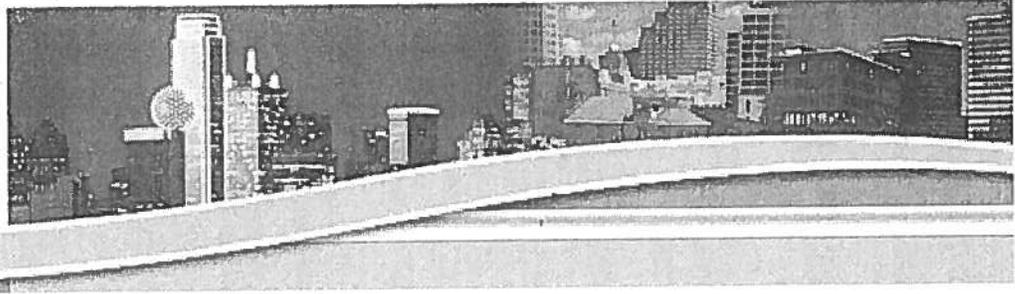


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COVER STORY, JULY 2007

CRACKING THE BANKRUPTCY CODE

A look at how bankruptcy reform has affected commercial real estate leases in Texas.

Trent Rosenthal

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Since the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, landlords and tenants still may be unaware of provisions that have changed what they've come to expect from the Bankruptcy Code. Landlords and tenants need to be aware of these new provisions when they negotiate leases in order to fully understand the risks and benefits that the new law provides. Landlords will need to negotiate harder for more favorable terms based on their expected risks of a bankruptcy, such as when looking at the prospective tenant's past credit. Bankruptcy clauses are very important in lease negotiations and landlords and tenants must understand how the law affects them in the event of a default.



Rosenthal

Landlord Rights

In bankruptcy, a tenant has two options with commercial real estate leases: the tenant may reject the lease and surrender the premises to the landlord, or the tenant may assume the lease while curing all defaults and providing assurance of future performance. Under the latter option, the landlord recovers everything owed and maintains the tenant as a source of future cash flow. If it makes economic sense, the tenant can also assume the lease and try to sell (assign) it to a third party.

Since the value of most commercial real estate is heavily dependent on the property's income stream, any interruption — like a tenant's bankruptcy — can have a huge effect on the investment. The new bankruptcy law preserves the value of investment real estate by reducing the landlord's uncertainty as to when the space can be recovered and the income stream restored.

Under the new law, a tenant or trustee in Chapter 11 bankruptcy must decide earlier whether to stay on the premises or reject the lease. The law gives tenants 120 days to decide whether to assume or reject the lease and allows for only one 90-day extension. The old law gave tenants only 60 days to decide — but with the possibility of an unlimited number of extensions, which meant the landlord could be stuck waiting. Now, the Bankruptcy Court may not grant further extensions without the landlord's approval. Until the decision to assume or reject the lease is made, the tenant is required to perform all lease obligations — including the timely payment of post-filing rent.

However, a landlord must be more proactive in protecting its rights against a tenant that files Chapter 7 liquidation bankruptcy. When small businesses file Chapter 7 liquidation, a trustee is appointed that succeeds the tenant's rights under the lease. Rarely does the trustee need or want the premises since the business is shut down.



As previously mentioned, under the old law the trustee had 60 days to decide whether to assume or reject the lease. If a decision was not met in this time, the lease was considered rejected. Previously, most landlords could wait for the 60-day period to expire to recover their space, but the new law extends that period to 120 days. Unless the landlord uses the Bankruptcy Court to force a decision, the space could be tied up for at least 120 days.

The new law also makes it easier for small businesses in Chapter 11 to reorganize by streamlining deadlines and eliminating complexities, which means landlords will know earlier whether the business will survive the Chapter 11 process. Now, instead of two separate pleadings, small business tenants can combine their plan of reorganization and disclosure statement. In turn, the Court is required to hold earlier hearings to approve the plan and the tenant's potential exit from Chapter 11.

Tenant Protections

One important tenant protection that has not changed is that a tenant bankruptcy filing prohibits the landlord from taking any action against the tenant, such as eviction, without Bankruptcy Court approval.

Additionally, if the tenant does not need the premises and rejects the lease, the landlord's damage claims are only limited to 1 year's worth of rent, plus any past due rent as of the bankruptcy filing date. This benefits the tenant that escapes from paying everything that is owed under the lease, leaving the landlord with a vacant space and costly interruption in rental income stream.

However, small business owners may no longer immediately file Chapter 7 bankruptcy to avoid their obligation. An individual tenant (as opposed to a company) may be forced to file Chapter 13 restructuring if he or she has the ability to pay some or all of his or her debts over time and the majority of these debts are non-business related.

Overall, the law states that a tenant must pay all past due rent, cure all other monetary defaults under the lease at the time of assumption and provide adequate assurance of future performance. However, the new law states a tenant does not need to cure certain non-monetary defaults, making it easier for tenants to satisfy the requirements for lease assumption.

In general, landlords prefer tenants to assume the lease and cure all defaults. If tenants assume the lease, they may not have to cure certain non-monetary lease provisions — such as those regarding the tenant's financial condition that are critical to the landlord other than basic rent and economic terms. These could include restrictions on "going dark" periods or other non-monetary provisions that could not be cured by the tenant. This may make it easier for the tenant to assume a lease under which it has defaulted and assign it to a third party.

Outcomes

Tenants appear to be dealing with the new bankruptcy law by making lease arrangements with their landlords prior to filing bankruptcy and making decisions more quickly. Tenants operating from a primary business location are assuming a lease early on, which eliminates uncertainty for the landlord that knows the tenant is taking action to cure all defaults.

However, if the tenant decides prematurely to assume the lease and then defaults, not only is the value of the property affected, the landlord's administrative claim for damages is limited to only 2 years worth of rent. The availability of money to pay that administrative claim is unlikely if the tenant goes out of business while in bankruptcy. In addition, a buyer of a property with a bankrupt tenant may factor in these details in deciding what to pay for the property.

The new law will have its greatest effect on retailers with multiple locations — they must decide much earlier which leases to assume based on their value and which do not. By requiring tenants to make decisions earlier, the new laws benefit landlords and their real estate investments while allowing some protections for tenants. Tenants and landlords must understand and adapt to these new laws when negotiating commercial real estate leases.

Trent Rosenthal is a shareholder at Houston-based Boyar & Miller law firm and is board certified in business bankruptcy law by the Texas Board of Legal Specialization.

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