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## Dealing with Restaurant and Retail Leases in Bankruptcy

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The recent Great Recession and the wave of bankruptcy filings that accompanied it presented a number of challenges for landlords and tenants. Yet, as the economy has recovered, we still continue to see restaurant and retail chains turn to the bankruptcy court's for relief. Over the past year, a number of restaurants and retailers filed bankruptcy petitions. For example, American Apparel, Radio Shack, Anna's Linens and Hot Dog on a Stick have sought protection from the bankruptcy courts. As this trend continues, both lessors and lessees need to be aware of the issues involved with a potential lease workout and bankruptcy.

### Bankruptcy Basics for Landlords and Tenants

A tenant can file a bankruptcy petition under either chapter 7 or chapter 11 of the Bankruptcy Code. Under chapter 11, the debtor seeks to reorganize its business, restructure its debt, and hopes to emerge from bankruptcy as a more efficient, competitive and profitable company. Under chapter 7, the debtor has determined that it cannot continue to conduct business as a going concern, and chooses to liquidate its business in order to maximize value for its creditors and equity holders.

### 1. The Automatic Bankruptcy Stay Protects the Tenant Debtor.

Once the debtor files its bankruptcy petition, an automatic stay immediately arises under Section 362 of the Bankruptcy Code to protect the property of the debtor's estate. This stay prohibits actions by creditors, landlords and others to (i) commence any judicial or other similar action against the debtor, (ii) exercise control over or obtain possession of property of the debtor's estate, and (iii) create, perfect or enforce any lien against property of the debtor's estate or the debtor.

For a landlord, prohibits the landlord from taking any action outside of the Bankruptcy Court to repossess the premises. There are some notable exceptions. For example, a landlord is not stayed and may seek to obtain possession with respect to a commercial lease that has terminated by the terms of the lease either before the commencement of the case or during the bankruptcy case. Alternatively, the landlord can seek to obtain relief from the automatic stay to continue with its unlawful detainer proceedings, which may be granted at the discretion of the bankruptcy judge. Failure to pay post-petition rent is one example where such relief may be granted.

### 2. The Tenant Debtor's Right to Assume, Assign or Reject the Lease.

Section 365 of the Bankruptcy Code deals with executory contracts and unexpired leases, and the heart of that section allows for the tenant debtor to assume (*i.e.*, retain the benefits) or reject (*i.e.*, elect to terminate) any unexpired lease. The tenant can, subject to court approval, also elect to assign the lease to a third-party. The Bankruptcy Code gives the debtor tenant 120 days from the petition date to decide to assume, assign or reject the lease. The court may, for "cause," give a debtor an additional 90 days to make such a decision. Any further extension beyond this 210-day period can only be obtained with the prior written consent of the landlord. While the debtor tenant decides whether to assume, assign or reject the lease, the debtor is required to pay the landlord post-petition rent, and such payments must begin within 60 days of the filing of the bankruptcy petition, unless the court extends that period for cause.

*Assumption of the Lease.* If the tenant wants to remain in possession of the leased premises, it must (i) cure all defaults under the lease including payment of unpaid prepetition and post-petition rent, and applicable fees and costs due under the lease, and (ii) provide "adequate assurance of future performance." The Bankruptcy Code excuses the cure of certain non-monetary defaults like breach of going-dark provisions.

*Assignment of the Lease.* Even though a lease may have an anti-assignment provision, the Bankruptcy Code overrides such a provision and authorizes a debtor tenant, with court approval, to assign the lease to another party interested in the location. This typically comes into play where a third party intends to acquire some or all of the debtor's business operations, or where the lease is below-market and the tenant debtor can obtain a monetary benefit from a third party willing to purchase the debtor's rights under the lease. In order to effectuate an assignment, the lease must be assumed, meaning all eligible defaults are cured, and the third-party assignee must demonstrate adequate assurance of future performance under the terms of the lease. This prevents the assignment of a lease over the objection of the landlord to a non-creditworthy third party. Furthermore, special "shopping center" provisions in the Bankruptcy Code provide landlords with further tools to prevent assignment of the lease where the proposed assignee would disrupt the tenant mix of the "shopping center."



*Rejection of the Lease.* If the tenant debtor determines that it no longer requires use of a particular location, it may elect to reject the lease. The tenant may also choose to reject an above-market lease, hoping to negotiate for lower rent going forward. When the lease is rejected, the tenant must vacate the premises and return possession to the landlord. Upon rejection and turnover, the tenant is no longer required to pay post-petition rent to the landlord. The landlord will then have an unsecured claim (in addition to any other claims the landlord holds) in the bankruptcy case for future rent required to be paid under the lease. This rejection damages claim cannot exceed the greater of the amount of rent due for one year or 15% of the rent due under the remaining term of the lease (not to exceed three years). Different jurisdictions are split on whether claims for physical damage to the premises are subject to the rent claim cap.

### **3. Lessors in Bankruptcy**

Not only has the most recent economic downturn significantly impacted retailers and restaurants, it has also caused a number of property owners to seek bankruptcy protection. Under Section 365 of the Bankruptcy Code, these landlord debtors also have the right to assume, assign or reject the unexpired lease. If the landlord debtor rejects the lease, the Bankruptcy Code contains special protections for the non-debtor tenant to prevent them from being “rejected out onto the street.” The tenant has two options. The first option allows the tenant to stay in the premises for the entire remaining term of the lease plus any available renewals or extensions available under the lease. The non-debtor tenant must continue to pay rent, but it also waives any damage claim against the debtor landlord resulting from the rejection. The second option allows the non-debtor tenant to vacate the premises following rejection, treat the rejection as a termination of the lease, and assert a general unsecured claim against the debtor landlord.

#### **Strategies for Lessors in Dealing with Financially Distressed Tenant**

To avoid the pitfalls of bankruptcy, a landlord needs to proactively monitor its tenants and be prepared to act at the first sign of any trouble. The following non-exhaustive list highlights some key issues that landlords need to consider in order to be fully prepared in the event of a bankruptcy filing:

1. *Financial Monitoring of the Tenant.* Landlords should consider incorporating and enforcing provisions in the lease that require the tenant to provide reports of the debtor’s financial condition periodically and on demand. If the tenant’s financial condition deteriorates, the landlord should consider enforcing financial covenant defaults.

2. *Security Deposits.* While obtaining a large cash security deposit is a good strategy, the deposit becomes property of the bankruptcy estate and the landlord must obtain relief from the bankruptcy court to offset against it. A letter of credit is a better alternative as a landlord can typically draw on it without having to first go through the bankruptcy court. However, the landlord should negotiate for the right to draw on the letter of credit without first having to provide a formal demand on the tenant. Otherwise, the automatic stay would prevent the landlord from issuing a notice of default to the debtor, and the benefit of the letter of credit would be undermined.

3. *Restrict Assignments.* Even though the Bankruptcy Code invalidates provisions that attempt to restrict the assignment of leases, a landlord can avail itself of the special “shopping center” lease provisions that restrict assignment under the Bankruptcy Code by clearly classifying the property as a shopping center in the lease. Since the Bankruptcy Code does not define “shopping center” courts have been relatively liberal in construing what constitutes a “shopping center.”

4. *Tenant Improvements.* At the outset of the lease, landlords often provide tenants with a tenant improvement allowance to build out the premises. Typically, these TIAs are paid back through higher rent over the term of the lease. If a tenant files bankruptcy and elects to reject the lease early in the lease term, the landlord’s rejection claim will be capped and could be paid at a significant discounted percentage. Landlords may want to consider loaning the tenant the funds to pay for the improvements and have the tenant repay those funds as a separate obligation.

5. *Compel Rent Payments.* Following the commencement of bankruptcy, the landlord should consider filing a motion seeking immediate payment of the post-petition rent obligations and to compel the debtor to make its decision to assume or reject the lease. Alternatively, the landlord can seek relief from stay to continue its unlawful detainer action, if it can show sufficient cause.

6. *Beware of Preference Liability.* If a tenant is delinquent on its rent obligations, and then makes a significant payment to the lessor, a payment made within 90 days of the bankruptcy filing can be set aside as a preference. The landlord should consider requiring a third party to make such “catch-up” payments on behalf of the debtor tenant.



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## **Strategies for Financially Distressed Tenants in Dealing with Landlords**

There are a number of issues for a financially distressed tenant to consider prior to commencing a bankruptcy case. These decisions will certainly impact the available rights and remedies of the debtor post-petition.

1. *Analyze the Relative Value of the Leases.* Prior to the commencement of bankruptcy, the tenant should analyze whether its leases are above-market or below-market and establish a plan for dealing with each of them. In bankruptcy, the debtor tenant may be able to monetize the “designation rights” related to its ability to assign below-market leases that it no longer wishes to retain.

2. *Avoid Changing the Term of the Lease.* As part of a pre-bankruptcy lease workout, landlords may require the tenant to restructure the lease and advance the termination date. Tenants should be wary of such requests, particularly converting the lease to a short-term tenancy because landlords are not subject to the automatic stay with respect to leases that are termed out prepetition or during the bankruptcy.

3. *Conserve Cash.* In order to conserve cash and build a sufficient fund to support its reorganization efforts, the distressed tenant should consider how far in advance to cease paying its monthly rent. This may provide a significant benefit if the tenant intends to vacate a number of its locations. However, if the tenant desires to assume the lease for a particular location, those payment defaults will need to be cured.

4. *Delay the Timing for Payment of Post-Petition Rent.* While the debtor tenant must pay its post-petition rent obligations, it can seek relief from the court to delay those payments to up to 60 days following the petition date. Having availability of these funds may help the debtor by permitting it to focus on other critical restructuring expenditures.

5. *Timely Seek an Extension of Time to Assume or Reject the Lease.* In order for the debtor tenant to benefit from the additional 90-day period to decide whether to assume or reject the lease, it must file its motion and the order granting such motion must be entered before the expiration of the initial 120-day period.

### **Concluding Thoughts**

This article is not an exhaustive list of all of the possible options available for dealing with distressed leases. Landlords and tenants should thoroughly evaluate their particular

circumstances with their leasing and bankruptcy counsel to decide the best overall approach for each particular situation.



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