

The Appropriations Act – Changes Regarding Commercial Leases in Bankruptcy

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The \$2.3 trillion Consolidated Appropriations Act of 2021 brought relief to many people and businesses struggling due to the COVID-19 pandemic when the act became effective on December 27, 2020. The relief provided under the act, however, also included provisions intended to aid commercial tenants that seek protection under the Bankruptcy Code.

One such provision is the extension of time commercial tenants that qualify under the new subchapter V small business designation have to pay rent after filing bankruptcy. Under the Small Business Reorganization Act of 2019, small businesses (and individuals engaged in business) with primarily commercial debts totaling \$7,500,000 or less can choose to file under subchapter V of the Bankruptcy Code. Before the Appropriations Act, under section 365(d)(3) of the Bankruptcy Code, debtor/tenants had 60 days from the date of their bankruptcy filing to fully perform under the terms of the lease — i.e., pay rent. The Appropriations Act extends that deadline to 120 days if the debtor “experience(s) a material financial hardship due, directly or indirectly” to COVID-19 — a presumably very low bar, which effectively doubles the time commercial landlords have to wait to receive rent payments from qualifying debtor/tenants.

Another key change, which applies to all debtors, not just those that designate under subchapter V, is that debtors now have an additional 90 days to determine whether to assume or reject unexpired nonresidential leases. Under section 365(d)(4), debtor/tenants previously had 120 days from the date of their bankruptcy filing to make that determination. The deadline is now 210 days. Also, debtor/tenants can further extend the deadline for an additional 90 days (from 210 to 300), upon a motion for cause — again, a presumably low burden in the current environment.

Both of these provisions are currently set to sunset on December 27, 2022, but will apply to all cases filed on or before that date.

These extensions clearly benefit debtor/tenants by providing additional time to pay and assess whether to assume their leases post-bankruptcy and, at the same time, likely decreases certainty and bargaining power for commercial landlords. However, the Appropriations Act also included a provision likely to aid commercial landlords — an addition to section 547.

As many commercial landlords are familiar, before the Appropriations Act, landlords that entered into agreements or received payments from debtor/tenants in the 90 days before the debtor’s bankruptcy filing may have those agreements/payments avoided as preferential transfers under section 547 of the Bankruptcy Code. Section 547 is meant to protect creditors as a whole from a debtor favoring certain creditors by paying them in advance of their bankruptcy filing and not paying other disfavored creditors. However, to incentivize creditors to continue to do business with potential debtors pre-bankruptcy filing, section 547 long recognized certain defenses to avoidance of a transfer, including if the creditor gave new value in return for the payment received, if the transfer was a contemporaneous exchange, or if the transfer was made in the ordinary course of the debtor’s business.

The Appropriations Act added another defense to avoidance (under a new subsection (j)), which protects payments of “rental arrearages.” Under the new subsection, certain payments of arrearages “made in connection with an agreement or arrangement” between a landlord and a debtor/tenant are exempt from avoidance as a preference. The defense is subject to certain criteria, including that the payment of arrearage: (i) must be made pursuant to an agreement or arrangement entered into on or after March 13, 2020, between the debtor/tenant and landlord to defer or postpone the payment of rent and/or other periodic charges under an unexpired lease of nonresidential real property; (ii) cannot exceed the amount of rental and other charges due under the lease agreement executed before March 13, 2020; and (iii) cannot include fees, penalties, or interest greater than the amount of fees, penalties, or interest scheduled to be paid under the lease agreement. As with the other Appropriations Act revisions, the section 547(j) defense will expire on December 27, 2022, but will continue to apply to all cases filed before that sunset date.

Commercial landlords should keep the foregoing in mind when dealing with tenants potentially facing the prospect of seeking bankruptcy protection, including steps to protect themselves based on the new rules. Our team of professionals is prepared to assist with these and any other potential lease or distressed asset questions in and outside of bankruptcy.

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