



## Beating the BK Blues

With proper planning, managers and owners can minimize the downside of tenant bankruptcy

by Pamela V. Rothenberg

**T**he floundering economy's impact on real estate can be seen in the recent wave of commercial tenant defaults and bankruptcies. When a tenant files a bankruptcy petition, federal law triggers an injunction that automatically stays most actions against the tenant. The automatic stay permits the tenant to remain in the space until the lease is affirmed or rejected in the bankruptcy proceeding. During the post-petition period and until the tenant assumes or rejects the lease, the tenant must pay rent. However, if the tenant fails to do so the landlord may be left with no rental stream unless either they obtained a letter of credit security deposit or the lease has been guaranteed.

Bankruptcy not only stays a landlord's right to draw on a cash security deposit but also can interfere with their ability to issue a default notice. If the lease is affirmed, the tenant must pay all post-petition rent and cure all defaults. If the lease is rejected, all unpaid rent and damages for the termination become an unsecured claim.

Since the automatic stay prevents the landlord from terminating the lease, the landlord will not be able to re-let the premises unless the lease is rejected. A bankruptcy petition will also stay any pending eviction proceedings and the tenant is not obligated to cure past due rent arrearage unless and until the tenant decides to assume the

lease. However, if a lease is properly terminated under state law before the tenant files for bankruptcy protection, a landlord can usually obtain a lift of the automatic stay and evict.

Before signing a lease with a financially unstable tenant, a landlord should require the payment of advance

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rent and a security deposit, and should seek a lease guaranty. If the security deposit is of any significant amount, the tenant should be required to post a letter of credit instead of cash for the deposit, since the letter of credit will afford significant protection to the landlord in the event of bankruptcy. A letter of credit is an obligation of a financial institution to the landlord and is not property of the tenant's bankruptcy estate, and, therefore, landlords can often draw on its full amount. Landlords should avoid lease conditions affecting their right to draw upon the letter of credit.

If reclaiming the space is the best approach to handle a failing tenant, landlords should provide all lease-required default notices, terminate the

lease and begin eviction proceedings before the bankruptcy petition is filed. Pre-bankruptcy termination will limit the tenant's ability to retain the premises and affords landlords greater leverage. If there is a realistic possibility the tenant can remain viable, a landlord may prefer to keep the tenant

rather than incur the costs of re-letting the space.

Finally, before exercising any rights against the tenant, a landlord must resolve if the application of the security deposit will trigger any lender rights, as well as determine the existence of requirements on how the proceeds of the security deposit must be applied.

Although a tenant's bankruptcy can be trying, proper planning and timely action can enable landlords to minimize the downside and avoid economic loss. Landlords should immediately and aggressively pursue their right in any tenant bankruptcy proceeding. □

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