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Lease Termination Disputes and Bankruptcy

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As the brick and mortar retail industry continues to decline, landlords are likely to engage in an increasing number of lease disputes with delinquent tenants. As we have seen over the past five years, those disputes often end up in bankruptcy court and may drag on for months before a landlord is able to shake its non-performing tenant. But what if the landlord terminated the lease before the tenant filed for bankruptcy relief? Can the tenant revive and assume the lease? In some instances, yes. This Insolvency Insights blog post provides an overview of the effects of a lease termination prior to bankruptcy, how courts analyze termination, and pitfalls to avoid when terminating a financially distressed tenant's lease.

Assuming a Lease

Under the Title 11 of the United States Code (the "Bankruptcy Code"), property of a debtor's bankruptcy estate includes all property owned by a debtor as of the date on which the debtor files for bankruptcy relief (the "Petition Date"). A debtor's valid leasehold interest is property of the estate. Section 365 of the Bankruptcy Code enables a debtor to assume a valid lease even despite its bankruptcy filing so long as (i) any defaults under the lease are promptly cured and (ii) the debtor is capable of proving its ability to perform under the terms of the lease.

Those two hurdles are often enough to prevent a bad tenant from assuming a lease. The first hurdle—curing all defaults—requires a tenant to pay all past-due obligations "promptly." While the bankruptcy code does not define "prompt", courts typically require the payment of all outstanding obligations within one to six months. That may be too difficult for tenants that are already struggling to meet their monthly rent obligations.

The second hurdle is often equally difficult for a struggling or perpetually delinquent tenant. In addition to paying its cure obligation, a tenant must also prove that it can meet all lease obligations on a going-forward basis. In bankruptcy-speak, the tenant must provide "adequate assurance of future performance" under the lease. That "adequate assurance" may require the tenant to show that its reorganization or debt restructuring will enable it to have sufficient cash flow to pay its landlord. If the debtor-tenant's projections suggest that making payments will be a close call, the landlord may demand additional protection, such as an affiliate guaranty or additional security deposit. If the tenant proves capable of curing defaults and showing adequate assurance of future performance, it may assume the lease and continue as a tenant.

Effect of Termination on a Debtor's Right to Assume a Lease

Property of the estate does not include a debtor's bare possessory interest as a holdover tenant under a real property lease terminated *prior to* the Petition Date. As a result, a bankrupt tenant cannot typically assume a lease that was already terminated when the tenant filed for bankruptcy. In essence, there is no lease for the tenant to assume. A landlord may even proceed with eviction proceedings against a tenant without violating the automatic stay because the tenant has no right to remain in possession of property following the termination of the lease. An eviction proceeding without stay relief is not, however, a best practice, and is exceedingly risky. A landlord may face serious repercussions—including financial sanctions—if it wrongfully evicts a bankrupt tenant from its place of business during a pending bankruptcy case.

Fudging Termination – A Tenant Loophole

How can an eviction be perceived as "wrongful" if the lease was terminated before the tenant's bankruptcy? That question is litigated with surprising frequency. In short, a tenant will contest the legitimacy of an eviction proceeding if it believes the landlord incorrectly terminated the lease. To most real estate professionals, the idea of an "incorrect termination" sounds preposterous. Most state laws allow for freedom of contract, and most sophisticated commercial real estate leases have landlord-friendly termination provisions. Even so, "incorrect" terminations occur more frequently than one might expect, and courts are often willing to grant a tenant a get-out-of-jail free card when a landlord slips up.

So what is an "incorrect" lease termination? It is a purported termination that fails to strictly comply with the terms of the lease. For instance, if a lease requires 10 days' notice and opportunity to cure and a landlord provides only 7 days' notice, the termination may be deemed incorrect and therefore ineffective as a matter of law. If a landlord demands payment of a greater cure obligation than that to which it is entitled under the express terms of the lease, the landlord's later termination for the tenant's failure to pay that cure may be set aside. If a lease requires that a demand be made prior to termination, the demand must be proper, specific, and reasonable and cannot exceed specific amounts due under the lease. A termination may even be set aside in circumstances in which a landlord's demand is simply too vague or just references "defaults under the lease."

After all, in Texas, as in many states, courts disfavor lease termination and the forfeiture of a tenant's rights under a lease. Where equities support a continuation of the lease rather than forfeiture, courts will often find a way to restore a tenant's contract rights. That is especially true where lease defaults are non-monetary, where a landlord can be made whole by payments from a tenant, and where terms of a lease, or the issue in dispute, are unclear or subject to differing calculations.

Disputing Termination in Bankruptcy

Once a tenant files for bankruptcy relief, it may immediately file a motion to assume the lease in dispute. In its motion to assume, the tenant may challenge the validity of the landlord's pre-bankruptcy lease termination. Bankruptcy courts in Texas have addressed just how to adjudicate a challenged lease termination on multiple occasions. At least two Texas bankruptcy courts have ruled that the effectiveness of a landlord's purported termination is a matter that may be heard in bankruptcy court as a contested matter. A contested matter, unlike an adversary proceeding, is not a full-fledged lawsuit and may be litigated on an expedited basis with expedited discovery.

Other courts have punted the adjudication of the effectiveness of a purported lease termination to state courts more familiar with state contract law. In those instances, tenants have had the opportunity to assert defenses to termination in both eviction proceedings and in declaratory judgment actions.

In each scenario, tenants were entitled to their day in court before the bankruptcy judge allowed the landlord to enforce its rights or the tenant to assume the lease. If a tenant has even a colorable argument that a landlord's termination was improper, it will likely avoid a summary dismissal of its leasehold rights in bankruptcy. Landlords should therefore approach each potential lease termination with caution, focus, and scrutiny of the terms of the lease addressing termination. Landlords should terminate leases in strict compliance with the express terms of the lease, and should seek nothing more than that to which they are entitled. While it may be difficult, landlords should bifurcate lease negotiations from termination proceedings and ensure that demand letters, notices of default, and notices of termination avoid matters that fall outside the letter of the lease.

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