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Buckle Up in Advance of the Storm—A Landlord's Guide to Mitigating Risks in Tenant Retail Bankruptcies

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The authors of this article address several considerations to best position landlords leading up to a tenant bankruptcy and ways to protect their interests once such a bankruptcy has commenced.

Reports of retail bankruptcies and announced store closings are widespread given the rapidly changing paradigm in consumer behavior. Projections for store closings in 2017 alone are as high as 8,600, more than four times the number of closings in 2016 and well above the number experienced at the height of the Great Recession in 2008–2009. 2017 has seen bankruptcy filings by the owners of many well-known brands, beginning with The Limited in January and including Payless ShoeSource, Gymboree, rue21, Gander Mountain, and many others.

Others have announced their intention to cut jobs and close scores of locations across the nation (e.g., Macy's, JC Penney, GameStop, and Ascena Retail Group's brand names).

Landlords have taken notice and begun preparing themselves for coming tenant defaults and bankruptcies, perhaps those of several tenants at the same location.

In this article, we address several considerations to best position landlords leading up to a tenant bankruptcy and ways to protect their interests once such a bankruptcy has commenced.

"Preference" Risk

With so much distress roiling the retail landscape, it is not surprising that many retailers are left with few choices but to stretch rental payments in order to preserve precious liquidity, particularly in respect of unprofitable locations. Of course, landlords are motivated to maximize recoveries, but in doing so they also must be careful to mitigate the risk that

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pre-petition that is collected is not later subject to recoupment in bankruptcy.

The most prominent risk is avoidance of prepetition payment as "preference" under the Bankruptcy Code.

Very generally, a debtor (or Chapter 7 or Chapter 11 trustee of such debtor, if applicable) may avoid a transfer of an interest in the debtors' property (whether in the form of cash payments, providing a new or larger security deposit or granting a new lien on its assets) to the extent made:

(1) During the 90-days prior to the commencement of the bankruptcy;

(2) On account of antecedent debt (*e.g.*, rent previously due); and

(3) While the debtor was insolvent, if such transfer allows the landlord to receive more than it otherwise would in a liquidation of the tenant's assets had such transfer not been made.

As a result, if, for instance, an insolvent tenant makes a rental payment two weeks late, and then files bankruptcy within the next 90 days, that payment may be subject to recoupment as a preference.

There are various statutory defenses available to creditors facing potential preference liability, two of which are particularly notable landlords:

- *Ordinary Course Defense*. If an otherwise preferential payment was made in the ordinary course of the parties' commercial relationship (*e.g.*, the tenant regularly made its rental payments roughly two weeks after the due date in the lease, such payment may be protected from avoidance). The determination of what constitutes an ordinary course payment is necessarily subjective and will be considered on a case-by-case basis.

  As a result, it is important that a landlord maintain a well-documented payment history with its tenant and, to the extent feasible under the circumstances, avoid actions that might be used as evidence that the ordinary course exception does not apply. Actions that may undermine the ordinary course defense include delivery of payment demands or dunning notices where the notice of a default is not otherwise required.

- *Contemporaneous Exchange Defense*. If a payment was a contemporaneous exchange for new value, such payment may also be protected from avoidance. Where the landlord otherwise is prepared to provide a waiver or forbearance agreement with respect to existing tenant defaults that otherwise would have entitled it to terminate the lease, it may be able to defend subsequent payments it receives from the tenant as a potential preference by structuring its agreement with the tenant as an affirmative right to remain in the premises despite the prior default.

The agreement should expressly evidence the parties' intent that payments made under such agreement were not on account of its failure to pay prior rent but instead as a contemporaneous exchange of new value enabling the tenant to occupy the leased premises.

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Lease Termination

In confronting distressed tenants, particularly those that already have defaulted on their lease obligations, landlords must be proactive in assessing whether it is preferable to terminate the lease or not.

On the one hand, termination may require the commencement of eviction proceedings, diminished prospects for recovering unpaid rent and dealing with more vacant space in a difficult leasing environment.

On the other hand, if it does not terminate and the tenant files for bankruptcy, the landlord will be stymied by the automatic stay from exercising remedies and may become embroiled in the tenant's bankruptcy case as its tenant decides whether to assume, assign or reject such lease. In order to preserve options, these decisions must be addressed as early before a potential bankruptcy as feasible. If the landlord determines that termination is preferable, it should take actions to terminate promptly. If properly terminated by a landlord in accordance with applicable state law prior to a bankruptcy filing, a tenant's pre-petition leasehold interests ceases to exist and such terminated lease will not constitute "property of the estate."

A landlord's opportunity to better position itself may first arise with an early default under a lease, at a time when a retailer may not yet have determined whether the premises are valuable in an overall restructuring. This may represent the ideal chance to negotiate a tighter covenant package, increase the security deposit or require other credit enhancements (by, for instance, obtaining a parent guaranty of the lease or a letter of credit) and firm-up termination provisions, among other things.

For example, a landlord might negotiate to shorten or eliminate any cure periods for monetary or non-monetary defaults and/or provide for an automatic termination upon failure to timely pay. Such modifications may prove extremely valuable in the future should the landlord wish to terminate the lease in advance of a possible bankruptcy filing.

It is important to note that termination provisions based on the financial condition of the tenant, commencement of a bankruptcy case or appointment of a trustee or receiver over its assets are unenforceable in bankruptcy. These so-called *ipso facto* clauses have been barred under the Bankruptcy Code as contrary to public policy that favors restructuring.

Nonetheless, incorporating termination provisions into a lease that allows the landlord foresight into financial difficulties for its tenant is helpful (*e.g.*, financial covenants) because they are enforceable prior to the commencement of bankruptcy.

The Automatic Stay

If the lease is not effectively terminated prepetition, a landlord's ability to terminate after the case is commenced will be severely restrained by the imposition of the automatic stay. The stay serves to protect the debtor from adversarial actions that may impair its ability to reorganize or conduct an orderly sale.

Importantly, the protection afforded the lessee debtor by the automatic stay will prevent landlords from exercising otherwise valid termination rights (or even sending notices in that regard), from commencing or continuing

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eviction proceedings, and from seizing property of the debtor, including security deposits, in each case, without getting authority from the bankruptcy court. A court may lift the automatic stay for cause, which may include the tenant's failure to provide adequate insurance or failure to properly maintain the premises, although such relief is rare early in a case. Willful or knowing violations of the automatic stay may lead to sanctions and the landlord must be careful when taking any action that may arguably violate the automatic stay.

A Debtor's Post-Petition Obligations

While the automatic stay is restrictive, bankruptcy also affords landlords some very important protections. Beginning within the first 60 days following the petition date, the debtor is required to timely perform all of its post-petition obligations under any unexpired lease of nonresidential real property (until assumption or rejection discussed below). This strict requirement that it perform its obligations relieves the landlord of its burden to establish that it is otherwise entitled to a post-petition administrative claim (*e.g.*, a claim for the actual and necessary costs of preserving the estate).

The scope of obligations that must be performed certainly includes rent, taxes and insurance but courts are inconsistent when determining whether to extend it to items such as CAM charges, reimbursement of professional expenses and other items. If presented with the opportunity prior to a bankruptcy, a landlord might seek to amend the lease so that it clearly characterizes all such obligations of the tenant as "rent" or "additional rent" and plainly expresses the parties' intent that all such items are to be paid in full following any bankruptcy in accordance with applicable provisions of the Bankruptcy Code.

Courts are similarly inconsistent when addressing payments that straddle both pre- and post-petition periods, *e.g.*, a post-petition invoice for taxes that cover a period beginning prior to the petition date and ending after the petition date. Certain courts will apply the "proration method" to allocate charges over period of time that they accrue. These courts would allocate the tax invoice in the example above and require payment by debtor for only that portion related to post-petition period.

Other courts will apply the "billing method" and look to the date on which the payment was due and would require payment in full by debtor if the invoice came due post-petition. Those courts that apply the billing method present a challenge for landlords when addressing payment of rent paid in advance. These courts often find that stub rent — that portion of rent for the period from the petition date though the next due date — would not be entitled to current payment in full. They reason that because the rent was due pre-petition, none of the post-petition stub rent constitutes a post-petition obligation.

The impact on a landlord could be significant where its tenant strategically files bankruptcy on the day after rent is due. Landlords facing such a scenario should seek allowance of their claim for the stub period as an administrative claim which is entitled to priority over pre-petition claims and must be paid in full in order to confirm a plan of reorganization. Of course, this would not entitle the landlord to current payment and may be subject to challenge if the lease did not provide some benefit to the estate (*e.g.*, if the premises were vacant or underutilized).

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From the outset of a tenant's bankruptcy, it is critical that a landlord pay close attention to ensure that its rights are not unfairly compromised. In particular, the landlord should carefully review the debtor's "first-day" motions filed at the outset of the case for a better understanding of the debtor's strategy, including with respect to the landlord's lease. For example, a declaration filed on or about the first day may provide valuable background on the difficulties faced by the debtor and its strategies for existing bankruptcy as a going concern or via liquidation.

Additionally, careful review of a budget attached to a post-petition financing motion may signal whether the debtor plans to retain a particular lease, and if so, provide detail on the projected timing and amount of payments. Landlords should pay close attention to any motions relating to asset sales or other divestitures, particularly with respect to "going out of sale" programs and/or to the procedures for the assumption or rejection of unexpired leases. Many retailers file bankruptcy to effect an orderly liquidation of their assets, including a transfer of unexpired leases containing below market rental rates or other attractive terms to a third party. Others are filed in order to restructure the business and seek to exit bankruptcy as a going concerned, unburdened by leases on unprofitable or otherwise undesirable locations.

Lease Rejections

The debtor's ability to reject certain unexpired leases and assume others is a hallmark of retail bankruptcies. This decision must be made within the first 90 days of the case, which period can be extended to 210 days upon a showing of cause. Courts will often defer to the debtor's decision, applying a "business judgment" standard when authorizing any assumption or rejection.

If a lease is rejected, a landlord not only will be left with a general unsecured claim for its damages, but also one that is capped. Specifically, the Bankruptcy Code limits rejection damages to the greater of one-year of rent or 15 percent of the rent remaining under the term of the lease but not exceeding three years of rent.

In general, this means unless the remaining lease term is for more than six years (and in the absence of large step-ups in the annual rental rate over such remaining term), a landlord will have an unsecured claim for one year of rent. Given that unsecured claims often recover only a small fraction of their face amount in bankruptcy, Landlords should carefully access prepetition what protections may be available to them to minimize their losses should their distressed tenant file for bankruptcy and reject its lease.

There are three primary means for avoiding the impact of the cap on rejection damages and/or minimizing such loss:

(1) Obtain a guaranty;

(2) Obtain a letter of credit; and

(3) Obtain a security deposit.

The first two options are preferable to a security deposit insofar as they generally will not be subject to the cap imposed on rejection damage claims in bankruptcy.

A landlord may pursue the full amount of damages it incurs from rejection of its lease against a non-bankrupt guarantor of such

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lease obligations, though note that if the guarantor files for bankruptcy the damage cap will apply to the guaranty claim (and the automatic stay in the guarantor's bankruptcy will apply to stay the landlord from enforcing its rights against the guarantor).

A letter of credit generally is preferable to a security deposit because the landlord can draw on it notwithstanding the imposition of the automatic stay in the tenant's bankruptcy case and may avoid having its recovery under the letter of credit limited by the damages cap, particularly if it otherwise avoids filing a proof of claim in its tenant's bankruptcy case.

A security deposit posted by the tenant has the benefit of securing the landlord's claim — which may enable it to recover far more than it would have on account of its unsecured claim — but is nonetheless subject to the cap imposed by the Bankruptcy Code. Further, unlike a landlord's ability to pursue non-bankrupt guarantors or letter of credit issuers, a landlord will be stayed by the tenant's bankruptcy from applying its security deposit. Understanding how its claim for damages may be capped and obtaining the best credit protection from its tenant that it can (by for instance requiring a guaranty or letter of credit to be provided in connection with any prepetition negotiations that do not result in termination of the lease) are critical considerations for a landlord to address *before* its tenant ends up in bankruptcy.

If instead a lease is assumed, the lessee must generally cure all pre-petition monetary defaults (or provide "adequate assurance" that such defaults will be cured). If leases are to be assumed and assigned, lessors will want to be sure they have sufficient time to consider proposed cure amounts (*e.g.*, pre-petition monetary defaults) and the ability of the assignees to provide adequate assurance of future performance.

Generally, the bankruptcy rules restrict a debtor from assuming and assigning leases within the first 21 days of a case absent a showing of immediate and irreparable harm. Careful attention should be paid to motions presented early in the case seeking approval of assumption and rejection procedures as they may limit notice to landlords and/or seek retroactive rejection of leases.

Conclusion

Retail is under considerable pressure, driven largely by changing customer habits. This trend has taken hold during a relatively benign economic environment. What might happen when this dynamic meets a recession?

Those landlords that are well-informed and proactive in identifying and addressing issues with their leases will be better prepared ride out the storm that is battering the retail landscape.

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