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What Every Commercial Landlord Needs To Know About Tenant Bankruptcies

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Experts estimate that our current economic downturn will continue through the end of 2009 and likely beyond. Many have predicted that the next “meltdown” will directly hit the retail sector. Over the past year, 14 major retailers have filed for Chapter 11 protection. It is likely that over the next year that number will seem small when compared to the upsurge in retail bankruptcies.

This article is directed to our landlord clients and friends as a tool to better understand the bankruptcy process as it affects you. When your commercial tenant files for bankruptcy protection, you will need to be pro-active to assure that you are: (a) treated fairly in the process; (b) maximizing recovery; and (c) minimizing the loss.

Pre-Petition Rent. It is not uncommon for a Debtor to be past due on rent and other lease obligations at the time he files his Chapter 11 petition. If he had money to pay the rent, he might not have needed to file for bankruptcy. The unpaid rent and other charges due for the period prior to the date of the filing of the bankruptcy petition is treated as a general unsecured claim. A proof of claim for the full amount owed must be timely filed with the court in order to participate in the proceeding unless the Debtor properly schedules the debt. It is unlikely for the Debtor to do so and the better course of action is to file a claim for what is owed.

Stub Rent. In most situations, a Debtor files its petition during a rental period as opposed to, for example, the first day of the month. This leaves a “stub period” breaking that first rent period into pre-petition and post-petition administrative obligations. If the Debtor paid the rent for that initial period prior to filing its bankruptcy petition, there is no need to compute a “stub period” rent due. If the rent was not paid prior to the filing, the pro rata amount of rent for the period prior to the petition date will be a general unsecured claim. The period from the petition date to the end that rental period will generally be treated as an administrative expense. It should be noted, however, that some districts do not recognize a “stub period” and treat all rent due prior to the filing of the petition as a general unsecured claim.

Administrative Rent. The Debtor is obligated to pay rent during the administration of its bankruptcy proceedings. Generally, that rent obligation will be the amount of rent provided for in the lease. However, in certain situations (the market rate is substantially below the lease rent) the Debtor may ask the court to determine a different amount as the reasonable fair use and occupancy charge for the premises.

Stay Relief. In the event the Debtor fails to remain current with its administrative rent obligations, the landlord may either: (1) bring on a motion before



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the bankruptcy court for relief from the “automatic stay” to enable it to commence dispossession proceedings in “landlord-tenant” court, or (2) file a motion with the bankruptcy court to direct the Debtor to timely pay the administrative rent. Remember that once a Debtor has filed for protection under the Bankruptcy Code, all actions to collect debts and enforce claims against the Debtor are “automatically stayed.” This includes both pending actions as well as any new actions. Any party that engages in actions in violation of the automatic stay may be subject to contempt proceedings and sanctioned by the court.

Letters of Credit or Rent Security. If a landlord holds rent security as a deposit under the lease and has not applied the deposit prior to the bankruptcy, he must obtain relief from the stay once the Chapter 11 plan is filed. However, the Chapter 11 filing doesn’t implicate the letter of credit standing as rent security and the landlord is free to assert its claim against the issuer of the LC without violating the automatic stay.

Lease Rejections. Perhaps the most compelling reason for a retailer to seek Chapter 11 protection as it relates to its leases is to enable the retailer to divest itself of those it deems to be burdensome leases. Once the bankruptcy petition is filed, the Debtor will need to either assume or reject each of its leases within 120 days from the Chapter 11 filing. If the Debtor does not assume a lease within 120 days from the petition date, the lease is deemed rejected and the Debtor must immediately surrender the premises to the landlord. The court may extend this initial period up to an additional 90 days for good cause shown. In order to obtain an extension, it is generally considered to be a prerequisite that the Debtor is current in its post-petition rent obligations. After the 90-day extension the Debtor can only obtain additional extensions with the landlord’s consent. This an important bargaining chip.

The Bankruptcy Code provides for damages to the landlord for the Debtor’s rejection of the lease. Congress, in the adoption of the Bankruptcy Code and its amendments, established a cap on a landlord’s lease rejection claim at the greater of one year’s rent or 15% of the balance of the rent, not to exceed three years of the rent reserved in the lease.

Once the lease is rejected, the landlord will need to file a proof of claim. If the landlord has already filed a claim for unpaid pre-petition rent, it can amend the original filing to include lease rejection damages.

Assumption of Lease. In order to assume its lease, the Debtor must (a) cure all defaults; (b) compensate any party (other than the Debtor) for any pecuniary loss resulting from the default(s); and (c) provide adequate assurance of future performance of the lease. Adequate assurance does not mean an absolute guaranty but rather a reasonable likelihood that the lease obligations will be fulfilled. Thus, if the landlord

has filed a proof of claim for unpaid pre-petition rent and the Debtor subsequently assumes the lease, then as a condition to its assumption, it must pay the landlord the unpaid pre-petition rent, or such other amount as the Debtor and landlord may agree to.

Assignment of Leases. Very often – especially when a Debtor is liquidating through the bankruptcy process – debtors will sell and assign their leases under the Bankruptcy Code, even where the lease by its terms is not assignable. The Debtor must cure the defaults and the assignee must demonstrate adequate assurance of future performance as a condition to the assumption. In the case of the assignment of a lease of real property in a shopping center, there must be adequate assurance (a) of the source of rent and other consideration due under the lease; (b) that the financial condition and the operating performance of the assignee and its guarantors, if any, shall be similar to or better than the financial condition and operating performance of the Debtor and its guarantors, if any, as of the time the Debtor entered into the lease; (c) that any percentage rent due under the lease will not decline substantially; (d) that the assumption and assignment of the lease is subject to all of the provisions thereof including any provisions for radius, location, use or exclusivity and will not breach any provision contained in any other lease relating to the shopping center, and (e) that the assumption and assignment will not disrupt any tenant mix or balance in the shopping center.

Renegotiation of Leases. Once the Debtor has filed the petition, a dynamic playing field emerges as the Debtor seeks to cut costs by reducing its rent obligations. Landlords may or may not be in a position to negotiate concessions. Based upon the declining conditions in the retail market coupled with growing vacancies, one can expect landlords to be more willing to explore concessions that will keep tenants on their rent rolls without sacrificing future opportunities or profits.

The next two or three years promise to be a changing time for retailers and their landlords as the present economic crisis completes its cycle and a recovery is secured.

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