

The Bankrupt Landlord: Preparing for a Tenant's Opportunities

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As General Growth Properties filed for bankruptcy on April 16, 2009, the United States has experienced a major commercial landlord bankruptcy. This case represents the largest real estate company bankruptcy case in U.S. history. Although most financially troubled landlords have managed to cope with their debt burdens sufficiently to avoid bankruptcy filings as of year-end 2008, the tight credit market and declining real estate values strongly suggest that 2009 will see bankruptcy filings by commercial landlords.

Because a landlord bankruptcy can dramatically impact a retail tenant, tenants should take steps to protect themselves in advance of any bankruptcy filing by a landlord. Most importantly, a tenant can prepare so that the bankrupt landlord will be required as part of the bankruptcy proceeding to correct breaches of a lease—such as overcharges or violations of the landlord's covenants about the quality of the shopping center.

What should a retail tenant do to protect itself in the event of a landlord bankruptcy and to see that past landlord breaches are addressed?

First, a retail tenant should understand the landlord's and the tenant's rights and obligations under bankruptcy law in the event of a landlord's bankruptcy.

Second, before a landlord files for bankruptcy protection, a retail tenant should assess its critical leases to document existing breaches that may be affected by a landlord bankruptcy. The protections that will be offered by a bankruptcy court to the tenant of a bankrupt landlord will vary depending on how thoroughly a tenant can demonstrate an existing breach of the lease.

Third, a retail tenant should prepare for how little time it will have to respond to actions in a landlord bankruptcy. A retail tenant should take steps to ensure it gets prompt notice of events in a landlord's bankruptcy proceeding.

1. A Tenant Should Understand How Bankruptcy Law Will Affect the Rights of Landlords and Tenants in a Landlord Bankruptcy

It is important for a tenant to a lease to understand how bankruptcy law will affect its rights and obligations in the event of a landlord bankruptcy. When a bankruptcy is commenced by a landlord, each of its unexpired leases is subject to "assumption" or "rejection" under Bankruptcy Code § 365.

The business dynamic for bankrupt landlords makes it unlikely that a landlord will seek to reject its existing retail leases. First, in today's economic climate, a landlord likely will want to keep an existing lease and keep the tenant on the premises and paying rent. After all, leases entered before the downturn likely provide for rents that would be above market today. Second, the law provides that a landlord cannot use rejection to evict tenants from properties and establish a more profitable lease. However, rejection does generally terminate the landlord's duties to perform under the contract, such as the obligation to pay for tenant improvements or to maintain the shopping center.

Thus, rejection is most likely to occur where the bankrupt landlord has determined that it cannot operate, or sell, a shopping center at a profit. In such a situation, it may seek to "sell" the shopping center to its secured lender for nothing more than a release of liability. It may also abandon the center and allow the secured lender to foreclose. In either circumstance, the lender will reject the lease so that it is not required to perform its obligations under the lease. In these circumstances, the "subordination, non-disturbance, and attornment" or "SNDA" agreements between a tenant and its landlord and the landlord's lenders will control the situation. To prepare for these

circumstances, a tenant should make sure it has easy access to its SNDA agreements and related provisions of its leases—and that the tenant has complied with any formal requirements of those agreements or provisions.

In the declining real estate market, it is more likely that a landlord seeking to reorganize itself under the Bankruptcy Code's Chapter 11 will choose to assume leases that were entered before the recent economic downturn. The ability to control profitable leases will be central to the landlord's attempt to re-create its business through the bankruptcy so that it will be successful going forward.

When a lease is being assumed, a retail tenant has a unique opportunity to force a landlord to come into compliance with a lease and even to obtain payment for overcharges and other remedies. Specifically, before the bankruptcy court will approve a landlord's assumption of a lease, the bankrupt landlord is required to bring itself into compliance with the terms of the lease. The bankrupt landlord's obligations for assumption fall into three groups. First, it must "cure" existing defaults—for example, pay back overcharges that constitute a default of the landlord's obligations, or clean up a shopping center that has fallen out of "first class condition." Second, it must "compensate" for pecuniary losses from the defaults. Third, it must demonstrate "adequate assurance of future performance"—that there won't be future defaults under the lease. Thus, to keep the lease, the landlord will have to cure and compensate for all overcharges or damages incurred by the tenant. The landlord will be required to do so in the full amount shown by the tenant—and not at the "cents on the dollar" that are usually paid to those who were owed money prior to the bankruptcy filing.

In addition, for assumption, a tenant must pay all past due rent to keep the lease. In addition, a tenant is required to cure any other breaches that the tenant may have caused.

2. Before a Landlord Files For Bankruptcy Protection, A Tenant Should Identify Landlord Breaches to Ensure They Will Be Remedied

Before a landlord files for bankruptcy protection, a retail tenant should analyze its leases, document the landlord's overcharges and broken promises, and develop an accounting of the losses that the tenant has incurred as a result. A tenant that is prepared to present a detailed analysis of the breaches will be in a position to request that the bankruptcy court require the breaches be remedied prior to assumption of the lease in bankruptcy. A tenant who instead is prepared only to present general allegations of the landlord's lease noncompliance will run the risk that the bankruptcy court will allow an assumption based on nothing more than generalized promises of cure from the landlord.

The more specific a tenant can be about existing defaults, the more likely it will be able to obtain protection from the bankruptcy court. Thus, the tenant should aim to present, in advance of the potential bankruptcy, a clear listing of any existing breaches to the potentially bankrupt landlord. In sum, the tenant should:

- a. Examine the language of the leases;
- b. Marshal facts that support the tenant's position on the meaning of the lease provisions;
- c. Develop facts demonstrating what the Bankruptcy Code calls the "pecuniary losses" arising from the landlord's failure to keep its promises.

Some obvious "pecuniary losses" that could be asserted by a tenant would be overcharges for rent assessments pursuant to the lease, such as for CAM charges or the tenant's share of taxes. But pecuniary losses should also be asserted by a tenant when a landlord's failure to comply with covenants of the lease has resulted in demonstrable damage to the tenant. Examples would be declines in revenues due to the landlord's failure to comply with requirements for shopping center occupancy rate, tenant mix, or "first-class condition." Bankruptcy law expressly provides for compensation for such losses before assumption will be permitted.

If a tenant is prepared with this information, a landlord's bankruptcy will force the landlord to respond to claims of breach. The bankrupt landlord will need bankruptcy court approval to assume the lease. Faced

with a prepared tenant's documented assertion of existing breaches, the landlord will need to address the breaches to get the assumption it needs. It will be required to do so either by agreement with the tenant or by demonstrating to the court's satisfaction that cure, compensation, and adequate assurance are being provided. The conventional foot-dragging of landlords in responding to such claims of tenants is impossible if they wish to retain the lease and to make the necessary progress toward reorganization.

In contrast, if the tenant is unprepared to assert the specific breaches and the resulting damages, and instead simply tells the court that "the landlord is in breach," the result likely will be less favorable to the tenant. The bankruptcy court will be far more likely to accept general assurances from the bankrupt landlord that the unspecified breaches will be addressed in the future. A demand presented to the landlord prior to the commencement of the bankruptcy, before the "automatic stay" of bankruptcy takes effect, will make presenting the issue to the bankruptcy court more effective.

3. A Tenant Should Be Prepared to Act Quickly When a Landlord Files For Bankruptcy

Once a landlord files for bankruptcy, the tenant should immediately take steps to ensure that it will obtain prompt notice of the landlord's actions in the bankruptcy. The common perception is that bankruptcies are very slow moving, primarily because major Chapter 11 reorganizations may take years to complete. But actions regarding unexpired leases can be much faster because they need not wait for the development of a formal plan for reorganization.

In a landlord's bankruptcy, a landlord might move for the assumption of key leases in the very early days of the bankruptcy. Major decisions are made in bankruptcy court based on motions that can be heard on ten days' notice—or less, if the matter is deemed urgent. Absent a request from the tenant, notice of the motions can be provided by first-class mail.

A prepared tenant will see that it is included on the electronic notice lists in the bankruptcy to ensure that it receives immediate notice of developments in the bankruptcy. This will include motions to assume leases. But it will also include other landlord actions that might affect the tenant, such as rejections or motions to sell the subject property to a new landlord.¹

Further, if the lease analysis has not been completed prior to bankruptcy, it should be completed immediately upon receiving notice of a landlord's bankruptcy filing. Because bankruptcy creates an automatic stay of pending actions involving a bankrupt landlord, once a landlord has filed for bankruptcy protection, any demands or documentations of breach should only be presented through counsel to avoid possible sanctions.

Conclusion: Tenants Should Prepare Now

While it requires a determined effort for a retail tenant to prepare for a potential landlord bankruptcy filing, such an effort will pay off when the prepared tenant successfully minimizes the substantial risks posed by a bankrupt landlord. Under some circumstances, a prepared tenant may in fact turn those risks into remedies for the landlord's previous breaches.

¹ One federal court of appeals recently allowed the sale of a property "free and clear" of existing leases. While the Bankruptcy Code has a number of protections for a tenant to avoid losing its lease in such a way, a failure to object to such a proposed sale is deemed by some courts to be "consent" sufficient to allow the sale. Timely notice of such a move by a landlord will be essential to avoiding a bad result.