenants Should Take When Facing a Landlord's Bankruptcy

By Monique D. Almy, Gregory D. Call, Thomas F. Koegel, and Randall L. Hagen*

This article addresses just one of the consequences in the wake of COVID-19: the expected rise in bankruptcy filings by commercial landlords and, as a corollary, what retail tenants should do to protect their rights and seek available remedies when faced with a landlord's bankruptcy.

Retail tenants are experiencing unprecedented difficulties stemming from the COVID-19 pandemic, including government shutdown orders for non-essential businesses and shelter-in-place rules that have virtually stopped all in-person shopping. Even as these restrictions are finally being relaxed to a limited degree, the dramatic effects of the pandemic will long be felt in the retail industry. This article addresses just one of the consequences in the wake of COVID-19: the expected rise in bankruptcy filings by commercial landlords and, as a corollary, what retail tenants should do to protect their rights and seek available remedies when faced with a landlord's bankruptcy.

When a landlord files for bankruptcy, it has the right under the Bankruptcy Code to "assume" (to keep in place) or "reject" (to elect to breach the lease as of the date of the bankruptcy) its unexpired tenant leases.[1] Neither of these options under the Bankruptcy Code changes the terms of a lease. But a tenant who is unaware of the operation of bankruptcy law, or who is unfamiliar with the rights provided under its lease, risks losing or impairing its lease rights. The unprepared tenant could also lose potential opportunities unique within bankruptcy to improve the position of its lease *vis-à-vis* other tenants and creditors of a landlord. A summary of a bankrupt landlord's options, and a retail

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1 *See* 11 U.S.C. § 365(a).

tenant's responses to protect and even improve its lease position, are discussed in turn below.

WHEN THE BANKRUPT LANDLORD WISHES TO KEEP A RETAIL LEASE: TENANT HAS FULL RIGHTS TO REQUIRE A LANDLORD TO CURE BREACHES IF THE LANDLORD SEEKS TO "ASSUME" THE LEASE

Most landlord bankruptcies begin with the debtor-landlord seeking to reorganize (as opposed to liquidate). The landlord thus will desire to assume and retain existing retail leases with terms favorable to it. Retaining rent-paying tenants is the lifeblood of every commercial landlord, especially those tenants under leases commencing prior to the COVID-19 shutdown that now may have an above-market rental rate.

To Assume and Retain a Lease, a Bankrupt Landlord Must Cure All Breaches, with Monetary Breaches Paid 100 Cents on the Dollar

The prospect of being tied to an above-market lease is considerably less appealing to a retail tenant. Fortunately, the Bankruptcy Code requires that prior to lease assumption the landlord must promptly cure all existing defaults. These would include non-payment of a tenant's improvement allowance or failure to maintain the property to the required standard. Perhaps most significantly, a landlord could not assume a lease in the face of breaches of conditions regarding tenant mix, shopping-center occupancy, and other obligations regarding quality of the leasehold.

Some lease defaults that cannot, as a practical matter, be cured, such as a landlord's failure to provide cleaning services or building security prior to assumption, are not required to be cured. But even in regard to these breaches, the tenant is entitled to a monetary payment for resulting losses. And, finally, the landlord can assume a lease only after it demonstrates "adequate assurance of future performance," meaning that the landlord will not default in the future.

Any monetary cure payment is not paid as a pre-petition unsecured claim, which type of claim typically only receives pennies on the dollar. In order to keep the lease, landlords will need to pay in full any monetary damages that are established. If those payments cannot be made, or if conditions to the effectiveness of the lease cannot be satisfied, a tenant's objection in the bankruptcy court will prevent the landlord from keeping the lease until damages are paid or conditions satisfied.

A Tenant with a Full Understanding of the Provisions of Its Lease May, By Objecting to Assumption, Create Powerful Leverage for Negotiations to Obtain Affirmative Recoveries or Rent Concessions on the Lease

That the landlord is required by law to cure breaches presents an excellent opportunity for a retail tenant to renegotiate its existing lease on more favorable terms. The tenant may accomplish this by carefully analyzing its existing lease and preparing a detailed and documented list of the landlord's past and ongoing breaches. This analysis should include not only "pecuniary loss" stemming from defaults but crucial non-monetary breaches that negatively affect the value of the leasehold to a tenant.

The prepared retail tenant will be armed with hard data to back up its request to the bankruptcy court that the landlord be required to cure its breaches and pay all monetary losses before it is allowed to assume the lease. In the face of such a detailed objection by the tenant, the landlord will be compelled to come to the table.

In contrast, if a tenant fails to prepare and instead opposes assumption by relying on general allegations of a landlord's noncompliance, then it is more likely the bankruptcy court may permit assumption based on nothing more than the landlord's general assurances to cure. Such assurances are of course worth little.

WHEN THE BANKRUPT LANDLORD WISHES TO RID ITSELF OF A RETAIL LEASE: TENANT HAS THE RIGHT TO REMAIN IN POSSESSION EVEN UPON "REJECTION" OF THE LEASE

Where a retail lease contains terms unfavorable to the bankrupt landlord, it may elect to reject the lease. Fortunately for tenants, the Bankruptcy Code contains special protections so that a landlord cannot reject a lease in order to simply evict a tenant.

A Landlord Cannot Remove a Tenant from Its Leasehold Premises by Rejecting the Lease; Instead, It Is the Tenant's Choice Whether to Stay or Go

Section 365(h) of the Bankruptcy Code provides that if a debtor-landlord rejects a real estate lease, the tenant has two choices.

First, the tenant may treat the lease as terminated and vacate the premises (and file an unsecured claim in the bankruptcy case for damages caused by the landlord's termination).

Second, so long as the lease term has commenced, the tenant may elect to remain in possession at the same rental rate for the remaining term, including any renewal or extension period, as provided in the lease and permitted by state law.

If the tenant elects to remain in possession, then it must continue to pay rent and perform all its other obligations under the lease. The landlord, however, will no longer be required to perform its lease obligations, such as repairs, maintenance, or building security, thus potentially compelling the tenant to perform the landlord's obligations. The tenant is entitled to offset its expenditures in performing the landlord's duties, as well as damages related to the landlord's failure to meet lease conditions such as tenant mix and shopping-center occupancy, against future rent. These requirements are expressly protected by the Bankruptcy Code. Notably, the rent offset is the tenant's sole recourse against a rejecting landlord.

Even Where a Bankrupt Landlord Seeks to Reject a Lease, and the Tenant's Rights Appear Assured by the Bankruptcy Code, the Tenant Must Be Vigilant to Ensure That the Landlord Does Not Take Steps in the Bankruptcy to Eliminate Those Rights

A tenant's rights upon landlord rejection should be preserved by law. Nevertheless, debtors in bankruptcy frequently take advantage of the willingness of some bankruptcy courts to allow a debtor to take acts that are beyond the written powers of the law itself. In practice, many proceedings in bankruptcy are done on what is colorfully called a "scream or die" basis. The debtor mails (or sometimes merely emails) a short notice to what might be thousands of creditors, seeking court authorization to act in furtherance of the debtor's reorganization.

Unfortunately, where creditors have not been diligent in reviewing such notices and therefore fail to "scream," they may find that their rights have effectively "died." A landlord might, for example, ask the court to set a deadline for all tenants under rejected leases to elect to keep their lease and stay on the premises, with a tenant's failure to object on a short timeline constituting an abandonment of the tenant's leasehold. Tenants must remain vigilant throughout a bankruptcy proceeding to avoid being caught in such a trap.

WHEN THE BANKRUPT LANDLORD SEEKS TO SELL THE PROPERTY IN WHICH A RETAIL TENANT HAS A LEASEHOLD

Along with assumption of leases by a reorganizing landlord, a retail tenant may find that its landlord intends to raise needed cash by selling the property in which its leasehold exists. This sale would occur to a new entity, such as a different commercial landlord. The purchaser might even be a newly created entity that looks very much like the old landlord, but which is not burdened by the bankrupt landlord's debt incurred prior to the COVID-19 crisis. Courts dealing with this scenario have developed case law that is far less clear on whether a tenant has the right to remain in possession of the premises, and of the benefits of its existing lease.

A Tenant Must Be Alert to the Possibility That Its Landlord May Seek to Strip Off Its Lease Rights by Selling the Property to a Different Landlord

The sale of a property subject to a retail lease would occur as a "363 sale" in bankruptcy. Section 363 of the Bankruptcy Code allows a debtor, under certain circumstances, to sell its assets "free and clear" of existing liens and interests.[2] This provision was used, for example, to allow "new General Motors" and "new Chrysler" to acquire the working assets of their predecessor companies while shedding original liabilities. The "interests" that may be affected by such a bankruptcy sale include retail leases. Consequently, an apparent conflict arises between Sections 363(f) (which appears to allow the sale of real property free of leases) and 365(h) (which preserves a tenant's rights).

Federal courts are split on which section trumps the other.[3] The majority view holds that the possessory interests of tenants under Section 365(h) are superior to the rights of asset purchasers under Section 363(f), which means the retail tenant can continue to possess and operate its business even after a 363 sale. The minority view says that a 363 sale can be free and clear of tenant interests if the leases are not rejected under Section 365(h). Even the minority position, however, allows for tenants to protect themselves by demanding adequate protection under Section 363(e) in response to a proposed sale free and clear. Adequate protection may include the right to remain in possession of the leased premises.

A Timely Objection in the Landlord's Bankruptcy Is Necessary for a Tenant to Have Any Chance of Preserving Its Lease Rights in a 363 Sale

So how does the retail tenant avoid this potential trap? Simple answer: be vigilant!

In *Spanish Peaks,* for example, the U.S. Court of Appeals for the Ninth Circuit (governing nine western states including California) adopted the

[2] *See* 11 U.S.C. § 363(f).

[3] *See In re Spanish Peaks Holdings II, LLC*, 872 F.3d 892, 898 (9th Cir. 2017) (citing cases taking the "majority" approach and "minority" approach).

minority view that disfavors tenants. But even worse for the tenant, the circuit court declined to address what adequate protection would be due the tenant (which is available under the minority view) because it had failed to ask for adequate protection at the bankruptcy court level.

The bottom line is simple but critical: before your landlord files for bankruptcy, know your lease terms and the rights created therein, and as soon as your landlord files for bankruptcy ensure you are on the electronic notice list in order to receive immediate notification of all filings by the debtor-landlord. Read the notices to stay abreast of any activity in the case which could interfere with your leasehold rights, such as a motion to assume or reject under Section 365 or motion to authorize a Section 363 sale. The retail tenant who is not actively aware of developments in its landlord's bankruptcy risks losing its lease, possession of the premises, and other rights it may have against the landlord.

CONCLUSION

The retail industry has been among the hardest hit by the COVID-19 pandemic. As society moves through the shutdown stage and begins reopening, if only gradually, economic suffering will remain. Thus, in COVID-19's wake, retail tenants must be prepared to know and pursue their rights and remedies in a landlord's bankruptcy proceeding.

This requires knowledge not only of the Bankruptcy Code's treatment of assumption and rejection of an unexpired lease, but, critically, a detailed understanding of rights granted in the unexpired lease itself. Where threat of landlord bankruptcy exists, retail tenants should be preparing now to face a potential rapid onslaught of actions in a bankruptcy proceeding which likely will affect their leasehold rights. Forewarned is forearmed.