# Commercial Lease Law Insider®

The Practical, Plain-English Monthly Newsletter for Owners, Managers, Attorneys, and Other Real Estate Professionals

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# How New Bankruptcy Code Changes Will Affect You

On April 20, 2005, President Bush signed the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.* This new law makes five changes to the U.S. Bankruptcy Code that could benefit you—whether you own a shopping center or an office building—if a tenant files for bankruptcy, say Maryland bankruptcy attorney Michael J. Lichtenstein and New Jersey real estate/bankruptcy attorney David J. Rabinowitz. But along with the good news, there's some bad news: a change to the Bankruptcy Code that could hurt you.

Most of the new law's provisions, including those discussed below, go into effect on Oct. 17, 2005, although some apply now to all new bankruptcy filings. Here's a rundown on the five changes in the new law that could benefit you and the change that could hurt you.

## Five Beneficial Changes

The new law will change the Bankruptcy Code to your benefit you in the following ways:

**Sets firm deadline to assume/reject lease.** When a tenant files for bankruptcy, it must decide whether to assume or reject its lease, says Rabinowitz. If the bankrupt tenant assumes its lease, it must cure any lease violations and continue to honor its lease obligations, including paying rent, he explains. Or it can assign its lease to another tenant. If the tenant rejects its lease, it must move out of its space, he adds.

In the past, the Bankruptcy Code gave a bankrupt tenant 60 days to make the decision to assume or reject a lease, says Rabinowitz. But a bankrupt tenant typically would claim that 60 days wasn't enough time and would repeatedly ask the bankruptcy court for—and almost always get—deadline extensions, sometimes stretching out its decision for years, he explains. And during that time the owner would be stuck with the bankrupt tenant in the space and be unable to evict it, he adds.

The new law sets a firm deadline by which a bankrupt tenant must decide whether to assume or reject its lease, says Lichtenstein. It effectively eliminates the endless deadline extensions that have been all too common, explains Rabinowitz.

Essentially, there's now a 210-day firm deadline by which a bankrupt tenant must decide what to do with its leases. The bankrupt tenant has 120 days

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**NEW BANKRUPTCY CODE CHANGES** (continued from p. 1)

to make its decision, Rabinowitz says. If the bankrupt tenant needs more time, it can request one 90-day extension "for cause" (although that term isn't defined). But you must give written approval for any further extensions, notes Lichtenstein.

**Strengthens protections against lease assignments that disrupt tenant mix.** Shopping center owners get specific protections in the Bankruptcy Code, points out Rabinowitz. One key protection is that the assignee of a bankrupt tenant's lease is bound by the lease's clauses, including the use clause, and so can't disrupt the center's tenant mix, he notes. So in theory, an owner can block a bankrupt clothing store tenant from assigning its lease to, say, a hardware store, he says.

But in the past, the Bankruptcy Code was interpreted to give bankruptcy courts the right to strike any "anti-assignment" clauses—including the use clause—from a bankrupt tenant's lease so that it could be assigned to virtually any tenant, notes Rabinowitz. And the courts' exercise of this right often undermined the shopping center owner's protections, he explains.

The new law gives the shopping center owner's protections priority over the bankruptcy courts' right to strike any anti-assignment clauses in a bankrupt tenant's lease, notes Rabinowitz. This means that you should be able to hold a proposed assignee to the lease's use clause, giving you more control over the assignment of a bankrupt tenant's lease, explains Lichtenstein.

**Allows cure of nonmonetary lease defaults.** The Bankruptcy Code requires a bankrupt tenant to cure all lease defaults when it assumes its lease, says Rabinowitz. But in the past, some bankruptcy courts ruled that when the default was nonmonetary—such as the tenant's failure to continuously operate—the bankrupt tenant couldn't cure the default and thus couldn't assume the lease, he explains. So a bankrupt tenant could be prevented from assuming its lease—even if the owner wanted it to do so.

The new law says that if the bankrupt tenant's nonmonetary lease default is failing to continuously operate, the tenant can cure that default by resuming operations when it assumes its lease, says Rabinowitz. And the tenant must pay you any damages that resulted from its failure to continuously operate, he adds.

**Sets firm deadline for tenant to file Chapter 11 "plan of reorganization."** If a bankrupt tenant rejects your lease, you'll have what's called an unsecured claim for the rent due subject to a cap for rejection claims. That cap is equal to the greater of one year's rent or 15 percent of the remaining rent, not to exceed three years' rent, notes Lichtenstein. And if the tenant files for bankruptcy under Chapter 11 of the Bankruptcy Code, you can't get paid for that unsecured claim until its "plan of reorganization" is finalized and confirmed by the court.

In the past, a bankrupt tenant had the exclusive right to file a plan of reorganization within the first four months of its bankruptcy case. During that "exclusive right" period, neither you nor any other creditor was allowed to speed up the process by filing a plan of reorganization for the bankrupt tenant. The problem was that courts would repeatedly extend the length of

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the exclusive right period. So creditors with unsecured claims—like you—had to wait years for the plan of reorganization to be finalized and confirmed, notes Lichtenstein.

To avert that problem, the new law gives a bankrupt tenant the exclusive right to file a plan for only 18 months—and a court can't extend that period, says Lichtenstein. So the bankrupt tenant can't procrastinate for years, he says. You'll get paid faster than you would have in the past, assuming the bankrupt tenant has enough money left to pay its unsecured claims.

**Eases proof of 'ordinary course of business' argument.** If a tenant pays you rent within three months before filing for bankruptcy, a bankruptcy trustee might try to get that rent back from you, claiming that the bankrupt tenant unfairly gave you preferential payment treatment over its other creditors. The Bankruptcy Code lets you keep that rent if you could successfully argue that the rent was paid in the "ordinary course of business."

To do that in the past, you had to prove to a bankruptcy court that: (1) the tenant made those rent payments on the same terms as its prior rent payments; *and* (2) the timing of the rent payments was typical within the commercial leasing industry. Proving both points was difficult to do, notes Lichtenstein. So, chances were high that you would have to give back the rent.

The new law makes it easier for you to prove that the tenant's rent payments were made in the ordinary course of business, and this gives you a better shot at keeping rent paid within three months of the tenant's bankruptcy filing, says Lichtenstein. You now must prove only one of the two points you had to prove in the past—either that the tenant made those rent payments on the same terms as its prior rent payments *or* that the timing of the rent payments was typical within the commercial leasing industry, he explains.

## One Change Could Hurt: Administrative Claim Cap

You could get hurt—and your tenants could benefit—from a change to the Bankrupty Code involving administrative claims. Here's how: Suppose a bankrupt tenant assumes its lease but later decides to reject that lease, as the Bankruptcy Code allows it to do. In the past, the Bankruptcy Code protected you financially by letting you make an "administrative claim" for the rent (and any other payments, excluding penalty payments) that would have been due if the tenant hadn't rejected the lease after assuming it. (An administrative claim entitles you to "100 cents on the dollar" for each dollar of rent the tenant owed you, Lichtenstein explains. It's generally also paid before other claims.) That means that if the bankrupt tenant rejected your lease when eight years remained in the lease term, you could have made an administrative claim for eight years of rent.

But the new law imposes a cap on the amount of your administrative claim, says Lichtenstein. If the remaining term of the rejected lease is two years or more, you'll be entitled to make an administrative claim for no more than *two years* of rent (and any other payments, excluding penalty payments). So, for example, if the bankrupt tenant rejects its lease when eight years remain on the lease term, you can make an administrative claim for only two years of rent. You can try to make an unsecured claim for the rent due for the remaining six years, but it will be subject to the cap on rejection claims, says Lichenstein. But there's no assurance that the tenant will have any money left to pay that unsecured claim. ▲

***CLLI Sources***

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