Lease Restructurings Now (Part 2)

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(**Note**: This is Part 2 of a two-part alert on lease restructurings during the time of the COVID-19 pandemic. You can read Part 1 here. Barley Snyder recently started a Lease Restructuring Team to assist landlords and tenants when lease agreements need to be changed.)

The restructuring of a commercial lease proceeds based on local real estate lease laws. However, no effective restructuring can be accomplished, particularly under conditions of financial distress, without placing the restructuring in the context of bankruptcy law. The U.S. Bankruptcy Code contains a number of provisions of importance to the lease restructuring, including the automatic stay, Section 365 addressing leases and executory contracts and various provisions addressing the treatment of various types of claims. These provisions will have serious ramifications and will alter the outcome of otherwise carefully negotiated lease restructurings, absent some careful thought and prior planning. A few of the points to consider are:

- The automatic stay of Section 362 of the U.S. Bankruptcy Code, which takes effect automatically with the bankruptcy filing, will prevent a landlord from taking action against a tenant to collect rent or to regain possession of the property without first seeking an order of the bankruptcy court. Bankruptcy judges in several recent retail store Chapter 11 cases filed during the COVID-19 pandemic have declined to grant landlords relief from the automatic stay for an extended period of time. Some landlords have worked at early termination agreements even though it may require the landlord to take a loss on the property, but it does avoid tying up the property in the bankruptcy case.

- The various rent forgiveness and deferral arrangements may result in claims which may be asserted in a bankruptcy case and which are treated differently depending upon the nature of the arrangement and timing. Claims for rent accruing or coming due during the bankruptcy case are treated as administrative claims which have a higher priority above other unsecured claims and equal to that of the bankruptcy professionals in the case. To confirm a Chapter 11 plan, administrative claims must be paid in full and in cash. Delaying the actual forgiveness of abated rent until the end of a lease may afford a landlord the opportunity to claim general unsecured creditor status for the forgiven rent, if the lease is rejected during the bankruptcy case or the tenant again defaults prior to the filing of the bankruptcy case.

- If the tenant wishes to continue at the property and maintain the lease, the law allows for that. The tenant may assume the lease during the bankruptcy case even if the landlord objects. However, the tenant is required to cure its defaults, including the payment of past due rent. Again, the timing of the payment of deferred rent, or the forgiveness of abated rent, may be important in the event of a lease assumption. If a tenant decides to reject its lease during the bankruptcy case, it can relegate the landlord's claim to a pre-bankruptcy, unsecured claim status, rather than an administrative claim.

- In addition, the U.S. Bankruptcy Code caps a lease rejection unpaid rent "pre-bankruptcy" claim to the greater of

one lease year, or 15% not to exceed three years of the remaining lease term. Because the balance of lease terms may be lengthy, U.S. Congress decided to cap these claims to balance the availability of a dividend to all creditors. The importance of this in a retail or Chapter 11 case seems obvious. For purposes of the cap, the remaining term of the lease is calculated from the earlier of the date of the filing of the bankruptcy and the date on which the landlord repossessed or the tenant surrendered the leased property and the claim will also include any unpaid rent due under the lease, without acceleration, on the earlier of such dates.

- The proceeds of a letter of credit provided as credit enhancement will not be viewed as an asset of the bankruptcy debtor and should be available to the landlord. In most cases, guarantors of the tenant's obligations also will not receive any protection from the filing of the bankruptcy case. However, landlords will not be able to proceed against a cash security deposit after the bankruptcy case has been filed without a court order lifting the automatic stay.

In addition to the real estate law and bankruptcy law concerns, the COVID-19 pandemic also implicates a wide array of state and local governmental orders and regulations with respect to the occupancy of properties. Also, there are considerations for *force majeure* provisions and their application to commercial leases.

The present COVID-19 emergency really makes careful planning of the restructuring imperative. Landlords and tenants currently finding themselves in commercial lease relationships that don't fit with their current needs should seek assistance in determining the best mitigation and exit strategies. If you have any questions on lease restructuring, please call Tim Dietrich, Maria Elliott or any member of the Barley Snyder Lease Restructuring Team.

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