BOSTON BUSINESS JOURNAL
BUSINESS NEWS ESSENTIAL TO BOSTON'S LEADERS.

Apr 14, 2008, 12:00am EDT

So your commercial tenant may file for bankruptcy

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Boston Business Journal

With a predicted recession in the offing, commercial property managers need to sharpen their focus on anticipating and dealing with potential commercial tenant bankruptcies. This article will outline some of the things to look for before a troubled commercial tenant files for bankruptcy and highlight key concerns in dealing with a tenant bankruptcy once filed.

Especially in troubled economic times, property managers need to be tuned into what is happening with potentially troubled tenants.

Once a property manager concludes that a tenant bankruptcy may be forthcoming, the most important step the manager can take is to terminate the lease, if possible, as soon as possible. If a commercial tenant files for bankruptcy before the lease is terminated, the lease will be an asset of the bankruptcy estate. If, however, the lease is properly terminated pre-petition, the lease will not be an asset of the debtor and the landlord should be able to promptly extricate its property from the control of the bankruptcy court.

Upon the filing of a tenant bankruptcy, all rent due and owing after the date of filing enjoys the status of an administrative claim in the bankruptcy which, in almost all cases, assures payment of the rent. Rent due pre-petition, however, has the status of an unsecured claim of the debtor and is treated just like all of the other unsecured claims of the debtor, which are usually paid with pennies on the dollar, if at all. Finally, if the lease is not assumed and assigned, but is instead rejected by the debtor, then the property owner has a statutory claim for damages for lost future rent, usually capped by law at one year's worth of rent.

The most important issue for the property owner when a commercial tenant files for bankruptcy is whether the tenant can "assume and assign" the lease to a third party. Upon the filing of the bankruptcy petition, the commercial lease becomes an asset of the debtor to be dealt with in connection with the bankruptcy case.

The general rule is that a debtor in bankruptcy may assume and assign a commercial lease to a third party without the consent of the landlord, even if the lease requires landlord consent. Typically, a debtor in bankruptcy will hire a broker to market the lease and seek to recover, for the benefit of the creditors, as much money as possible by way of a sale of the lease to a third party. This creates a serious potential conflict between the

interests of the bankruptcy estate in receiving as much money as possible for the creditors and the property owner's interest in having a responsible and productive tenant of its own choosing. The landlord does not share in any payment made by the winning bidder for the lease, receiving only the economic benefits under its lease. If a third party does acquire the lease, it must cure any pre-petition rent arrears and, with certain exceptions, must comply with all of the terms and conditions of the lease. One of the key exceptions to this rule is that the Bankruptcy Court can modify a use restriction in the lease.

The shopping center lobby has effectively carved out an important exception to the "assumption and assignment" rules for property located in a shopping center. For example, the third party must have substantially similar financial wherewithal to comply with the lease that the original tenant had at the time the lease was signed, including a similar ability to pay percentage rent as the debtor. Most important, however, the prospective tenant must strictly comply with the use provisions of the lease and may not disrupt the tenant mix in the shopping center. Thus, a change from a high-end retailer to a discounter may not be permitted if it would disrupt the tenant mix in the center.

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