COVID-19 Leads to Temporary Modifications to Key Real Estate Lease Provisions Under the Bankruptcy Code

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In-house counsel ("counsel") to commercial landlords and asset-based lenders ("clients") are no strangers to the challenges created by the bankruptcy filings of financially beleaguered tenants. When confronted with a bankruptcy filing, counsel must be prepared to advise clients regarding imminent abated rent payments, potential impact of pre-petition payments or settlements, likelihood of recouping pre-petition rent arrears, and the turbulent waters of chapter 11 plan negotiations and the confirmation process, among myriad additional legal and practical concerns. The economic standstill wrought by the COVID-19 pandemic further complicated these dynamics, as many commercial tenants have been unable to perform their payment obligations for months at a time given outside constraints including government restrictions, greatly limiting the menu of solutions available to both lessee and lessor. [1]

On December 27, 2020 then-President Trump signed into law the Consolidated Appropriations Act, 2021 (the "CAA"), an omnibus spending bill that included amendments to the Bankruptcy Code in an attempt to ameliorate some of the issues currently plaguing commercial tenants by delaying tenants' obligations to make post-petition rent payments, extending the deadlines by which tenants must decide to assume or reject a lease, and encouraging landlords to work out payment schedules to address arrears with struggling tenants.[2] Counsel should familiarize themselves with this new paradigm in order to properly advise clients in anticipating and preparing for the CAA's continued impact on landlord-tenant relations.

One key obligation under the Bankruptcy Code modified by the CAA is the non-residential debtor-tenant's obligation to pay post-petition rent under Section 365(d)(3) of the Bankruptcy Code. This section generally requires that debtors timely perform their obligations under a lease during a bankruptcy case, including payment of rent, and provides that the bankruptcy courts may extend "for cause" the debtor's time for performance of its obligations for up to 60 days after the filing date. Therefore, as the law existed pre-CAA a debtor-tenant can obtain a 60-day (two-month) abatement of rent payments at the start of the bankruptcy case upon a showing of cause.[3]

The CAA further amends Section 365(d)(3) of the Bankruptcy Code to permit debtors in certain cases — those commenced under Subchapter V of Bankruptcy Code Chapter 11[4] — to now request an *additional* 60-day extension of the debtor's time for performance under a lease if the debtor "is experiencing or has experienced a material financial hardship due, directly or indirectly, to [Covid-19]." This additional extension, in effect, gives Subchapter V debtors a total 120-day abatement of their rent payment obligations from the date of the bankruptcy filing. Counsel should expect courts to routinely grant this additional 60-day extension, as (i) the broad scope of the "directly or indirectly" hardship language will be highly difficult for landlords to persuasively oppose; and (ii) debtors will likely have already established a COVID-related cause for the initial 60-day extension.

While this amendment sunsets on December 27, 2022, it will continue to apply to all Subchapter V cases filed before that date and obviously may be further extended. Counsel should thus, for the next two years, as a matter of cautious planning, anticipate a 120-day rent abatement in any income projections involving financially distressed, potential Subchapter V debtors who have either filed for bankruptcy protection or are on the precipice of doing so.

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The goal of the CAA is to balance the impact of these changes and ensure that landlords eventually receive the rent abated during the 120-day extension period. In the event of such an extension, all deferred rent payments during the 120-day abatement will be treated as an administrative expense under Section 507(a)(2) of the Bankruptcy Code for the purposes of Chapter 11 plan confirmation and will fall second in the chain of priority of distribution. Counsel should advise clients, therefore, that clients are well-positioned to receive full payment of the post-petition arrears allowed under the Section 365(d)(3) amendment, that these amounts are not subject to negotiation by the debtor and must be paid in full before virtually all other secured and unsecured creditors upon confirmation of plan of reorganization. Counsel should also, however, advise clients of the possibility that if a debtor-tenant receives the 120-day abatement and does not confirm a plan, then such administrative claim may never be paid unless there are sufficient funds in the chapter 7 case.

The CAA also amends the deadline for a commercial debtor-tenant's obligation to assume or reject the lease.[5] This provision applies to all cases, not just those commenced under Subchapter V. Under pre-CAA Section 365(d)(4) of the Bankruptcy Code, a debtor-tenant of a nonresidential real property lease was required to assume or reject a lease within 120 days of the bankruptcy filing. The court was able to grant a 90-day extension of this deadline "for cause," and extensions were common. As a result, in many cases pre-CAA, the debtor-tenant had 210 days to assume or reject the lease.

The CAA replaces Section 365(d)(4)'s 120-day initial deadline with a new 210-day initial deadline. The debtor-tenant may then seek a further 90-day extension of the 210-day deadline for cause, which means that the debtor-tenant can have almost a year to decide whether to assume or reject its lease. This amendment sunsets on December 27, 2022, at which time the CAA-created 210-day deadline will revert back to the pre-CAA 120-day period. The amendment will, however, continue to apply in all Subchapter V cases filed before the sunset date. The amendment is silent as to the treatment of the leases of non-Subchapter V tenants that are beyond the "new" 120 day deadline upon the sunset date; so as of now the impact on cases pending for non-Subchapter V tenants when the amendment sunsets is unclear—this may simply be a question of lack of clarity in drafting that will be cleaned up eventually but counsel should keep an eye out for updates down the road.

The global impact of these changes for now is that counsel should thus advise clients to anticipate that all tenants who file for bankruptcy protection will be able to remain on the premises for at least 300 days. As a result, counsel might want to consider the business risks associated with waiting almost a year to be paid pre-petition arrears or know what is happening with a lease. Counsel has to consider the possibility of a failed case where administrative obligations are pushed to the end of the case and the client does not get paid. It may be worth a careful risk analysis as to whether there is a benefit to considering a negotiated agreement with a tenant on long-term arrears payment plans in cases where debtor-tenants have accumulated significant arrears; given that client and debtor will likely be tied at the hip for approximately 10 months post-petition it is a long wait to see if the debtor can or will assume a lease. Of course, if there are guarantors, as there often are, counsel should query whether they will provide a source of alternative recovery as those claims are not stayed by the bankruptcy filing or these amendments (although backlog in the state courts may make pursuit of these claims not immediately rewarding).

The CAA also includes an amendment to the Bankruptcy Code's handling of preferential transfers that will significantly increase the amount of solutions available to landlords dealing with defaulting tenants in the months prior to the bankruptcy filing. Pre-CAA Section 547 of the Bankruptcy Code authorizes a debtor in possession or trustee to claw back preferential prepetition transfers made by the debtor to creditors within the 90 days (or one year if the payment is made to an insider of the debtor) prior to the bankruptcy filing on account of a past due obligation. While creditors have several affirmative defenses against preference actions, including that the transfer was made (i) in the ordinary course of business between the debtor and creditor; or (ii) by the debtor in exchange for new value provided by the creditor, these are costly litigations.[6]

As a result of the business restrictions and income shortages caused by the COVID-19 pandemic, many businesses defaulted on their rent payments and/or were paid outside of the ordinary course; landlords, in turn, received delayed payments or entered into rent forbearances and deferral agreements which may have left the landlords open to clawback actions. When payments have been deferred or delayed, landlords have been hampered in asserting certain traditional preference defenses because the arrearage payments were not made in the ordinary course of the business relationship with the tenant (landlords, of course, can contend that forbearance was for new value). The end result was that landlords have ostensibly been punished for extending a life raft to struggling debtors during a global pandemic.

The CAA addresses this unfortunate dynamic by adding subsection (j) to Section 547 of the Bankruptcy Code, which prohibits the debtor or trustee from recovering "covered payments" by debtors to certain creditors as preferential transfers; such covered payments include payment of rental arrearages in connection with an "agreement or arrangement" between the debtor-tenant and creditor-lessor to defer or postpone rent under a lease of nonresidential real property entered into on or

after March 13, 2020. These payments cannot include fees, penalties, or interest in an amount greater than: (i) was scheduled to be paid under the original underlying contract; or (ii) that which the debtor would owe if it had made every payment due under the underlying contract. These amendments apply in all bankruptcy cases and sunset on December 27, 2022 but will continue to apply in any bankruptcy case commenced prior to that date.

Counsel should advise clients that they will no longer be punished for negotiating and securing deferred arrearage payments from financially distressed tenants who may be on the verge of filing bankruptcy. Landlords can now rework defaulted leases with the comfort of knowing that these payments will not be clawed back by the bankruptcy estate, and counsel should thus advise clients that they are incentivized to work out payment arrangements and continue their relationship with defaulting tenants as opposed to exercising termination and eviction rights.

As the impact of COVID-19 rolls forward, there may be other significant changes to the Bankruptcy Code. For now, however, the amendments enacted by the CAA magnify the ramifications of the triggering of a bankruptcy case by a debtor-tenant and significantly alter the normal bankruptcy time frames and dynamics between landlords and tenants. Counsel must advise landlord clients to exercise patience and willingness to explore and realize solutions with debtor-tenants, given the increased time and latitude given to both parties to assess their positions and negotiate during the bankruptcy process.

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Endnotes

1. Outside of bankruptcy, other legislation has impacted landlord-tenant matters in New York. On May 4, 2021, Governor Cuomo signed into law an extension of the COVID-19 Emergency Eviction and Foreclosure Prevention Act of 2020, which places a moratorium on residential evictions until August 31, 2021 for tenants who have endured COVID-related hardship upon submission of a (i) COVID hardship declaration or (ii) document explaining the source of the hardship by the tenant. On that same date, Governor Cuomo extended the New York State COVID-19 Emergency Protect Our Small Businesses Act of 2021, which also places a moratorium on certain qualifying small businesses upon proof of COVID-related hardship until August 31, 2021.
2. Landlords should be aware that the CAA adds an amendment to Section 541 of the Bankruptcy Code, that "recovery rebates" (pandemic relief / stimulus payments) are not considered property of the estate and therefore will not be available to satisfy obligations owed to creditors.
3. A recurring issue which arose during the pandemic is whether the force majeure provision in a lease can excuse a commercial tenant from paying post-petition rent, in light of government-mandated business shutdowns. For helpful opinions on this issue, see *In re Hitz Rest. Grp.*, 616 B.R. 374 (Bankr. N.D. Ill. 2020) and *In re CEC Ent., Inc.*, No. 20-33162, 2020 WL 7356380 (Bankr. S.D. Tex. Dec. 14, 2020). These cases demonstrate courts' disparate treatment of force majeure clauses, as the *Hitz Rest. Grp.* court ruled that government-mandated in-person dining shutdowns triggered the lease's force majeure provision and therefore partially excused the tenant's obligation to pay rent, while the *CEC Ent., Inc.* court ruled that the shutdowns did not trigger the force majeure clause and excuse the tenant's rent obligation.
4. Subchapter V of Bankruptcy Code Chapter 11 was created under the Small Business Reorganization Act ("SBRA"), enacted Feb. 19, 2020. The SBRA was designed to reduce the costs and complexities of the Chapter 11 reorganization process for certain small business debtors ("Subchapter V Debtors"). Currently the debt limits have been increased from aggregate debts of $2,725,625 or less (no less than 50% of which come from the commercial or business activities of the debtor), to $7,500,000 under the Coronavirus Aid, Relief, and Economic Security ("CARES") Act on March 27, 2020, and will revert to the original amount on March 27, 2022.
5. When a lease is assumed all arrears must be paid in full under Section 365(b).
6. *Strategies To Protect Your Company From Clawback Actions During These Turbulent Times and Beyond*, Leslie A. Berkoff, NYSBA Inside Summer 2020, Vol. 38, No. 2.