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Bankruptcy law provisions offer some protection for tenants

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Last October, the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act significantly changed the United States Bankruptcy Code while providing important protections to building owners and landlords involved in a tenant's bankruptcy. However, small business owners involved in commercial leases in Texas may still be unaware of how the provisions affect their businesses.

The new law

In all, the new laws have made it much more difficult for a person to file Chapter 7 bankruptcy and obtain a release or discharge of obligations. Instead, the new provisions force people with the ability to pay to file under Chapter 13 and to repay some or all of their debts over time. Only those who truly can't afford to pay any portion of their debts will be able to file for liquidation.

This new provision may now make an individual tenant or guarantor of a lease think twice before defaulting because it's impossible, in many cases, to file bankruptcy to avoid the obligation. Whether this has had an effect on reducing tenant defaults in commercial lease settings has yet to be determined.

The lack of a bankruptcy option won't likely stop the opening of a new business, although it may make that small business owner think twice about personally signing or guaranteeing a lease. Small business owners should focus on the type of entity that can be used to provide them with as much protection as possible.

Tenants in bankruptcy continue to have breathing room because the landlord is prohibited from taking any action against the tenant, such as eviction, for a certain period of time without bankruptcy court approval.

Overall, the new law has helped reduce uncertainty as to when the income stream can be restored or the space can be recovered by the landlord.

Tenant and landlord rights

In a bankruptcy, the tenant can either assume the lease or reject the lease and surrender the premises to the landlord. The new law gives the tenant 120 days to make a decision and allows for only one 90-day extension for cause shown without the landlord's consent.

The bankruptcy court may not grant any further extensions unless the landlord consents. Therefore, the tenant in Chapter 11 would be forced to decide early on whether to stay on the premises or reject the lease.

Also, to mitigate the effects of a possible early assumption by the tenant before the tenant's reorganization effort has been finalized, Congress has limited the amount of an administrative claim that the landlord can assert. Landlords now have a right to two years' worth of rent if the lease is assumed but the tenant's reorganization fails.

The new provision does have one unintended outcome that affects a landlord's rights in dealing with a tenant that has filed Chapter 7 bankruptcy to liquidate its business.

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Under the old law, the trustee had 60 days to decide whether to assume or reject the lease; otherwise, the lease was deemed rejected and the trustee was required to turn over the premises to the landlord. The landlord could sit idly and wait for the 60-day period to expire and then be in a position to recover space.

The new law extends the period to 120 days. Unless the landlord seeks some relief from the Bankruptcy Court to force the trustee to make a decision, the space could be tied up for at least 120 days if the trustee were to fail to make an earlier decision. Therefore, a landlord facing a tenant in Chapter 7 bankruptcy must be more proactive in protecting his or her rights.

Under the new law, a tenant isn't required to cure certain prior nonmonetary defaults, such as covenants, regarding the tenant's financial condition. This provides tenants with greater ease in satisfying the requirements for assumption of a lease.

Year in review

Filings of corporate Chapter 11 cases have been down over the past year, mainly because of the availability of credit in the marketplace. The true effects of the new laws have yet to be established.

In the cases that have been filed, however, tenants appear to be dealing with the new law in several ways.

First, tenants are trying to make arrangements with landlords regarding their leases prior to filing bankruptcy. Second, tenants are evaluating their leases and making decisions much more quickly.

The new law will have the greatest effect on the retail owner with multiple locations, who will now be forced to decide much sooner which leases have value and which do not. In these cases, legal professionals will have to act more quickly to assist the tenant in assessing each lease in order to preserve its value.

Finally, tenants are assuming leases early on, eliminating the uncertainty for the landlord. The result of this arrangement has positive and negative ramifications.

On the upside, the landlord won't be involved in the bankruptcy process, and some uncertainty will be eliminated. On the downside, the tenant may have made a premature decision that may not be viable, and the landlord will be faced with another default. This could affect the value of income-producing real estate because the tenant can still default.

In all, the new law appears to be working as it relates to landlords' rights. However, tenants will now have to make a number of hard decisions earlier to get business back to normal as soon as possible.

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