

Buying Leases Out of Bankruptcy: An Opportunity for Strong Tenants

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With retail bankruptcies skyrocketing, real estate opportunities exist for retailers with solid balance sheets and the willingness to take risk. A well-positioned tenant may be able to acquire a below-market rate lease or a favorable retail location by purchasing a lease out of a bankrupt retailer's bankruptcy estate. For example, in late 2008, Kohl's and Forever 21 won bankruptcy court approval to assume a total of 46 leases from Mervyn's bankruptcy estate.

Whether in a Chapter 11 (Reorganization) or Chapter 7 (Liquidation) bankruptcy proceeding, all unexpired leases become property of the bankruptcy estate. The bankrupt debtor-in-possession or a trustee if appointed (each referred to in this article as the trustee) has the right to assume or reject all unexpired leases (and other executory contracts) within 120 days of the date of the bankruptcy (the 120 day period may be extended upon request by 90 additional days). If the trustee does not assume a lease within the 120 (or 210) day period, the lease is deemed rejected. The process for rejecting leases and the landlord's rights and remedies in the event of a rejection are further specified in the Bankruptcy Code. If the debtor in a Chapter 11 bankruptcy

wishes to retain leases in some or all locations when it emerges from bankruptcy, it will need to assume the applicable leases. If the debtor does not wish to retain certain of the leased locations (or is being liquidated under Chapter 7), but some or all of a debtor's leases have value (due to below-market rent, favorable locations or other reasons) and there is the strong likelihood that others may be interested in purchasing the leases, during the 120 day period (or 210 days if extended), the trustee will seek offers from third parties to purchase the leases. This article discusses strategies for landlords and prospective purchasers, as well as the process by which leases are assumed and assigned. It is important to note that the bankrupt tenant's landlord can also be the purchaser of the lease (where the lease is below-market value) to allow the landlord to recapture the premises.

Assumption and Assignment Solicitation of Offers

Initially, the trustee will need to promptly determine which, if any, leases have value and could potentially be sold. The decision to reject or to seek an assumption should be made early because until a lease is rejected, rent will continue to be due and payable. All monies received from the sale of leases will become property of the bankruptcy estate and used to pay creditors. Once an initial determination is made as to what (if any) leases are to be sold, the trustee will need to set up a process for soliciting bids—ranging from a broker marketing the leases to an auction process (either open or private bid). Although not required, a trustee may seek Bankruptcy Court approval for the process to solicit bids. Purchaser Due Diligence. As with any lease transaction, a prospective tenant will need to do an adequate due diligence investigation. When evaluating whether to purchase a lease out of bankruptcy, a prospective tenant should consider the following:

■ Key lease terms and economic issues

Because the prospective tenant must assume the lease "as is," the purchaser must carefully review the lease and all associated documents to ensure that the lease, economic and other terms are satisfactory enough to submit a bid.

■ Title issues

Similarly, the prospective tenant should carefully review all title issues (including CC&Rs, other tenant exclusive use rights, etc.) to ensure that if the tenant assumes the lease, there are no restrictions that will unnecessarily limit the tenant's planned use of the premises.

■ Condition of premises and center

The prospective tenant should conduct an extensive investigation of the physical condition of the premises and center. This is particularly true in bankruptcy deals because the prior tenant may not have properly maintained the premises.

■ Condition of landlord (including landlord financing)

The prospective tenant will want to investigate whether the prior tenant's bankruptcy has had an adverse financial effect on the landlord, ranging from vacancies in the center, to defaults under the landlord's financing documents. Close attention should be paid to whether the landlord has financing on the center. If the financing is senior to the lease (and the tenant has not obtained non-disturbance protection), a foreclosure by one of landlord's senior lenders could wipeout the lease.

Motion to Obtain Court Approval

Often, there is not more than one offer (if any) to purchase a debtor's leases. If there is at least one offer, the trustee will need to determine whether the offer will satisfy the statutory requirements so the proposed

assignment can be submitted for Bankruptcy Court approval. If there are multiple offers, the trustee will need to determine the best offer (which may be difficult if some are monetary payments while others involve waiver or assignment of claims that may not be easily quantifiable) to submit for Bankruptcy Court approval. To obtain Bankruptcy Court approval, the trustee must bring a motion for the leases to be assumed and assigned – the process is governed by 11 USC §365.

To obtain Bankruptcy Court approval, the trustee and prospective purchaser must establish the following:

- All defaults are cured or adequate assurances are provided that such defaults will be promptly cured. This generally means all monetary defaults must be cured. Certain non-monetary defaults will also need to be cured (to the extent they are curable) by the trustee or assignee.
- The landlord is compensated or adequate assurances are provided that the landlord will be compensated for all pecuniary losses relating to debtor's default.
- Adequate assurances of future performance are provided. In a shopping center context, adequate assurances of future performance include:
 1. The financial condition of the proposed assignee is similar or better than that of the debtor at the time the debtor entered into the lease;
 2. Any percentage rent under the lease will not decline substantially;

3. The assumption or assignment of the lease is subject to all of the provisions of the lease (including radius, location, use and exclusivity provisions), and the assignment will not cause a breach of any provision in any other lease, financing agreement or master agreement relating to the shopping center; and
4. The assignment or assumption will not disrupt any tenant mix or balance in the shopping center.

The evidence supporting the findings is submitted to the Bankruptcy Court by signed declaration. When assuming the lease, the potential assignee must agree to abide by all of the existing terms of the lease without modification.

Potential Objections, Court Evaluation and Approval

Prior to Bankruptcy Court approval, a landlord (particularly if the landlord does not like the potential tenant seeking to assume the lease) may raise objections that the potential tenant has not provided adequate assurances of future performance and the tenant is not suitable. The objections must be supported by declarations. If there are multiple offers to purchase a lease, a creditor may also object, asserting the proposed offer is not the highest offer. This objection is generally only made in a situation where the multiple offers are difficult to compare (such as monetary offers vs. release/waiver or assignment of claims, litigation rights, etc.).

After receiving the motion from the trustee and any objections, the Bankruptcy Court must make a determination that:

1. The trustee exercised reasonable business judgment in soliciting offers and selecting the recommended offer; and
2. All of the requirements of 11 USC §365 (discussed above) are satisfied.

If the Bankruptcy Court determines the foregoing requirements are satisfied, the Court will order the leases assumed by and assigned to the selected purchaser.

Conclusion

Despite the downturn in the economy, there are opportunities for prospective tenants (and to some degree landlords) when a retail tenant declares bankruptcy. The keys are understanding the process and properly evaluating the potential risks and value of the real estate assets of the bankruptcy estate.

