WHEN CONSUMERS STOP SPENDING: THE RISKS FOR LANDLORDS WHEN RETAIL TENANTS FILE FOR BANKRUPTCY

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The slowdown in America's consumer spending based economy has been the subject of daily news reports since the fall of 2008. That slowdown has had a predictable effect on retailers. Anchor tenants such as Circuit City, Value City Department Stores, Gottschalks, and Boscov's, as well as regular shopping mall tenants such as Linens 'N Things and K B Toys, and strip mall staple Hollywood Video have all sought bankruptcy relief, with Blockbuster Video and others predicted to follow in their footsteps soon. The filing of a bankruptcy case by a retail tenant may immediately affect a commercial landlord adversely in multiple ways.

First, upon the filing of a bankruptcy case, an "automatic stay" goes into effect. Unless the tenant's lease has been terminated or has expired by its terms before the bankruptcy case is filed, the landlord is generally prohibited from taking any action to collect rent owed to it or to evict the tenant. This is true whether or not the landlord even knows that a bankruptcy case has been filed. A landlord that takes action against the tenant in violation of the automatic stay can be liable to the tenant for compensatory damages, attorneys' fees, and even punitive damages.

Second, even if the tenant has been paying rent regularly and files for bankruptcy with the intention of reorganizing and staying in business, the bankruptcy filing is likely to disrupt the payment of rent. Tenants who file for bankruptcy generally are not allowed to pay debts that came due before the bankruptcy filing. The Bankruptcy Code authorizes, indeed requires, tenants to pay rent that comes due after the bankruptcy filing at the rate specified in the lease until the tenant "rejects" the lease unless the bankruptcy court extends the time for payment. However, a tenant whose rent was due on the first of the month, but that had not paid rent when it filed for bankruptcy on the second day of the month, would not be required to pay rent until the first day of the next month when the first post-bankruptcy rent payment came due and would have difficulty convincing its other creditors or the bankruptcy court that payment of the pre-bankruptcy rent was appropriate when other pre-bankruptcy debts were not being paid. Moreover, the Bankruptcy Code permits the bankruptcy court to extend the date for payment of obligations that come due within the first 60 days after the bankruptcy filing until the end of that 60 day period. Bankrupt tenants request such extensions frequently and such requests are liberally granted, often on the day that the bankruptcy case is filed with little real notice to affected landlords.

Third, even if the landlord is fortunate enough to have the tenant continue to pay rent after the bankruptcy filing, the landlord's rights and the future of its space remain in limbo pending the tenant's decision whether to "assume" or "reject" its lease. Before certain amendments to the Bankruptcy Code in 2005, tenants frequently included among the numerous so-called "first day motions" (i.e. motions that are taken up by the bankruptcy court within hours of a bankruptcy filing with little notice to anyone), a

request to extend the time for making that decision until confirmation of a reorganization plan. As a result of the 2005 amendments, that decision generally must be made within 120 days of the bankruptcy filing and the bankruptcy court may only extend that decision period for a maximum of an additional 90 day period unless the landlord consents to the extension.

When a bankrupt tenant decides to "assume" a lease, it agrees to continue to be bound by the lease notwithstanding the bankruptcy filing. It is required to (i) cure, or "promptly cure," economic defaults, except those that are penalties, (ii) compensate or provide assurances that it will promptly compensate the landlord for prior defaults, and (iii) provide "adequate assurance of future performance" of the lease. Of course, what is "prompt" and "adequate" is determined by the bankruptcy court whose views may differ from those of the landlord.

Technically, the tenant must either assume the lease as it is written or reject it. It cannot modify the terms of the lease without the landlord's consent. However, tenants frequently use the threat of rejecting the lease and leaving the landlord with empty space as a lever to force landlords to renegotiate leases and then assume the leases as modified.

Assumption may be coupled with an assignment of the lease by the bankruptcy tenant to a new tenant. The Bankruptcy Code expressly provides that a lease may be assigned despite any prohibition on assignment in the lease. When the lease is to be assigned, it is the new tenant that provides the "adequate assurance of future performance." If the bankruptcy court determines that the assurance is adequate and approves the assignment, the original tenant is released from further obligations under the lease.

In the case of a lease of space in a shopping center, the Bankruptcy Code provides that the proposed use of the space by the new tenant must comply with radius, location, use, and exclusivity provisions and not disrupt any tenant mix or balance. This requirement, which was intended to protect shopping center landlords when it was enacted, is having an unintended effect in the current economy. A tenant such as Hollywood Video which files for bankruptcy because it is in an obsolete industry segment has little incentive to look for a replacement tenant when the Bankruptcy Code restricts it to looking for others in the same obsolete industry.

When a bankrupt tenant rejects the lease, the effect of rejection is to constitute a breach of the lease which is deemed to have occurred immediately before the bankruptcy case was filed. Rejection affects the landlord in several ways. First, rejection excuses the tenant from the obligation to pay post-bankruptcy rent at the rate specified in the lease. If the tenant has continued to occupy the space post-bankruptcy, to be paid for that use immediately as an "administrative expense," the landlord must prove the value to the bankruptcy estate of the use. That may not equate to the rent specified in the lease. Second, if the bankrupt tenant rejects the lease, any claim under the lease that cannot be shown to be entitled to administrative expense status and that is not secured by a security deposit will be relegated to the status of a pre-bankruptcy unsecured claim and subjected

to a cap applicable only to lease claims. The cap is governed by a fairly complex formula, but entitles the landlord to a claim for rent that was unpaid at the time of the bankruptcy filing plus a claim for future rent for, at most, the lesser of 15% of the remaining lease term or three years. This ability to reject leases and minimize resulting landlord claims may provide retail tenants with multiple locations looking to shed stores with a significant motivation to file for bankruptcy.

However, there is one benefit to the landlord of a bankrupt tenant's rejection of the lease. Upon rejection of the lease, the tenant is obligated to surrender the space to the landlord and the automatic stay no longer prevents eviction.

Because of the possible effects of a bankruptcy filing by a tenant, landlords must remain alert to signs of trouble and be proactive in enforcing leases. Because the automatic stay does not prevent eviction of tenants whose leases have been terminated before bankruptcy and a lease that has been terminated cannot be assumed, termination of a lease when permitted by the terms of the lease and applicable law can spell the difference between recovering leased space quickly and being tied up in a protracted bankruptcy case.

If you have any questions about the affect of a bankruptcy on commercial leases, please contact William L. Hallam at (410) 727-6600 or whallam@rosenbergmartin.com. If you need any assistance with any other creditor rights matters, please contact Bill or another attorney in our creditors' rights group:

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