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Broken leases and tenant bankruptcies during COVID - by Irve Goldman

January 08, 2021 - Front Section

Irve Goldman
Bankruptcy

With broken leases and bankruptcies continuing to rise during the pandemic, it's crucial for commercial landlords to understand the intersection of lease termination and tenant bankruptcy.

In Connecticut, in order to terminate a lease for a default such as nonpayment of rent, the landlord must take an action that clearly demonstrates an intent to end the lease, typically by service of a notice to quit. However, when a tenant files for bankruptcy protection under Chapter 11, it has 120 days to decide whether to assume or reject a lease of commercial real estate. Whichever occurs first–the bankruptcy filing or the notice to quit–is a matter of great importance to how the lease will be treated in a Chapter 11 case.

The CT Bankruptcy Court employs a two-part test dating back to the late 1980s for determining whether a lease that was terminated prior to a bankruptcy filing can be assumed by the debtor. The first part asks whether the lease was validly terminated pre-bankruptcy under state law, and the second part requires the bankruptcy court to determine whether the termination would be reversed under the state's equitable non-forfeiture doctrine.

Equitable non-forfeiture came before the Connecticut Supreme Court this fall in Boccanfuso v. Daghoghi, where a tenant sought to prevent the loss of a terminated lease due to some unforeseeable business setbacks related to delayed permit approvals. The tenant claimed, however, that it failed to pay rent due to some environmental issues with the property that were the landlord's responsibility to resolve, but the lower court found this reason to be a pretense and the Supreme Court accepted that finding. The case hinged on the tenant's deliberate withholding of rent: a tenant must be justified in withholding rent–it can't be used as a bargaining strategy.

In deciding whether the lease could be saved, the court reviewed the three things that would be required for a tenant to be entitled to relief under the equitable non-forfeiture doctrine: 1. The breach must not have been willful or grossly negligent; 2. Upon eviction the tenant will suffer a loss wholly disproportionate to the injury to the landlord; 3. The landlord can be made whole for the default.

The court sided with the landlord and held that withholding rent in order to stay in business or draw the landlord's attention, which was found to be the real reason for not paying the rent, was not the type of good faith that would negate a willful nonpayment. Bankruptcy courts will now be guided by this new decision in determining whether a lease termination would be reversed by equitable non-forfeiture.

Although the case was decided in September, the events of Boccanfuso v. Daghoghi occurred in 2014, well before COVID-19. It remains an open question as to whether a government shutdown or the like would constitute a willful nonpayment of rent.

The Bankruptcy Code requires a tenant under an "unexpired" commercial real estate lease to continue to pay rent under the terms of the lease, but there is a legal question as to whether a lease

that was terminated prior to bankruptcy is considered unexpired where there is a chance it can be saved under state law. The Second Circuit Court of Appeals has held that such a lease is “unexpired,” but left open the issue of whether rent must be paid based on the lease terms. At least one bankruptcy court has held that if there is a possibility under state law to reverse the termination, the lease will be considered unexpired and the tenant will be obligated to continue to pay rent in accordance with the terms of the lease.

Irve Goldman is chair of the bankruptcy, creditors’ rights and financial restructuring practice at Pullman & Comley, Hartford, Conn.