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Clients&FriendsMemo

LET THE LANDLORDS BEWARE: WHAT HAPPENS WHEN TENANTS FILE FOR BANKRUPTCY IN ROMANIA

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Dear Clients and Friends:

Landlords in particular are having problems in the wake of Romania's markets downturn and contraction in consumer spending. Many of their tenants, especially those in the retail and consumer goods sectors, are now considering filing for bankruptcy as a way of seeking protection. Others are simply thrown into bankruptcy by disgruntled creditors (suppliers, banks, etc.).

What does this mean for the landlord and what rights does he have? This is relevant particularly to landlords with the same tenant holding leases in multiple commercial locations, e.g. franchisees, tenants in shopping centers, etc.

Before answering that question, it is important to note what exactly the tenant is seeking. Consistent with OECD and EU Directives¹, Romanian bankruptcy rules allow for either a: (i) insolvency reorganization during which the company is protected from creditors and is allowed to restructure its business so as to hopefully re-emerge from the process as a healthy business, or (ii) if there is no hope of redress, outright bankruptcy and liquidation of the debtor's assets with a

¹ According to the "Doing Business 2009" snapshot offered by the International Bank for Reconstruction and Development and the World Bank, Romania ranks 85th out of the 181 economies surveyed, worldwide. In Romania it takes an average of 3.3 years to complete a bankruptcy proceeding, whereas the average time for the region is 3.1 years and the time required in OECD states averages 1.7 years. It costs an average of 9% of the estate in Romania, compared to an average regional cost of 13.4% and an OECD average of 8.4%. The average recovery rate is 29.5 cents on the dollar in Romania, compared to an average of 28.3 cents in the region and 68.6 cents on the dollar in the OECD countries.

view to covering the outstanding debt owed to creditors. Reorganization may imply a partial sale of assets to help a quicker recovery.

Once a tenant has filed for bankruptcy (whether reorganization or outright liquidation) and the court has started procedures, a number of legal consequences and bankruptcy-specific mechanisms kick in, which affect the landlord:

Unsecured Position of Landlords

- Without a successful reorganization, chances to recover pre-filing rents and accrued interest are low, since landlords are unsecured creditors. It is true that landlords under the Civil Code enjoy a lien over the tenant's goods located in the premises to ensure payment. But in insolvency proceedings, this has little value: the landlord cannot retain the goods since the trustee will ultimately seek possession and determine how best to use or dispose of them to further the interests of the creditors. Furthermore, the lien over the tenant's goods located in the premises may not be effective, in both situations where reorganization or liquidation are pursued (i.e., either enforcement of lien is suspended, or trade stock may prove insufficient to cover the claims).

No Self-help Remedies Available

- Under Romanian law, the landlord does not enjoy "self-help" remedies. As such, he cannot change the locks or take possession of tenant's goods. Also, it becomes irrelevant if it is the tenant or the landlord who has contracts with utilities providers for the leased premises, since the law expressly prohibits utilities providers themselves to stop or refuse provision of utilities to the tenant or its estate.

Past Rent and Accrued Interest Frozen

- All pre-filing rent arrears, accrued interest, penalties and damages are frozen and cease to be enforceable against the tenant from the insolvency date going forward. The judicial trustee will require the landlord to file its monetary claims and follow the collective procedure together with all other creditors, hoping for a good recovery rate during reorganization or ensuing liquidation. If reorganization is pursued, the judicial trustee may even propose a reduction in the landlord's pre-filing claims.

Enforcement Proceedings Halted

- There is an 'automatic stay' on all claims, which remains in place until the bankruptcy procedure is closed. A "stay" means that all enforcement and court proceedings against the tenant are brought to a halt – the bankruptcy court working at the advice of the creditors committee and the judicial trustee are the only bodies permitted to take decisions. This will prevent the landlord from terminating the ongoing leases, evicting the tenant, or even pursuing collection efforts. The freeze-out provides breathing space,

allowing for the debtor to deal with its assets in an orderly fashion. Any clauses entitling the landlord to terminate the leases as a result of bankruptcy are ineffective.

Discretionary Powers over Leases (Cherry Picking)

- All ongoing contracts are automatically taken over ('assumed', as per bankruptcy parlance) as of the date of the insolvency court order. If there are executory leases at the moment of the insolvency court order, they become subject to this rule, and cannot be terminated by the landlord. However, in order to "increase the value of the debtor's estate" the judicial trustee has the option to carve-out (or "reject") all or some of the leases. The rejection of leases means effectively renouncing the contracts, regardless of either party's default. Once the lease is rejected, the tenant must vacate and surrender the premises in due time.

Opt-out Mechanism

- If the landlord wants to forfeit the leases and regain possession of the locations for re-lease to another tenant, the only option is to file a request with the trustee, who is compelled to make a decision within thirty (30) days. Failure to respond by the trustee means the leases are 'rejected' and the landlord may proceed with eviction. Note that in practice a trustee will always consult with the tenant before rejecting leases, as these could prove to be essential in the 'reorganization' and the tenant has the right to challenge any rejection before the insolvency court.

Leases Mandatory if Assumed

- If the leases remain 'assumed', the tenant must comply with all their terms and continue or resume paying the rent, effective from the insolvency date. The rent cannot be modified without the landlord's consent.

Guarantees Available

- Third party guarantees benefiting the landlords (such as bank or parent guarantees) remain enforceable and can be pursued. Rental deposits are less secure: a landlord who failed to forfeit until insolvency date does not have an automatic right to keep a deposit, and if he nevertheless does, the trustee may request the insolvency court to claw back the amounts.

Insolvency through reorganization may last as long as three (3) years. An insolvency plan could be put together not earlier than three (3) months, also depending on the complexity of the business, the creditors' various interests and the amount of consensus the debtor and/or the trustee could build among creditors. The plan becomes operative once endorsed by the insolvency court.

If the tenant has filed for bankruptcy or there are fears that a filing is imminent, the landlord should immediately seek legal advice and form a pre-emptive or mitigating strategy, to minimize the effects of such actions. We list some general precautionary measures we recommend landlords to take in order to prevent tenants from running for insolvency protection and avoid eviction:

- Closely monitor tenant payments and be on the lookout for signs that trouble may be brewing, e.g., late payments, reports in the press, etc.;
- Have termination notices already prepared and ready to be sent immediately once there is suspicion of filing for insolvency. Time is of the essence, and delays encountered can only damage a landlord's position;
- Check validity of rental deposits and third party guarantees and be on the lookout for expiry dates;
- Follow closely notification procedures – failure to properly notify can lead to the notification being considered as not having been delivered.

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If you have any questions about this memorandum, please feel free to contact:

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