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New bankruptcy laws increase protection for building owners

The playing field has changed for building owners and landlords who become involved in a tenant's bankruptcy.

On April 20, President George W. Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which significantly changes the United States Bankruptcy Code. Many provisions deal with bankruptcy cases filed by individuals, but several provisions give landlords greater rights in tenant bankruptcies, while others benefit tenants.

THE NEW LAW

On the whole, the new law should help preserve the value of investment real estate because there is less uncertainty in the event of a tenant bankruptcy.

The new law makes it much more difficult for an individual to file bankruptcy and avoid obligations.

It uses a "means" test to determine who is eligible to file chapter 7 bankruptcy, commonly known as a liquidation, which permits a discharge (release) of debts. Only people who truly cannot afford to pay any portion of their debts will be able to file liquidation; the remainder will be forced to repay a portion of their debts through a Chapter 13 or Chapter 11 plan.

While commercial tenants frequently are entities rather than individuals, commercial leases typically involve a guaranty of one or more individuals. Under the new law, an individual guarantor who has less access to bankruptcy will have greater incentive to ensure that lease obligations are satisfied.

The filing of a tenant bankruptcy "stays," or prohibits, the landlord from taking any action against the tenant, such as eviction, without bankruptcy

court approval, and it thus gives the tenant breathing room. However, the value of most commercial real estate is dependent on the income stream of the property. If the income stream becomes questionable, the value of the real estate can be adversely affected.

TIME ELEMENT

The new law should help to reduce the uncertainty as to the future income stream in the case of a tenant bankruptcy.

In a bankruptcy, the tenant has essentially three options:

- Reject the lease and surrender the premises to the landlord.

- Assume the lease, curing all defaults and providing adequate assurance of future performance. Under this option, the landlord benefits by recovering everything owed and maintaining the tenant as a source of future cash flow.

- Assume the lease and assign it to a third party with approval of the bankruptcy court.

The prior law required the tenant to assume or reject within 60 days after the case filing, or the lease was deemed rejected. The tenant was required to keep current on rent and otherwise perform under the lease pending the election, but the bankruptcy court could extend the 60-day period.

Although the bankruptcy laws were thus designed to preserve the landlord's income stream and limit the tenant's time for making the election, the law lacked teeth to some extent — the bankruptcy court could extend the 60-day period for cause, and there was no time limit on such

extensions.

In most large Chapter 11 cases, the period typically was extended, leaving the landlord in the dark as to the tenant's intentions and with little ability to protect its interests in the interim period.

The new law gives the tenant 120 days to decide whether to assume or reject the lease and allows for only one 90-day extension for cause shown without the landlord's consent.

The landlord must consent to any further extensions, or the bankruptcy court may not grant the extension. The tenant in Chapter 11 will be forced to decide early whether it wants to stay in the premises or reject the lease.



TENANT
BANKRUPTCY

TRENT L.
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DOLLAR AMOUNT

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 if the lease is assumed but the tenant's reorganization fails. The claim is limited to two years worth of rent but is given administrative priority — higher priority than unsecured claims and on equal par with fees of professionals engaged by the tenant in its case.

One change that favors tenants addresses which obligations a tenant must cure if it assumes a lease. The tenant must:

- Pay all past due rent and cure all other monetary defaults under the lease at the time of assumption.

- Provide adequate assurance of fu-

ture performance.

In a retail shopping center setting, there are a number of additional requirements.

In most cases, an assumption of the lease is good news for the landlord because it makes the landlord whole. A question arose over the years as to what types of defaults must be cured as part of the assumption, such as covenants regarding the tenant's financial condition, which some courts construed to limit the ability of a tenant to assume a lease.

Under the new law, a tenant need not cure these prior non-monetary defaults, which provides tenants with greater flexibility in electing to assume.

Landlords now can rest easier in the event of a tenant bankruptcy. The new law grants significant additional protections to landlords while at the same time enhancing some rights of the tenant. The application of the new law to landlord-tenant rights should be interesting over the next few years. ■



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