WINSTON & STRAWN LLP

CLIENT ALERT

The CAA's Impact on Commercial-Real-Estate Bankruptcies

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Late last year, President Trump signed into law the Consolidated Appropriations Act ("**CAA**"), which provided $900 billion in a second wave of economic stimulus relief.[1] The CAA, a nearly 5,600-page law, supplements the Coronavirus Aid, Relief, and Economic Security Act (the "**CARES Act**") and amends several provisions of the Bankruptcy Code. Some of the amendments benefit commercial landlords, while others benefit business owner tenants. These amendments are limited, however, in that they only apply to bankruptcy cases that were commenced after December 27, 2020, and they will sunset as discussed below.

Significantly, the CAA pre-dates the recently enacted American Rescue Plan Act of 2021, which was signed into law by President Biden on Thursday, March 11, 2021, and which we published a summary of on Friday, March 12, 2021. Our analysis can be found here.

CAA Reduces "Preference" Exposure for All Commercial Landlords and Suppliers

The Bankruptcy Code provides certain causes of action by the debtor against those creditors who may have received payment just prior to the debtor's bankruptcy case to ensure an equitable distribution is ultimately made to all creditors. Specifically, the Bankruptcy Code provides that a debtor may recover certain payments it made while it was insolvent during the 90 days prior to the date it files for bankruptcy (the "**Commencement Date**") as a so-called "preference."[2] During COVID, some landlords agreed to defer commercial tenants' rent. If a tenant paid any of that deferred rent within the 90-day look-back period and subsequently filed for bankruptcy, then the tenant's (now debtor's) payment would be subject to avoidance (return) and recovery.[3] In other words, the debtor could potentially "claw back" the deferred rent payments it made 90 days prior to the Commencement Date to increase the distribution made to all its creditors.

The CAA, however, temporarily amends this section of the Bankruptcy Code, for the benefit of commercial lessors and, by extension, the commercial lessees. The amendment limits a debtor's ability to "claw back" certain deferred rent payments made within two years prior to the debtor's filing for bankruptcy as a preference.[4] Effectively, this eliminates preference risk for landlords who agree to defer rent and whose tenants later file for bankruptcy. Under

this amendment, a commercial-rent deferral is defined as a "covered payment of rental arrearages" and means a payment of arrearages that

i. is made in connection with an agreement or arrangement (I) between the debtor and a lessor to defer or postpone the payment of rent and other periodic charges under a [commercial lease]; and (II) made or entered into on or after March 13, 2020;

ii. does not exceed the amount of rental and other periodic charges agreed to under the [commercial lease] described in clause (i)(I) before March 13, 2020; and

iii. does not include fees, penalties, or interest in an amount greater than the amount of fees, penalties, or interest (I) scheduled to be paid under the [commercial lease] described in clause (i)(I) or (II) that the debtor would owe if the debtor had made every payment due under the [commercial lease] described in clause (i)(I) on time and in full before March 13, 2020.[5]

The theory is that this amendment will encourage landlords to be more open to providing tenants with rent deferrals if their exposure to a forced return of those funds in a tenant's bankruptcy case is eliminated.[6] This amendment will sunset on **December 27, 2022**.

Changes Affecting Subchapter V Small-BusinesS Tenant-Debtors with Less Than $7.5 Million in Debt

1. Subchapter V Debtors

On February 19, 2020, Congress enacted the Small Business Reorganization Act of 2019 (the "**SBRA**"), granting debtors the option to elect a new subchapter V of chapter 11 of the Bankruptcy Code ("**Subchapter V Debtor**"). The SBRA was enacted to provide small-business debtors the opportunity to reorganize in a more cost-effective manner than they otherwise would be able to under the Bankruptcy Code. The Bankruptcy Code defines a "small business debtor" as a "person (1) engaged in a commercial business activity, excluding the ownership of single asset real estate … (2) [that had] non-contingent liquidated secured and unsecured debt as of the date of the filing of the petition [in an amount] not more than $2,725,625 (excluding debts owing to affiliates and insiders), and (3) the majority of such debts must have arisen from the commercial or business activities of the debtor."[7] The CARES Act increased the $2,725,625 cap to $7,500,000, which is scheduled to sunset on **March 27, 2021**.

Notably, the CAA did not extend the increase of the Subchapter V Debtor cap. Therefore, after March 27, 2021, only debtors with $2,725,625 or less in debt will qualify as Subchapter V Debtors.

2. Increased Rent Deferral for Subchapter V Debtors

The Bankruptcy Code provides that once a commercial tenant files for bankruptcy, it must timely perform all of its lease obligations pending its decision to assume or reject the lease.[8] A debtor-tenant may request that the bankruptcy court permit it to defer paying its rent for 60 days after the Commencement Date, which is routinely granted by a bankruptcy court upon a showing of sufficient cause.[9]

The CAA temporarily amends this section of the Bankruptcy Code solely for Subchapter V Debtors. If a Subchapter V Debtor files for bankruptcy because of coronavirus-related financial hardship, then the CAA's Bankruptcy Code amendment permits such businesses to defer their rent to the earlier of (i) 120 days after they file for bankruptcy (twice the time that the debtor would normally have) and (ii) the debtor's assumption or rejection of the commercial lease.[10] As a result, debtors have more flexibility in paying their rent, while landlords assume the risk of providing a further involuntary extension of credit (and tenancy) to the debtor.

Any claims arising from the deferral of a debtor-tenant's rent under a commercial lease will be treated as an "administrative expense" under the Bankruptcy Code. Administrative expenses receive a special priority payment and are paid before other general unsecured creditors. This amendment will sunset on **December 27, 2022**.

3. Subchapter V Debtor-Tenant's Time to Assume or Reject a Commercial Lease Increased

Under the Bankruptcy Code, all debtors must determine whether to assume or to reject a commercial lease by the earlier of (a) 120 days after the Commencement Date and (b) the date of the confirmation of their plan of reorganization.[11] The bankruptcy court may may—and frequently does—extend the 120-day period on motion by the debtor by 90 days such that a debtor has up to 210 days after the Commencement Date to determine whether to assume or to reject a commercial lease.[12] Generally, if a debtor-tenant assumes its commercial lease, then it may assign the lease notwithstanding any provision in the lease that prohibits, restricts, or conditions the assignment of that lease, provided that the assignee can adequately demonstrate its ability to perform under the lease terms.[13] There are certain exceptions to a debtor's ability to assume and assign a shopping-mall lease.[14]

The CAA's Bankruptcy Code amendments, however, provide Subchapter V Debtors with an additional 90 days to determine whether to assume or to reject a commercial lease.[15] Therefore, Subchapter V Debtors have up to 300 days in which to determine whether to assume or to reject a commercial lease, placing additional pressure on commercial landlords. This amendment will sunset on **December 27, 2022**.

Regardless of the CAA's amendments to the Bankruptcy Code, if a commercial lease is rejected in bankruptcy, then a landlord's rejection-damages claim is capped at an amount equal to the greater of one year's unpaid rent or "15% … not to exceed 3 years" of the remainder of the lease term.[16]

4. Subchapter V Estate Property Does Not Include Pandemic-Relief Payments

Creditors, including commercial landlords, look to recover on account of their claims from available assets that qualify as property of the debtor's bankruptcy estate. "Property of the Estate" is broadly defined under the Bankruptcy Code, and generally includes all of the debtor's legal and equitable interests in property on the commencement of the bankruptcy case.[17] The CAA amends the Bankruptcy Code to provide that pandemic-relief payments are **not** property of the debtor's estate.[18] As a result of this revision, pandemic-relief payments will not be available to satisfy obligations owed to creditors. This amendment will sunset on **December 27, 2021**.

5. Subchapter V Debtors Eligible for Paycheck Protection Program Loans

The CARES Act led to significant litigation over its exclusion of bankruptcy debtors from being considered for Paycheck Protection Program ("**PPP**") loans. Effectively, debtors were prohibited from obtaining PPP loans.[19] The CAA does not remedy the existing litigation related to the CARES Act's exclusion of debtors getting PPP Loans. Instead, the CAA permits certain debtors to obtain PPP loans if they file for bankruptcy after December 27, 2020. Specifically, the Bankruptcy Code was amended to authorize PPP Loans to (i) Subchapter V Debtors, (ii) chapter 12 debtors (farmers), and (iii) chapter 13 debtors. Notably, the CAA excludes by omission chapter 11 debtors. This amendment will sunset on **December 27, 2021**.

6. Nondiscrimination Against Subchapter V Debtors Who Have Previously Received Aid Under the CARES Act

The CAA prohibits a landlord from utilizing a tenant-debtor's recent or current bankruptcy as the basis for denying a tenant's relief afforded by the CARES Act including the (i) foreclosure moratorium, (ii) provision providing for forbearance of residential-mortgage-loan payments for multifamily properties with federally backed loans, and (iii) temporary moratorium on eviction filings. This modification of the Bankruptcy Code is set to expire on **December 27, 2021**.[20]

We will continue to monitor bankruptcy and other relief provisions and will provide further updates as necessary.

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[1] Note, we previously have published a summary of the CAA which can be found here. This Alert specifically focuses on amendments the CAA made to the Bankruptcy Code and their impact on commercial real estate, which has been slow to recover from the pandemic's effects.

[2] 11 U.S.C. § 547. A "preference" is (a) a payment on an "antecedent" (meaning a previously incurred, as opposed to current) debt (b) made while the debtor was insolvent (c) to a non-insider creditor, within 90 days of the filing of the bankruptcy, (d) that allows the creditor to receive more on its claim than it would have had the payment not been made and the claim paid through the bankruptcy proceeding. Section 550 of the Bankruptcy Code allows the

trustee to avoid and recover any preference payments by filing a lawsuit against the creditor. The Bankruptcy Code presumes that a debtor was insolvent if it receives a payment during this 90-day period, thus shifting the burden to the landlord to prove that the tenant was not insolvent. Under the Bankruptcy Code, a debtor is generally considered to be insolvent if its debts exceed its assets on the day that it files for bankruptcy protection. There are several defenses to preferences that landlords and other commercial counterparties regularly employ that are beyond the scope of this alert.

[3] Id.

[4] CAA § 1001(g).

[5] Id.

[6] Section 1001(g) of the CAA offers similar protections for certain suppliers who agreed to defer a debtor's payments because of financial hardship caused by COVID. Like the requirements for a landlord to take advantage of this amendment, such supplier deferrals are defined as "covered supplier arrearages" and mean a payment of arrearages that

- is made in connection with an agreement or arrangement (I) between the debtor and a supplier of goods or services to defer or postpone the payment of amounts due under an executory contract for goods and services and (II) made or entered into on or after March 13, 2020;
- does not exceed the amount due under the executory contract described in clause (i)(I) before March 13, 2020; and
- does not include fees, penalties, or interest in an amount greater than the amount of fees, penalties, or interest (I) scheduled to be paid under the executory contract described in clause (i)(I) or (II) that the debtor would owe if the debtor had made every payment due under the executory contract described in clause (i)(I) on time and in full before March 13, 2020.

[7] 11 U.S.C. § 101 (51D).

[8] 11 U.S.C. § 365(d)(3).

[9] Id.

[10] CAA § 1001(f).

[11] 11 U.S.C. § 365(d)(4).

[12] Id.. Typically, courts extend this deadline for debtors, but the net effect is that commercial tenants must decide whether to assume or to reject a commercial lease within 210 days after filing for bankruptcy.

[13] 11 U.S.C. § 365(f)(1). Significantly, contract provisions that declare a default in the event of insolvency or bankruptcy, or would otherwise affect and/or waive the rights of a debtor in bankruptcy, called *ipso facto* clauses, are generally unenforceable.

[14] Under § 365(b)(3), to demonstrate adequate assurance of future performances, an assignee of a lease in a shopping mall must demonstrate

- adequate assurance of the source of rent and other consideration due under that lease and, in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease;
- that any percentage rent due under that lease will not decline substantially;
- that assumption or assignment of that lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and
- that assumption or assignment of that lease will not disrupt any tenant mix or balance in the shopping center.

[15] CAA § 1001(f).

[16] 11 U.S.C. § 502(b)(6).

[17] 11 U.S.C. § 541(b).

[18] CAA § 1001(a).

[19] Debtors asserted that excluding them from obtaining PPP loans violated § 525 of the Bankruptcy Code. Section 525 provides debtors with protection from discrimination by (a) governmental units, (b) private employers, and (c) governmental units and private entities operating student-loan programs. The discrimination must be due solely to the fact that the debtor filed for bankruptcy, was insolvent, or failed to pay discharged debts.

[20] CAA § 1001(c).

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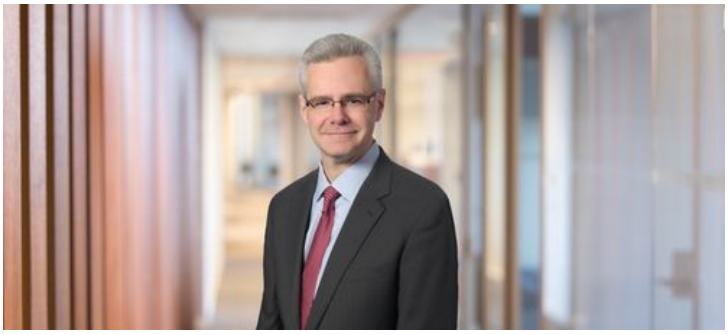

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