RETAIL BANKRUPTCIES
A LANDLORD'S INTRODUCTION

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Every commercial landlord, especially retail landlords, should be familiar with the phrase "retail apocalypse," which refers to the epidemic of retail store closings over the past several years. Many of these closings such as Toys "R" Us, Radio Shack, Gymboree, hhgregg, The Limited, Claire's, Nine West, among many more, were the result of those companies filing for bankruptcy.

Unfortunately for retail landlords, store closures are a trend that does not appear to be slowing. Accordingly, landlords should be aware of their rights in bankruptcy as well as potential traps for the unwary. While there are numerous considerations for a landlord dealing with a debtor tenant, this article addresses the most common, namely the automatic stay, first-day motions, assumption, rejection or assignment of leases, and claims issues.

The Automatic Stay

The first thing that a landlord should be aware of is the automatic stay. 11 U.S.C. § 362. Once a tenant files for bankruptcy, it is protected from many self-help remedies that a landlord would normally have available such as commencing an eviction action, changing locks, or even demanding payment of past-due prepetition rent. A willful violation of the automatic stay may allow the debtor to recover actual damages, including attorneys' fees; and, in some cases, punitive damages. 11 U.S.C. § 362(k).

Often, a landlord can file a motion with the bankruptcy court to seek relief from the automatic stay if certain conditions are met. While that can be a very useful strategy, it can be costly and may be premature early in the case depending on the tenant's postpetition plans for the property, as discussed more below.

It must be noted that the automatic stay is applicable even if the terms of the lease state that the lease is terminated upon the filing of a bankruptcy case. Such clauses, known as ipso facto clauses, are generally unenforceable in bankruptcy. 11 U.S.C. § 365(e).

First-Day Motions

When a debtor files a case under Chapter 11 of the Bankruptcy Code, it will immediately file a series of motions known as "first-day motions." It is important that landlords review these motions as the debtor may seek to alter the landlord's rights in a variety of manners, including attempting to have leases deemed rejected as of the petition date, which may result in a tenant remaining in the leased premises post-petition without paying rent; enforcing the automatic stay; approval of debtor-in-possession (DIP) financing, in which the debtor may attempt to offer the lender liens that prime the landlord's lien; and myriad others. Additionally, in conjunction with its cash collateral and DIP financing motions, the debtor will provide operating budgets, which a landlord must review to ensure that the debtor has included proper post-petition rent in its budget.

Lease Assumption and Rejection

Under Section 365 of the Bankruptcy Code, a debtor may elect to assume or reject any unexpired lease. If the debtor fails to make an election within the earlier of 120 days after the petition date or the date of an entry confirming the debtor's plan of reorganization, then the lease is deemed rejected and the debtor must immediately surrender the leased property to the landlord. 11 U.S.C. § 365(d)(4). That period may be extended by 90 days upon motion.

Oftentimes, if a lease is burdensome or not economically viable, the debtor will reject the lease. Upon rejection, the landlord becomes a general unsecured creditor holding a claim for rejection damages in an amount equal to any unpaid rent due under the lease, as of the earlier of the petition date or the date on which the debtor surrendered possession, plus the greater of one year's rent, or 15 percent, not to exceed three years, of the remaining term of the lease. 11 U.S.C. § 502(b)(6). However, as a result of being a general unsecured creditor, a landlord will likely receive less than the actual amount of the rejection damages claim.

In addition to the potential to recover little, the rejection of a lease (other than a lease deemed rejected under § 365(d)(4)) does not remove a tenant from the leased premises. As a result, the landlord may incur additional expenses in removing the holdover tenant through an eviction action in state court, after seeking relief from the automatic stay in the bankruptcy court.

Fortunately, even if the debtor rejects a lease, it is liable to the landlord for rents that became due post-petition and before the debtor rejected the lease, the debtor also must perform its other obligations under the lease prior to rejection. 11 U.S.C. § 365(d)(3). Post-petition rent and other monetary lease obligations are entitled to be paid as administrative expenses, which allow the landlord to recover those amounts as a priority claim.

It is clear that, from the landlord's perspective, it is preferable that the debtor assumes the lease. Not only does assumption assure the continued occupancy of the premises, but in order to assume a lease the debtor must first cure or provide adequate assurance that it will cure all defaults, including nonmonetary defaults, compensate or provide adequate assurance of compensation to the landlord for any actual pecuniary losses resulting from the defaults, and provide the landlord with adequate assurance of future performance under the lease. 11 U.S.C. § 365(b)(1). When a debtor proposes to assume a lease, the landlord should ensure that the debtor has stated the correct amount necessary to cure the defaults and compensate the landlord for losses.

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In addition to assuming or rejecting the lease, the debtor may also assume and assign the lease. This is most common when the lease has value (i.e. below market rates) but the debtor may not want to continue to operate in that location. Because the Bankruptcy Code provides that anti-assignment clauses in leases are generally not enforceable in bankruptcy, the debtor has a lot of leeway in determining whether to assign a lease. 11 U.S.C. § 365(f)(1). In order to assign a lease, the debtor must assume the lease, including curing all defaults, and provide adequate assurance of future performance by the assignee of the lease. 11 U.S.C. § 365(f)(2).

If the lease involves premises within a shopping center, the landlord generally has more protections against assignment. In order to assign a lease in a shopping center, the debtor must also provide adequate assurance of the financial condition and ability to perform under the lease of the proposed assignee; that any percentage of rent due under the lease will not decline substantially; that the assignment of the lease is subject to the terms of the lease, including radius restrictions, exclusivity provisions, use restrictions and any master agreement relating to the shopping center; and that assumption or assignment of the lease will not disrupt any tenant mix in the shopping center. 11 U.S.C. § 365(b)(3).

The Bankruptcy Code does not define "shopping center," so whether a leased premises is in a shopping center must be determined by the bankruptcy courts. Generally courts examine such factors as a combination of leases, one single landlord, all tenants engaged in the commercial retail distribution of goods, a common parking area, fixed store hours, the existence of a master lease, restrictive use provisions in the lease, percentage rent provisions in the leases, the right of a tenant to terminate its lease if an anchor tenant leaves, among others. *See, e.g., In re Joshua Slocum Ltd.*, 922 F.2d 1081 (3rd Cir. 1990).

Proof of Claim

A landlord must file a proof of claim for its damages claims. In each case, there will be a claims bar date, which is the last day to file a proof of claim. However, the landlord may not know the amount of a damages claim by the proof of claim deadline if the debtor has not made an election to assume or reject the lease. As a result, the notice of the bar date normally contains an additional provision giving the landlord a certain amount of time to assert damages resulting from the rejection of a lease after the debtor rejects the lease. It is very important that a landlord be aware of these dates and file its proof of claim timely.

As explained above, when the debtor rejects a lease, the landlord has a general unsecured claim for rejection damages and prepetition rent arrearages. Additionally, a landlord may have an administrative claim for any unpaid postpetition use of the premises, which is entitled to priority treatment.

The debtor may object to the landlord's proof of claim. Fed. R. Bankr. P. 3007(a). A debtor may object if it disputes the amount of the damages claimed, if the proof of claim was untimely, or for numerous other reasons. A landlord can respond to the objection, however, depending on the nature and extent of the objection, it is often in the parties' best interest to resolve the objection on mutually agreeable terms than to litigate the dispute.

Conclusion

With rumors of other large retailers, and many small ones, on the brink of bankruptcy, it is clear that the "retail apocalypse" is not ending soon. Landlords should be aware of their rights and restrictions when dealing with a tenant in bankruptcy. Failure to take the correct action can lead to an inability to recover money and affirmatively taking the wrong action can result in assessments of damages against a landlord.

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