When the Best Defense is a Strong Defense - A Commercial Landlord's Guide to Dealing with Financial Distress and the Bankruptcy of a Tenant

By Trent Rosenthal and Lee A. Collins

Commercial landlords, property managers, and real estate lawyers are familiar with the golden rule of real estate—location, location, location. Over the years, those three words have been heard as the magical answer to any question or problem involving real estate. But the unfortunate reality is that a myriad of problems the commercial landlord and the lawyer must deal with cannot be resolved so simply. The difficulty is no more apparent than when a commercial tenant experiences financial distress and files Chapter 11 bankruptcy reorganization or Chapter 7 liquidation after it is unable to work out something with its landlord and other creditors. Commercial landlords and real estate lawyers do have strategies that can maximize the value of the outcome.

The best offense for dealing with a tenant in financial crisis or bankruptcy is a strong defense, and the defense starts when the real estate lawyer representing the landlord drafts the lease. A well-versed real estate practitioner will include a number of provisions in the landlord's "standard" form that are designed to protect the landlord's rights and offer favorable remedies in the event of a tenant default under the law of the state where the improved real property is located. Landlords should think twice before negotiating away the various rights and remedies that are available under their "standard" form lease. These can take center stage when a tenant's financial crisis hits.

Still thinking defense, a landlord should take some basic steps, namely the perfection of a contractual lien, as soon as the lease is signed to prepare for a possible tenant bankruptcy. Most commercial leases have both contractual and statutory landlord's liens. Although a statutory landlord's lien is not enforceable in bankruptcy under Bankruptcy Code § 545 (11 U.S.C. § 545), a properly perfected contractual landlord's lien under the applicable state Uniform Commercial Code will give a landlord a security interest in the tenant's property. Although it may be difficult for a landlord to obtain a first lien on the tenant's property because the tenant will usually have some bank financing in place, a landlord with a junior lien may be able to use the lien as leverage to gain an advantage in any subsequent bankruptcy and/or to receive a greater distribution on a secured claim. If a landlord waits until a tenant has financial problems to perfect its interest in the collateral, it may be too late, and potentially the interest can be set aside as an avoidable transfer known as a preference.

Careful monitoring of the financial condition of its tenant is another basic step the landlord should take. Although public companies usually have public reporting requirements that make it easier for a landlord to monitor the tenant's financial condition, a landlord can still monitor private companies by requiring the tenant to comply with financial reporting requirements. Landlords should review the information on a regular basis and not merely toss it to the file. Early signs of a tenant's deteriorating financial condition include the obvious, such as a tenant's habitual late payment of monthly rent and other obligations due under a lease, and the less obvious, such as negative financial information reported on public filings. Waiting to act until a monetary lease default may be too late.

A tenant suffering from financial distress may approach the landlord with a request for rent concessions. Most tenants experiencing serious financial difficulty believe that they can "finance" their reorganization, whether in court or out of court, through rent concessions. Should the landlord decide to engage in restructuring negotiations in a proposed workout situation to help keep the tenant afloat, it is absolutely critical for the landlord to use a "negotiation agreement" when dealing with a tenant in a proposed workout situation. A negotiation agreement should have the tenant acknowledge and confirm that no oral agreements 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 keeps pressure on the tenant to work something out.

If, however, the landlord's sole objective is to obtain control of the space and evict the tenant, it should terminate the lease in its entirety and not just the tenant's right of possession. The bankruptcy court will look to state law to determine if the lease has been properly terminated and will enforce ter-

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mination provisions that are properly drafted. See *Comp III, Inc. v. Computerland Corp. (In re Comp III, Inc.)*, 136 B.R. 636, 638–39 (Bankr. S.D.N.Y. 1992). According to Bankruptcy Code § 362(b)(10), 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 Section 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.

Practitioners should advise their landlord clients of the risk attendant to a pre-petition termination of a lease. If the debtor has value in a lease terminated by the landlord, some authorities suggest that such termination can be set aside as a preference or fraudulent transfer. *In re Finelli Jewelry Co., Inc.,* 79 B.R. 521 (Bankr. D.R.I. 1987). On the other hand, a court held that a lease termination could not constitute a preference or fraudulent transfer because the lease was above market value. *In re Durso Supermarkets, Inc.,* 193 B.R. 682, 704–06 (Bankr. S.D.N.Y. 1996). Thus, the law is unsettled on the issue. 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 landlord that wants to recapture the space and avoid a tenant bankruptcy may find an agreed lease termination or buyout of the lease a workable solution. In such a situation, the landlord should be advised that it must pay "reasonably equivalent" value to avoid a subsequent attack on preference or fraudulent transfer grounds. If the lease had already been terminated as a result of a default, then, presumably, the tenant would not be entitled to receive much in the way of "reasonably equivalent" value.

When the bankruptcy petition is ultimately filed, it is time to put the offense on the field. Understanding how leases are treated and the options available to a debtor is critical. A primary concern to a landlord is a tenant's failure to pay rent both before and after the filing of the bankruptcy petition. Securing prompt payment of post-petition, pre-rejection rents should be one of the goals of the practitioner. Bankruptcy Code § 365(d)(3) requires the debtor to "timely perform all the obligations" under the lease that arise on and after the petition date and continuing through the effective date of rejection. In other words, the bankruptcy laws *require* the tenant to pay all rent from and after the filing date so long as it retains the space. The majority of courts allow administrative claims for post-petition rent without regard to the use of the property. This is true without regard to the trustee's use for the leased premises, that is, operating the business or just storing the debtor's records after the debtor has vacated the premises. See, e.g., *Towers v. Chickering & Gregory (In re Pacific Atlantic Trading Co.),* 27 F.3d 401 (9th Cir. 1994). Claims arising under Section 365(d)(3) are allowed in the amount of rent due under the lease. *In re Mr. Gatti's,* 164 B.R. 929 (Bankr. W.D. Tex. 1994). The post-petition, pre-rejection obligation extends to common area maintenance, escalation charges, and any other monetary obligations that could be construed or defined as "additional rent" under the terms of the lease. Should the debtor or trustee fail to make payment, the practitioner should file a motion for payment of an administrative claim under Bankruptcy Code § 503 to obtain a court order compelling payment.

One of the debtor's options is to reject the lease and surrender the premises to the landlord. If the tenant does not elect to assume or reject the lease within 60 days of the filing date, then the lease is deemed rejected by operation of law. Rejection of a lease in a bankruptcy case under Chapter 7 most often occurs in this fashion. In a case under Chapter 11, it is more common for the rejection to occur on entry of an order approving the debtor's motion to reject. The court can, and likely will, extend the 60-day period on cause shown, which is fairly typical in retail cases. The landlord should (1) object to unreasonably long requests because any extension lengthens the period of uncertainty about the debtor's intentions for the lease and (2) seek to condition the extension on the debtor's performance of its Section 365(d)(3) lease obligations.

When a lease is rejected, landlords often have a two-pronged unsecured claim against the debtor for unpaid rent as of the date the bankruptcy petition is filed and for rent damages by virtue of the rejection of the lease. These two claims are combined under Bankruptcy Code § 502 and are commonly referred to as a landlord's "rejection damages." Section 502(b)(6) sets the "cap" on a landlord's damage claim at (1) any unpaid rent due under such lease on the earlier of the petition date or the date on which the landlord repossessed (or the lessee surrendered) the leased property, *plus* (2) the rent reserved in the lease, without acceleration, for the greater of one year or 15% (not to exceed three years) of the remaining term of the lease, calculated from the earlier of either the petition date or the date on which the landlord repossessed (or the lessee surrendered) the leased premises.

The application of Section 502(b)(6) has given rise to a number of questions. One question is, "How do you calculate the cap?" Put another way, does "15 percent of the remaining term of the lease" refer to 15% of the remaining lease term or 15% of the remaining rental value of the lease? Courts have gone both ways on this one. At least one court has held that the calculation should be made on the basis of the aggregate rents remaining under the lease rather than on the time peri-

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od. *In re Gantos, Inc.*, 176 B.R. 793 (Bankr. W.D. Mich. 1995). Other courts have held that this section refers to a calculation of time as opposed to rental amounts. See, e.g., *In re Financial News Network, Inc.*, 149 B.R. 348 (Bankr. S.D.N.Y. 1993).

A second question concerns what Congress meant by "the rent reserved under the lease." A rule of thumb is that any regular fixed periodic charge under a lease falls within the scope of the phrase "rent reserved in the lease." *In re Conston Corp.*, 130 B.R. 449 (Bankr. E.D. Pa. 1991). The damages flowing from a debtor's breach of a lease covenant are also probably within the scope of the statutory cap. *In re Mr. Gatti's*, 162 B.R. 1004 (Bankr. W.D. Tex. 1994). Some charges are not considered "rent reserved in the lease" even if collectible under a lease. Despite the belief among many clients that the invoices they receive from their attorneys are far too regular, attorney's fees incurred by the landlord are typically not part of the rejection damages claim. See *In re Pacific Arts Pub., Inc.*, 198 B.R. 319 (Bankr. C.D. Cal. 1996). A charge is considered "rent reserved under the lease," however, if it is defined as "rent" under the lease. *In re Clements*, 185 B.R. 895 (Bankr. M.D. Fla. 1995). The lease should thus include attorney's fees in the definition of "rent" under a lease so as to encompass pre-petition attorney's fees within the unsecured claim. State law mitigation principles have also crept into the debate over the calculation of rejection damages under Bankruptcy Code § 502(b)(6), and, in some states, debtors increasingly raise the issue of mitigation in claim objection proceedings to reduce rejection damage claims. Bankruptcy courts may consider whether state law requires mitigation and whether such efforts are reasonable in light of applicable state law, irrespective of Section 502(b)(6). *In re Heck's, Inc.*, 123 B.R. 544 (Bankr. S.D. Va. 1991). Application of mitigation principles to Section 502(b)(6) claims are straightforward when the premises have been relet because the amount of rent received from the new tenant is merely deducted from the overall damages claim before the application of the cap. *In re Bob's Sea Ray Boats, Inc.*, 143 B.R. 229 (Bankr. D.N.D. 1992). The application is not so straightforward when the premises have not been relet because of the interplay of federal bankruptcy law and applicable state law mitigation principles, which vary from state to state.

The debtor also has the option of assuming the lease as it is written. A debtor's assumption of the lease is conditioned on curing its defaults and providing adequate assurance of future performance. In practice, the tenant may use this opportunity to try to renegotiate the lease with the landlord by threatening rejection and leaving the landlord with a dark space and an unsecured claim. Any renegotiation of the lease should be conditioned on the tenant's assumption of the new modified lease, on an agreement not to seek assignment of the lease, and on the express approval of the bankruptcy court. As with virtually any obligation arising under the Bankruptcy Code, however, the requirement for a debtor to cure on assumption is not absolute and without judicial exception. A recent decision of the Court of Appeals for the First Circuit casts doubt on whether a tenant assuming a lease must cure all nonmonetary defaults. In *Eagle Ins. Co. v. Bankvest Capital Corp. (In re Bankvest Capital Corp.)*, 360 F.3d 291 (1st Cir. 2004), the court held that a debtor assuming a personal property lease was not required to cure certain nonmonetary defaults. This case could have a broad-ranging effect on landlords because a debtor may be able to assume the lease without curing violations of nonmonetary lease provisions, effectively allowing the debtor to disregard the negotiated terms of the lease so long as the bankruptcy case is pending. This is not the only situation in bankruptcy in which the debtor can change the terms of the deal.

Bankruptcy courts routinely permit tenant liquidation sales even when a lease agreement specifically prohibits them. After the client stops the swearing that inevitably follows this disclosure, the first question it may ask is whether the tenant can turn its store into a flea market in the process. To avoid the carnival-like atmosphere that can result when a debtor is left to its own devices, the practitioner should advise the client that Bankruptcy Code § 363(e) allows for the imposition of reasonable restrictions on a tenant's liquidation sale. Frequently, a landlord's success in imposing guidelines hinges on whether an efficient process is in place for notifying the key decision maker within the landlord's organization of a tenant's bankruptcy filing. Debtors employ a strategy of filing "first day motions" along with the bankruptcy petition to catch some creditors unprepared and unable to respond in a timely manner. In larger retail cases with numerous lease locations, debtors use this strategy to steamroll landlords with requests for relief that ordinarily give landlords heartburn. Liquidation sales can fall into the category of first day motions. The landlord that acts quickly on receipt of notification is in the best position to evaluate the debtor's request and determine whether it should seek protection of its rights. Liquidation sales are conducted by the debtor, as is common in smaller cases, or by a court-approved liquidator, which is seen in large retail cases with a number of planned store closures. Separate and apart from who conducts the sale is the equally, if not more, important concern over the timing and manner of the sale, parameters for signage, and adherence to the mall's rules and regulations. A landlord should consider guidelines for the size, placement, type, number, wording, and color of any signage used. Additional guidelines to consider should include rules and regulations:

- prohibiting the sale of tangible personal property other than the debtor's inventory;
- regarding the removal of any furniture, fixture, equipment, and unsold inventory in accordance with the mall's regulations;
- mandating that the liquidator and debtor are liable for satisfying all financial obligations under the lease, such as insurance and indemnity obligations;
- requiring the liquidator or debtor to maintain the premises and to surrender them promptly after the conclusion of the sale in accordance with the lease;
- compelling rejection or assumption and assignment of

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the lease by the time the sale concludes;
- prohibiting the alteration of the premises;
- providing that all furniture, fixture, equipment, and inventory that remain on the premises after the sale are deemed abandoned so that the landlord can, without seeking a further order of the court, discard those items; and
- requiring that the liquidator track and report sales for reporting percentage rent.

The debtor's final option is to assume the lease and assign it to a third party. The debtor's objective when employing this option is to extract value from the lease through an assignment. A debtor will pursue this option if the lease is undermarket or if the purchaser of debtor's assets wants to keep the business in place at the same location. The third party must provide adequate assurance of future performance. On any assignment, the debtor is relieved from any liability for any breach occurring after such assignment under Bankruptcy Code § 365(k). In addition to requiring adequate assurance of future performance from any assignee as required by Section 365(f)(2), the landlord may also require a deposit or other security for the performance of the debtor's obligations substantially the same as would have been required by the landlord on the initial leasing to a similar tenant.

Conclusion

By acting quickly and decisively, a commercial landlord can minimize the exposure to potential loss in the event of a tenant bankruptcy. Commercial landlords are well advised to engage competent counsel experienced in this area on the first signs of financial distress. Combining an aggressive offense with a tactical defense can increase the odds of a successful outcome for the landlord on the bankruptcy playing field. ■

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