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Congress Incentivizes Rent Deferral During COVID-19 Pandemic Through Bankruptcy Code Amendments in Stimulus Bill

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In the recently-passed *Consolidated Appropriations Act, 2021* (the "Act"), Congress provided much-needed cover for landlords that enter into forbearance agreements with their tenants during the COVID-19 pandemic by protecting landlords from exposure to preference litigation arising out of the deferred rent payments if the tenant were to later file bankruptcy.

What is a preference?

Generally, when an entity files bankruptcy, payments it made to its creditors in the 90 days prior to the bankruptcy filing are subject to potential recapture—*even though the payment was made on account of a legitimate obligation*. The Bankruptcy Code seeks to equalize treatment among all creditors by recovering payments made to creditors that were "preferred," that is, those that received *more* than they would have received if the bankrupt company liquidated and the proceeds were distributed ratably among all creditors. A lawsuit by the bankrupt company or trustee to recover such a payment is called a "preference" action.

Landlords tend to be frequent targets of preference actions if the landlord received a "catch-up" rent payment following a period of forbearance or default because the receipt of rent on account of a prior and overdue debt may be considered "preferential." This is in contrast to the receipt of rent in the ordinary course of business, which is a valid defense to a preference action. Early lease termination agreements may also be considered preferential, thereby exposing landlords to preference litigation.

Therein lies the potential pitfall for landlords in entering into forbearance agreements with their tenants: when a landlord agrees that a tenant may pay rent months (or years) after the rent originally came due, the eventual payment is arguably outside the ordinary course. As a result, the payment could be subject to disgorgement as a preference if the tenant were to file bankruptcy within 90 days of when the "deferred" rent payment was made. In other words, landlords that agreed to a rent deferral as a result of the business closures associated with the COVID-19 pandemic may unwittingly have made themselves the target of preference litigation.

What does the Act do?

By the Act, Congress has retroactively alleviated most of the risk of preference exposure as the result of a rent deferral agreement prompted by the COVID-19 pandemic. The new law prevents bankruptcy debtors and trustees from avoiding a transfer of a "covered payment of rental arrearages"—a defined term that includes a payment of arrearages:

(i) made in connection with an agreement to defer or postpone rent and other periodic charges made or entered into on or after March 13, 2020;
(ii) that does not exceed the amount of rent and other periodic charges agreed to under the lease before March 13, 2020; and
(iii) that does not include fees, penalties, or interest in an amount greater than that scheduled to be paid under the lease or that the debtor would owe if the debtor had made every payment under the lease on time and in full before March 13, 2020.[1]

The protection is temporary: the modifications to the Bankruptcy Code relevant to preference actions will sunset two years after the date of enactment of the Act, or December of 2022.

Takeaways for Landlords.

The inclusion of this protection for landlords removes a significant risk for landlords when evaluating an agreement with their tenants to defer rent.

Landlords must understand that only the deferred payments that meet the definition of "covered payment of rental arrearages" are protected. Fees, penalties and interest are not protected, nor is any increase in the amount of base rent or additional charges. Thus, landlords are still taking on some risk by entering into forbearance agreements because landlords will either forego the fees and interest typically used to make the landlord whole for late rental payments, or accept the risk that the excess portion of the late rental payment may give rise to preference litigation in the event of a later bankruptcy filing.

Landlords should also note that the Act does not protect from preference exposure a termination payment a tenant may make in connection with an agreement to terminate their lease agreement early. Such a payment (or possibly even the lease termination agreement itself) still carries risk of preference litigation in the event that the tenant files bankruptcy within 90 days of making the payment.

It is also worth noting that a "deferred" rent payment that comes due after the tenant's bankruptcy filing would not be subject to preference litigation and might be entitled to administrative expense treatment (which, generally

[1] The Act provides similar protection against preference litigation to vendors who enter into agreements with their customers to defer payment for goods and services.

speaking, are paid in full). On the other hand, a "deferred" rent payment that comes due prior to the bankruptcy filing but is not paid would likely be treated as a general unsecured claim (which often receive pennies on the dollar), and is subject to the Bankruptcy Code's statutory cap on lease rejection damages.

Issues relating to landlords' potential preference exposure are very nuanced and require careful analysis. Buchalter's Insolvency and Financial Law and Real Estate Departments are prepared to assist their clients through these complex issues.

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