

5 Issues for Landlords During a Bankruptcy Lease Rejection

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When a commercial tenant files for bankruptcy, they have the option to assume or reject unexpired leases. A bankruptcy lease rejection is a significant action, as it communicates the debtor's intent to hand back the space.

In today's real estate market, tight supply for space has many commercial landlords eager to get their premises back so they can charge higher market rents. But, before you take those keys back, here are five issues to keep in mind:

When is the Effective Date for the Lease Rejection in Bankruptcy?

Although rejection of a commercial lease is effective only upon court approval, courts have the equitable power to order a rejection to operate retroactively, often to the bankruptcy petition filing date. This means that the effective date of rejection can be set earlier than the date on which the landlord retakes possession of the premises.

Early in the bankruptcy case, a debtor may file a motion to reject the lease as of the petition date. However, if the debtor was operating the premises between the petition date and when the motion is heard, you may have a good argument to oppose setting the rejection on the petition filing date. If successful, you could receive rent for this period and seek to be paid ahead of other creditors as an administrative claim.

Understand and Properly File Your Claims

Bankruptcy Code Sections 502 and 365 provide the various claims that landlords have in a tenant bankruptcy, including:

- a pre-petition claim for all amounts prior to the filing;
- a post-petition administrative claim for all amounts between the petition date and rejection or assumption of the lease; and
- a rejection claim for all amounts from rejection to the end of the lease.

Since the rejection of a lease does not terminate the lease, but rather constitutes a breach of the lease, the landlord can file a claim for damages resulting from the rejection.

However, there is a cap on the landlord's claim for lost rental income damages under the Bankruptcy Code. This cap is designed to balance the interests of the landlord and the bankruptcy estate, limiting the landlord's claim to a reasonable amount while allowing the estate to reorganize or liquidate without being unduly burdened by excessive claims.

Under section 502(b)(6) of the Bankruptcy Code, landlord rejection claims are capped at the rental amount for the greater of:

- one year; or
- 15 percent of the remaining lease term (which cannot exceed three years).

It is important to understand these landlord claims and ensure that they are filed on time in the bankruptcy court. Often, the debtor will place a 30-day time period to file rejection claims from the rejection date. Although creditors have the ability to amend their claims, the Bankruptcy Court is very strict about adhering to the claim deadlines.

Inspect the Space, Prior to Bankruptcy Lease Rejection

Issues can arise whether a claim is an administrative claim or a rejection claim. If it is an administrative claim, the claim has higher payment priority – meaning you may actually get paid your full claim, as opposed to a pro rata distribution.

Often a landlord will assert that damages arose while the tenant was in possession and that repairs should have been handled during this pre-rejection period. Debtors may assert that the damages occurred after the rejection date. To ensure that your claim is accurate, it is advisable to request an inspection of the premises prior to any lease rejection in bankruptcy. Reports, photos and eyewitness accounts can greatly assist with ensuring the proper priority of your claim.

Negotiate Side Letters

When a debtor rejects a lease they may request a bit of time to conduct going out of business sales. Often you can reach out to the debtor to negotiate terms of the going out of business sales – how often sign-walkers will publicize the sales, what is secured to the building, placement of sale ads, etc. All of these items can affect your claims before and during the rejection period.

Experienced and effective legal counsel can assist to allow you access to inspect your space, ensure that signs are not “hammered” into your building causing damage, and explain how your claims will be treated.

Secure Your Space

Once the leased space is rejected, it is imperative to act quickly to secure your property to protect your interest. Reaching out to the debtor to gain HVAC and security codes prior to turnover, as well as keys can save you time and money.

Rejection of a commercial lease in bankruptcy involves a careful balancing of interests, with specific provisions in place to protect both the landlord's rights and the debtor's ability to manage their bankruptcy estate effectively. Thinking about these five issues before a bankruptcy filing can ensure that you are managing your property as best as possible.

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