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NO GOOD DEED GOES UNPUNISHED:
WORKOUTS AND THE IMPORTANCE OF PREPARING FOR THE TENANT'S BANKRUPTCY

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Financial distress may be the retail landlord's first sign of an imminent bankruptcy filing by the tenant. While close monitoring of the tenant's financial condition by the landlord may serve as a distress warning, it is, more often than not, impractical in practice and a luxury the retail landlord cannot afford. Early signs of financial distress are often not the landlord's first and foremost consideration so long as the tenant is timely paying rent. The monitoring process, moreover, taxes scarce resources and the financial information, in and of itself, may be inaccessible to the landlord. For these and other reasons, the tenant's failure to pay rent or other obligations under the lease are typically the landlord's first sign of financial distress and a possible bankruptcy filing by the tenant.

Most tenants react to financial distress with efforts to reorganize outside of bankruptcy court and utilize the practice of using the landlord to "finance" its reorganization in the process. The tenant employing this practice reallocates cash that it would otherwise use to pay rent to other areas of its business deemed more critical to its ongoing operations. This practice manifests itself through the nonpayment of rent or a request for rent concessions from the landlord. When this situation arises, the landlord's focus is ordinarily on negotiating with the tenant to maintain the tenancy rather than preparing for an imminent bankruptcy. This point represents a critical juncture for the landlord — it can either negotiate a workout with the tenant in a vacuum, or it can do so within the context of a potential bankruptcy filing. In the latter scenario, the landlord is more likely to maximize its value proposition as a creditor in the bankruptcy proceeding. Under the former scenario, the landlord merely learns a difficult lesson: No good deed goes unpunished.

There are certain precautions the landlord should take, depending upon the particular workout scheme being negotiated with the tenant in order to fortify its position as a creditor if a subsequent bankruptcy occurs. In all circumstances, it is absolutely critical for the landlord to use a negotiation agreement in a proposed workout situation if the landlord decides to engage in restructuring negotiations to help keep the tenant financially afloat. The negotiation agreement should include the tenant's acknowledgment and confirmation that there are no oral agreements that can be enforced against the landlord and that the landlord reserves its right to exercise all of its available remedies at any time. A landlord does not want a tenant to argue that the landlord verbally agreed to a lease modification or otherwise verbally waived some of its rights. The negotiation agreement also serves as a useful tool to maintain pressure on the tenant to work something out.

The most common workout schemes in these situations are rent deferrals, promissory notes and lease terminations. Each of these proposed workout schemes is not without risk in a subsequent tenant bankruptcy, and landlords should understand the potential preference and fraudulent transfer issues that may arise.

Rent Deferral

Assuming the landlord is willing to grant a rent concession, the landlord should agree to defer rent only until some future date. The rent deferral document should refer to and define the deferred portion of the rent as rent due under the lease. In the event the tenant files bankruptcy prior to the due date for the deferred rent, the landlord is still able to argue that the deferred rent became due after the filing date of the Chapter 11 case and, therefore, must be timely paid as part of the tenant/debtor's obligations under §365(d)(3) of the United States Bankruptcy Code. Should the tenant/debtor assume the lease in the bankruptcy proceeding and the deferred rental is clearly defined as rent due under the lease, the tenant will be required to pay those amounts as part of its cure obligations under §365(b)(1)(A) of the United States Bankruptcy Code.

Note for Rent and Other Obligations

In some circumstances, the landlord will accept a promissory note for past-due rent. If a promissory note is accepted for past-due rent, it should clearly provide that the amounts due under the note shall constitute additional rent due under the lease. This precautionary drafting measure can make an important difference in a bankruptcy case because the tenant will have to cure the obligation if the lease is assumed, provided the payments under the note are not clearly designated and defined as rent under the lease. It is also essential for the landlord to include a cross-default provision in the drafting of the promissory note and, similarly, to amend the lease so the tenant/debtor may be required to cure both defaults in connection with an assumption of the lease. These precautions can improve the landlord's position as a creditor because there is case authority supporting the enforcement of cross-default provisions. *In re Koppel*, 232 B.R. 57, 68 (Bankr. E.D.N.Y. 1999); *In re Liljeberg Enterprises, Inc.*, 304 F.3d 410, 445-46 (5th Cir. 2002) (cross-default provisions held enforceable in a pharmacy agreement); but see *In re Sambo's Restaurants, Inc.*, 24 B.R. 755, 757 (Bankr. C.C.D. Cal. 1982).

Preference Issues

The landlord's acceptance of past-due rent, whether by way of a deferral agreement or a promissory note, is not without risk in a subsequent tenant bankruptcy. Any payments made within the filing date of the bankruptcy petition may become the subject of a preference or fraudulent transfer action by the tenant/debtor or trustee to recover such payments. It is not uncommon for the landlord facing an adversary proceeding to assert the common defenses, including that the payment was made in the ordinary course of business and the landlord gave new value to the tenant/debtor. The pitfall for the landlord in asserting the new value defense is the argument that the tenant was given new value through the landlord's forbearance in the exercise of its rights under the lease after receiving the tenant's payment. However, the case authority appears uniformly to hold that merely forbearing from an exercise of the landlord's rights under the lease does not constitute new value. See *Bernstein v. R. J. L. Leasing*, 50 B.R. 403 (D. Co 1985); *Sunbeam Oyster Co., Inc. v. Lincoln Avenue, Inc.*, 145 B.R. 823 (W.D. Pa. 1992). Some bankruptcy courts have crafted exceptions to this general rule. One such exception holds that there is subsequent new value in allowing the tenant/debtor to continue to use the space after a default. These courts reason that when the value to the debtor/tenant of the leased premises exceeds the total amount of the preferential payments, the landlord has provided subsequent new value. *In re Quality Plastics, Inc.*, 41 B.R. 241 (W.D. Mi. 1984) (holding that unpaid subsequent lease payments provided new value in the form of "free rent" for preferential lease payments).

Another possible exception to the general rule is demonstrated in *Brown v. Morton*, 201 B.R. 563 (W.D. Wa. 1996). In that case, the court held that the landlord could offset the full amount of lease payment defaults against any alleged preferential payments if the debtor/tenant defaulted after such payments. By allowing the debtor/tenant to remain in possession of the leased premises without paying rent, the landlord extended value that did not exist at the time the lease was executed. The Eighth U.S. Circuit Court of Appeals has also held that the rent-free use of property after a preferential payment constituted a material benefit to the debtor/tenant, thereby replenishing the bankruptcy estate after the alleged preferential payment and supporting the application of the subsequent new value defense. *Southern Technical College, Inc. v. Hood*, 89 F.3d 1381 (8th Cir. 1986).

It is important to note that these cases hold that new value could constitute additional time under the lease to retain the premises rent-free, which remains unpaid by the tenant. The additional benefit must be in the form of free and unpaid rent after the preferential payment is made. Free rent is obviously different from merely agreeing to forbear, and landlords should be cautioned that merely agreeing to forbear from exercising their rights under the applicable lease will not, in and of itself, give them a new value defense to a preferential payment. Of course, the landlord still may be able to argue the defense that the transaction was in the ordinary course of business, and that new value was extended in those subsequent months when rent remained unpaid.

Lease Termination

The delay and cost to a retail landlord resulting from a tenant bankruptcy can be considerable. By exercising a landlord's remedies in strict compliance with the lease and applicable law, however, a landlord may be positioned to negotiate with the tenant from a leveraged position and to mitigate its exposure in a subsequent bankruptcy.

An analysis of the available state law remedies under a lease is outside the scope of this article. However, if available, termination of the lease is the most advantageous tool for the landlord. The landlord that aggressively exercises its remedies, within the confines of the law, is in a better position to negotiate if and when the filing occurs. The termination of the lease can be accomplished either unilaterally by the landlord or bilaterally, as when it is mutually agreed upon by both the landlord and the tenant.

The landlord and the tenant may reach a mutual agreement to terminate the lease, which may be the most workable solution for the landlord that wants to recapture the lease space and avoid lengthy involvement in a subsequent tenant bankruptcy; or, if available, a landlord may exercise its right to terminate the lease upon a default by the tenant. According to §362(b)(10) of the United States Bankruptcy Code, a lease does not become property of the estate, and the landlord is not subject to the automatic stay if the lease has terminated by the expiration of its stated term before the bankruptcy filing. In this scenario, the landlord can obtain possession of the premises free of the bankruptcy court and without violating the provisions of the automatic stay.

This safe-harbor provision, however, may not apply if the landlord has terminated the lease because of a tenant default. Thus, it is not clear whether a landlord's post-petition efforts to repossess would violate the automatic stay when the pre-petition termination of the lease occurred by virtue of a tenant default. A landlord may attempt to draft itself within the exception of §362(b)(10) by crafting language in the default and termination provision of the lease. The language of such a provision could provide that the stated term of the lease is deemed to have expired on the landlord's termination of the lease for a tenant default. Because a bankruptcy court may view such a provision as form over substance, however, a landlord is still well advised to seek relief from the automatic stay to avoid any question of what, if any, rights under the lease or applicable state law a landlord may exercise after a bankruptcy filing.

When the tenant has value in a particular lease and the lease is terminated, there is some authority to suggest that such termination can be set aside as either a preference or fraudulent transfer. *In re Finelli Jewelry Co., Inc.*, 79 B.R. 521, 522 (Bankr. D.R.I. 1987). A lease termination is clearly a transfer of the tenant/debtor's interest in property. *In re Thompson*, 186 B.R. 301, 307 (N.D. Ga. 1995). In the case of *In re Durso Supermarkets, Inc.*, 193 B.R. 682, 696-700 (S.D.N.Y. 1996), on the other hand, the court held that a lease termination could not constitute a preference because the lease was above-market value. The state of the law is unclear on this issue, and the landlord should be advised of the risks. The risk is probably lower if the lease is at or below market. It is greater, on the other hand, if the landlord has unilaterally terminated the lease. Of course, it may be better for the landlord to take that risk and get control of its space with the knowledge that it may have to defend itself in subsequent litigation. The better practice for the landlord is to exercise its unilateral right of termination, if available, and then attempt to reach an agreement with the tenant on a mutual termination of the lease.

A landlord must pay "reasonably equivalent" value for the lease termination to avoid a subsequent attack on preference or fraudulent transfer grounds. If the lease had already been unilaterally terminated by the landlord as a result of a tenant default — provided such grounds existed under the lease — then, presumably, the tenant would not be entitled to anything in the way of "reasonably equivalent" value. In this scenario, the landlord has maximized its leverage with the tenant; reduced the chances of a subsequent preference action being brought by the tenant/debtor; and, if brought, managed the risk of exposure to a successful preference action.

Conclusion

Retail landlords typically see the first signs of financial distress by way of a monetary default under the lease. In workout situations, it is critical for the landlord to combine the use of negotiation agreements and an understanding of the effect that its pre-petition action has on its post-petition rights as a creditor in a bankruptcy proceeding. Employing this combination of skills and tools affords the retail landlord the best opportunity to position itself as a creditor before the tenant's bankruptcy filing. Retail landlords are well advised to engage competent counsel experienced in this area upon the first signs of the tenant's financial distress. ■

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