Tis' The Season For Retail Bankruptcies: A Landlord's Guide To Avoid The Post-Holiday Blues

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Empire Development Company Inc. just finished celebrating the holiday season and the one-year anniversary of its $60 million purchase of Gotham Shopping Center, a high-end regional shopping center located in New York, when it received the news every landlord fears: one of the four anchor tenants at Gotham Shopping Center just filed for bankruptcy. "This is the end of the world!," thought Empire's Chief Financial Officer, Bruce Wayne. Mr. Wayne knew nothing about bankruptcy, but he heard rumors about unlimited rights provided to a debtor. He also knew the debtor owed Empire at least three months of rent on the day the debtor filed for bankruptcy. When Mr. Wayne met with Empire's bankruptcy attorney, the attorney voiced his concern that Empire may have to file for bankruptcy because it may not be able to satisfy the loan payments to its lender without the rental income from the debtor. While learning that the debtor does in fact have numerous rights, Mr. Wayne realized that Empire has some important rights as well and that the debtor's bankruptcy filing did not signal the end of Empire's world. Here are the answers to the four questions Mr. Wayne asked.

Automatic Stay

- Can Empire recapture the premises?

No. Upon the filing of bankruptcy, an automatic stay comes into effect that stops almost all actions against the debtor and it remains in effect until the end of the bankruptcy case.[1] The automatic stay is intended to provide the debtor with some "breathing room" from its creditors to allow the debtor to develop a plan of reorganization and to protect creditors from each other by eliminating the otherwise inevitable "race to the courthouse" to obtain the advantage of being the first creditor to get a judgment against the debtor.

Section 362(a) of the Bankruptcy Code enumerates those actions that are stayed, such as suing the debtor in a court other than the bankruptcy court or continuing a suit already in progress even if the litigation will have no impact on the debtor's financial condition; attempting to enforce a pre-petition judgment against the debtor; terminating the lease; applying the security deposit against the outstanding rent without first obtaining relief from the stay; and requiring the debtor to pay pre-petition rent.

Section 362(b) of the Bankruptcy Code lists those actions that are not stayed, such as reclaiming possession of the premises if the lease has expired by its stated terms or has been properly terminated before the commencement of the bankruptcy case.[2] The question of whether the lease has been terminated prior to the bankruptcy filing is determined by examining the law of the state designated in the lease. If the landlord believes the lease was properly terminated prior to the debtor filing for bankruptcy, the landlord, before initiating an eviction action, should still seek relief from the automatic stay in the bankruptcy court as a prophylactic measure.[3]

The landlord can also enforce its rights against non-debtor parties such as a guarantor, and draw on a letter of credit because the proceeds thereof are not property of the debtor's estate. When the issuer honors a proper draft under a letter of credit, it does so from its own assets and not from the assets of its customer – the debtor – who caused the letter of credit to be issued.[4]

The standard to get the stay lifted in this situation is "cause," which is an intentionally broad and flexible concept that permits the bankruptcy court, as a court of equity, to respond to the facts of each case.[5] While cause requires more than simple nonpayment of rent, the landlord's desire to evict a debtor whose lease has been terminated pre-petition is sufficient cause for the bankruptcy court to grant relief from the stay.[6]

Debtor's Three Options

- What can the debtor do with the lease?

The debtor has three options. First, the debtor can get rid of the lease – reject it.[7] Indeed, this is one of the primary benefits that the Bankruptcy Code provides to retail debtors. Before rejecting the lease, the debtor must obtain an order from the court authorizing the rejection. If the debtor seeks a rejection date prior to obtaining court approval, Empire should object, arguing that the effective date of rejection should be the date the court authorizes the debtor to reject the lease.[8] The debtor should pay the rent through the effective date of rejection and surrender possession of the premises on or before the effective date of rejection. While the debtor is unlikely to surrender possession of the premises in accordance with the terms of the lease, Empire, at a minimum, should require the debtor to either remove all furniture, fixture and equipment from the store prior to surrendering possession, or abandon the property to allow Empire to dispose of it without liability to any third party that may have an interest in the property.

The debtor's second option is to keep the lease – to assume it. If the debtor decides to assume the lease, Empire will have little leverage to block the assumption. To assume the lease, the debtor is required to obtain court approval, and, if there has been a default under the lease, the debtor is required to (i) cure promptly such default; (ii) compensate the landlord for any actual pecuniary loss the landlord suffered as a result of the default; and (iii) provide adequate assurance of future performance under the lease.[9]

Courts draw a distinction between curing monetary and non-monetary defaults. While the debtor has limited flexibility regarding the timing of satisfying the cure payment, the debtor has greater flexibility in determining how and when it will cure non-monetary obligations.[10] The second requirement (compensate the landlord for any actual pecuniary loss) includes paying Empire's attorneys fees, assuming the lease contains such a requirement and Empire can demonstrate that it was required to incur such fees as a result of the debtor's breach of the lease.[11] Legal fees incurred by Empire's attorney for monitoring the bankruptcy case, however, are not reimbursable in connection with the debtor's assumption of the lease.[12] Finally, providing adequate assurance of future performance does not mean a guarantee of future performance; rather, a demonstration that rent will be paid and other lease obligations will be met is sufficient.[13] The debtor should have little, if any, difficulty in satisfying this last requirement.

The last of the debtor's three options is to sell the lease – to assign it.[14] If the debtor selects this option, all of the requirements for assumption apply.[15] The obligation to demonstrate adequate assurance of future performance, however, is required by the proposed assignee whether or not there has been a default under the lease to protect the landlord from the burden of a tenant who may likely default in the future.

Since the lease is located in Gotham Shopping Center, which is a regional shopping center, adequate assurance of future performance is defined by the following four requirements of 11 U.S.C. § 365(b)(3). First, the financial condition and operating performance of the proposed assignee and its guarantors, if any, must be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor entered into the lease. The primary purpose of this requirement is to provide assurance for payment of future rent.[16] In the absence of an extensive operating history, the proposed assignee's future performance is judged by, among other things, the financial strength of its backers, and its operating performance is judged by its principal's operating performance.[17]

The landlord's desire to evict a debtor whose lease has been terminated pre-petition is sufficient cause for the bankruptcy court to grant relief from the stay.

Second, the percentage rent due under the lease must not decline substantially. The proposed assignee, however, does not need to satisfy this requirement unless the lease contains a percentage rent provision and the debtor was paying percentage rent prior to filing for bankruptcy. If both conditions are present, the proposed assignee can easily satisfy this requirement by guaranteeing to pay the greater of: (i) the percentage rent the debtor was paying prior to the bankruptcy filing regardless of the level of sales generated by the proposed assignee; and (ii) the actual percentage rent due under the terms of the lease.

Third, and most importantly to the shopping center landlord, the assignment of the lease must be subject to all the provisions thereof, such as a radius, location, use, or exclusivity, and the assignment will not breach any such provision contained in any other lease, financing agreement or master agreement relating to the shopping center.[18]

Fourth, the assignment must not disrupt any tenant mix or balance in the shopping center.[19] Bankruptcy courts have held that the lease must show a specific intent to create a tenant mix with the other leases within the shopping center, and they are generally reluctant to use this last requirement to uphold a landlord's objection to the assignment of a valuable lease.[20]

Finally, in connection with the debtor's right to assign the lease, any provision in the lease that prohibits, restricts or modifies the lease upon assignment is unenforceable because the Bankruptcy Code favors the maximization of the value of the debtor's assets, particularly a lease for a desirable location and/or below-market rent.[21] Provisions that have been invalidated as anti-assignment provisions include: (i) a use restriction in a shopping mall lease, requiring premises to be used as home improvement center;[22] (ii) a provision

increasing the rent on assignment;[23] (iii) a provision requiring the tenant to pay a portion of the purchase price to the landlord as a condition to the assignment;[24] and (iv) a provision granting the landlord a right of first refusal in connection with any assignment.[25]

Deadlines and Extensions

- When will Empire find out if the debtor is going to keep or get rid of the lease?

Section 365(d)(4) of the Bankruptcy Code requires the debtor to make its decision to either reject, assume or assign the lease within sixty days after the bankruptcy filing unless that deadline is extended by the court based on the debtor demonstrating cause. Congress, when it enacted section 365(d)(4) in 1984, imposed a fixed deadline on the time to reject, assume or assign leases to "remedy the long-term vacancy or partial operation of space" by a bankrupt shopping center tenant, thereby reducing the "likelihood that provisions of the bankruptcy code will themselves add to the economic distress of retail merchants in shopping centers."[26] Notwithstanding Congress's intentions when enacting section 365(d)(4) of the Bankruptcy Code, debtors routinely obtain numerous extensions of the 365(d)(4) deadline beyond the initial 60-day period.[27] In fact, many debtors request an open-ended extension of the 365(d)(4) deadline to plan confirmation, which was the law prior to the 1984 amendments to section 365 of the Bankruptcy Code. While extensions to confirmation are granted in the Southern District of New York, most other jurisdictions limit extensions to 60 to 90 days at a time.[28]

The landlord should always object to all requests for open-ended extensions of the 365(d)(4) deadline. Since extensions are routinely granted, the landlord should try to reach an agreement with the debtor regarding the requested extension so that the landlord can get some consideration in return. For example, the landlord should try to limit the duration of the extension, require the debtor to continue to operate during the extension and if the debtor fails to comply, the debtor must immediately reject or assign the lease, and obtain "holiday protections" if the requested extension covers the months of September through January such protections would require to the debtor, if the debtor fails to reject the lease by September 1, to continue operating and paying rent through January 31 of the following year. If the parties are unable to reach an agreement, the landlord, even though not required, should show in its objection that it will be prejudiced by the requested extension to get the court to limit the duration of the extension.

Lease Obligations

- Is the debtor required to perform all lease obligations while in bankruptcy?

No. There is a distinction between pre- and post-petition obligations. The debtor is not required (or even permitted) to perform pre-petition obligations. Concerning the debtor's post-petition lease obligations, section 365(d)(3) requires the debtor to "timely perform all the obligations" under the lease that arise on and after the bankruptcy filing. Unfortunately, "all" does not mean ALL.

Clearly, the debtor is required to perform the financial obligations under the lease that arise after the bankruptcy filing such as paying rent and related charges.[29] The landlord, however, needs to be aware of the split in the jurisdictions concerning when a lease obligation

arises under section 365(d)(3) of the Bankruptcy Code.

A slight majority of jurisdictions follow the "pro-ration" or "accrual method" which allows the debtor to avoid paying during the bankruptcy case any financial obligation that became due after the bankruptcy filing, if the obligation accrued prior to the bankruptcy filing. Instead, the debtor can pro-rate the obligation and pay during the bankruptcy case only that portion of the obligation that accrued after the bankruptcy filing.[30] A substantial minority of courts have adopted the "billing date" method which requires the debtor to pay all financial obligations during the bankruptcy case that become due after the bankruptcy filing regardless of when the obligation accrued.[31]

The debtor is clearly not bound by an "ipso facto" clause, which is a provision in the lease that provides for the termination of the lease as a result of the debtor's bankruptcy filing.[32]

One lease obligation the debtor can avoid with the court's permission is the prohibition against conducting going-out-of-business (GOB) sales.[33] The rationale for invalidating this type of provision is that it contravenes the express intent of the Bankruptcy Code to maximize the value of the debtor's assets for all creditors. While courts will allow GOB sales to be conducted in the debtor's store notwithstanding the existence of a lease provision that prohibits GOB sales, courts recognize the need to place reasonable parameters upon GOB sales to provide adequate safeguards to protect shopping center landlords and other tenants in the mall.[34] Some guidelines to consider include: (i) restricting banners; (ii) prohibiting the use of neon colors; (iii) limiting the number of signs based on the square footage of the store; (iv) limiting the number of signs hanging in the window; (v) prohibiting augmentation of the debtor's inventory with non-debtor inventory, if doing so would violate an exclusive use provision of another tenant in the shopping center or the augmented inventory is not the type of inventory sold in the shopping center; (vi) making sure the landlord and customers have the name of a contact person; (vii) making sure the liquidator tracks sales, if necessary, for percentage rent purposes; and (viii) getting the space back promptly by requiring the debtor to decide whether to reject or assign the lease by the conclusion of the GOB sale to minimize the impact of having a dark store.

Another lease obligation the bankruptcy court will allow the debtor to avoid is the operating covenant because such a provision inhibits the debtor's ability to assign the lease, which in turn, impairs the debtor's ability to reorganize. If the debtor's violation of the operating covenant will harm the landlord because having a dark anchor store will trigger rent relief for other tenants in the mall, the landlord should file a motion with the bankruptcy court seeking to compel compliance with the operating covenant or the rejection of the lease so that the landlord can start the process of locating a replacement tenant. While the court should weigh the equities between the landlord and the debtor, the bankruptcy court favors debtors.

A final provision the bankruptcy court may not allow the debtor to avoid is the maintenance and repair obligations under the lease. In making its decision, the court will consider whether (i) the item to be repaired broke before or after the debtor filed for bankruptcy; (ii) the repair is necessary to protect the public from harm; (iii) the cost of repair; and

(iv) whether the debtor is likely to assume the lease.

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1 11 U.S.C. § 362(a), (c).

2 11 U.S.C. § 362(b)(10); *Robinson v. Chicago Housing Authority*, 54 F.3d 316, 318 (7th Cir. 1995); *see also* 11 U.S.C. § 541(b)(1)(2), which states that any residual interest a debtor may have in a terminated lease is not considered property of the estate.

3 *See e.g., In re Trang*, 58 B.R. 183, 188-9 (Bankr. S.D. Tex. 1985) (tenant's possessory interest in the premises is protected by the stay notwithstanding the fact that the lease was terminated prior to the bankruptcy filing); *In re Maxwell*, 40 B.R. 231, 237 (N.D. Ill. 1984) (The stay gives limited and temporary protection to a holdover tenant-debtor, based solely on possession).

4 *In re Farm Fresh Supermarkets* 257 B.R. 770 (Bankr. D.Md. 2001); *Official Comm. Unsecured Creditors of Baja Boats, Inc. v. N. Life Ins. Co. (In re Baja Boats, Inc.)*, 203 B.R. 71, 74 (Bankr. N.D. Ohio 1996).

5 11 U.S.C. § 362(d)(1); *In re Indian River Estates, Inc.*, 293 B.R. 429, 433 (Bankr. N.D. Ohio 2003).

6 *Matter of Lipply*, 56 B.R. 524, 528 (Bankr. N.D. Ind. 1986); *In re Merchant*, 256 B.R. 572, 576-7 (Bankr. W.D.Pa. 2000); *In re Nasir*, 217 B.R. 995, 997 (Bankr. E.D. Va. 1997).

7 Upon rejection of the lease, the landlord has a claim against the debtor's estate for any unpaid, pre-petition rent as well as a statutorily capped claim for rejection damages. 11 U.S.C. § 502(b)(6).

8 *Compare Thinking Machines Corp. v. Mellon Financial Services (In re Thinking Machines Corp.)*, 67 F.3d 1021, 1025-6 (1st Cir. 1995); *Westbury Real Estate Ventures, Inc. v. Bradlees, Inc. (In re Bradlees Stores, Inc.)*, 194 B.R. 555, 558 (Bankr. S.D.N.Y. 1996) *with Pacific Shores Development, LLC v. At Home Corp. (In re At Home Corp.)*, 292 B.R. 195, 200-2 (N.D. Cal. 2003); *In re CCI Wireless, LLC*, 279 B.R. 590, 595 (Bankr. D. Colo. 2002).

9 11 U.S.C. § 365(a), (b)(1).

10 *In re BankVest Capital Corp.*, 360 F.3d 291, 300-1 (1st Cir. 2004).

11 *In re Shangra-La, Inc.*, 167 F.3d 843, 849-50 (4th Cir. 1999); *In re Crown Books Corp.*, 269 B.R. 12, 15-17 (Bank. D. Del. 2001).

12 *In re Best Products Company, Inc.*, 148 B.R. 413, 414-5 (Bankr. S.D.N.Y. 1992); *In re Fobian* 951 F.2d 1149, 1153 (9th Cir. 1991).

13 *In re Embers 86th Street, Inc.*, 184 B.R. 892, 900-1 (Bankr. S.D.N.Y. 1995); *In re THW Enterprises, Inc.*, 89 B.R. 351, 357 (Bankr. S.D.N.Y. 1988).

14 The debtor could attempt to sell the lease pursuant to a lease auction or, since the debtor is an anchor tenant, the debtor could sell its right to assign its leases (commonly referred to as "designation rights"), which allows the debtor to realize value from its leases without having to market the leases and incur the carrying costs of the leases during the marketing period. *See In re Ames Department Stores, Inc.*, 287 B.R. 112, 125-6 (Bankr. S.D.N.Y. 2002).

15 11 U.S.C. § 365(f)(2)(A).

16 *In re Casual Male*, 120 B.R. 256, 264 (Bankr. D. Mass. 1990).

17 *Ramco-Gershenson Properties, L.P. v. Service Merchandise Company, Inc.*, 293 B.R. 169,177-8 (M.D. Tenn. 2003).

18 *See In re Trak Auto Corporation*, 367 F.3d 237, 242 (4th Cir. 2004); *In re Sun TV and Appliances*, 234 B.R. 356, 370-1 (Bankr. D. Del. 1999); *In re J. Peterman Co.*, 232 B.R. 366, 370 (Bankr. E.D. Ky. 1999); *but see In re Rickel Home Centers, Inc.*, 240 B.R. 826, 832 (D. Del. 1998) *appeal denied*, 209 F. 3d 291 (3d Cir. 2000).

19 *Trak Auto*, 367 F.3d at 243-4; *In re Federated Department Stores, Inc.*, 135 B.R. 941, 945

(Bankr. S.D. Ohio 1991); *In re TSW Stores of Nanuet, Inc.*, 34 B.R. 299, 306 (Bankr. S.D.N.Y. 1983).

[20] *LaSalle National Trust, N.A. v. Trak Auto Corp.*, 288 B.R. 114, 125 (E.D. Va. 2003); *In re Ames Department Stores, Inc.*, 127 B.R. 744, 753 (Bankr. S.D.N.Y. 1991); *In re Service Merchandise Company*, 297 B.R. 675, 691-2 (Bankr. M.D. Tenn. 2002).

[21] 11 U.S.C. §§ 365(f)(1) and (f)(3); *Double K Properties, LLC v. Aaron Rents, Inc.*, 2003 WL 21657914 *2 (W.D. Va. July 15, 2003); *EBG Midtown South Corp. v. McLaren/Hart Environmental Engineering Corp. (In re Sanshoe Worldwide Corp.)*, 139 B.R. 585, 597 (S.D.N.Y. 1992), *aff'd*, 993 F.2d 300 (2d Cir. 1993); *In re Standor Jewelers West, Inc.*, 129 B.R. 200, 201 (B.A.P. 9th Cir. 1991).

[22] *Rickel*, 240 B.R. at 831-2.

[23] *In re J.F. Hink & Son*, 815 F.2d 1314, 1317-8 (9th Cir. 1987); *In re Boo.com North America, Inc.* 2000 WL 1923949 *2-4 (Bankr. S.D.N.Y. 2000).

[24] *In re Jamesway Corp.*, 201 B.R. 73, 78-9 (Bankr. S.D.N.Y. 1996).

[25] *See Ramco-Gershenson,*, 293 B.R. at 174-5*; In re Mr. Grocer, Inc.*, 77 B.R. 349, 352-3 (Bankr. D.N.H. 1987).

[26] 130 *Cong. Rec.* S8891, S8894-95 (daily ed. June 29, 1984) (Statement of Sen. Orrin G. Hatch), *reprinted in 1984 U.S. Code Cong. & Ad. News* 590, 598-601; *see, e.g., In re Channel Home Centers, Inc.*, 989 F.2d 682, 686 (3d Cir. 1993); *In re Sea Harvest Corp.*, 868 F.2d 1077, 1079 (9th Cir. 1989).

[27] For a list of factors courts examine when determining if debtors have demonstrated cause for an extension of the 365(d)(4) deadline *see South Street Seaport Ltd. Partnership v. Burger Boys, Inc. (In re Burger Boys, Inc.)*, 94 F.3d 755, 761 (2d Cir. 1996); *In re Wedtech Corp.*, 72 B.R. 464, 471-2 (Bankr. S.D.N.Y. 1987).

[28] *Compare In re Ames Dept. Stores, Inc.*, 2002 WL 511556 (S.D.N.Y.) *with In re Victoria Station, Inc.*, 875 F.2d 1380, 1384-5 (9th Cir. 1989); *Matter of American Healthcare Management, Inc.*, 900 F.2d 827 (5th Cir. 1990).

[29] *Cukierman v. Uecker (In re Cukierman)* 265 F. 3d 846, 850-1 (9th Cir. 2001); *In re Pacific-Atlantic Trading Co.*, 27 F.3d 401, 403-4 (9th Cir. 1994).

[30] *In re Furr's Supermarkets, Inc.*, 283 B.R. 60, 65-6 (10th Cir. 2002); *Matter of Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125, 1126-7 (7th Cir. 1998); *In re Ames Dept. Stores, Inc.* 306 B.R. 43, 65 (Bankr. S.D.N.Y. 2004); *In re Phar-Mor, Inc., et. al.*, 290 B.R. 319, 325 (Bankr. N.D. Ohio 2003).

[31] *See HA-LO Industries, Inc. v. CenterPoint Properties Trust, (In re HA-LO Industries, Inc.)*, 342 F.3d 794, 797 (7th Cir 2003); *In re Montgomery Ward Holding Corp.*, 268 F.3d 205, 211 (3d Cir. 2001); *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986, 989 (6th Cir. 2000); *In re CCI Wireless*, 279 B.R. 590, 594-5 (Bankr. D.Colo. 2002).

[32] 11 U.S.C. § 365(e)(1).

[33] *In re Ames Department Stores, Inc.*, 136 B.R. 357, 359 (Bankr. S.D.N.Y. 1992).

[34] *Ames Department Stores*, 136 B.R. at 359.