Strafford

Presenting a live 90-minute webinar with interactive Q&A

Commercial Leases In Economic Distress: Pre- and Post-Bankruptcy Strategies for Landlords

Negotiating Lease Modifications With Distressed Tenants, Participating in the Bankruptcy Process

THURSDAY, JUNE 3, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Michael J. Riela, Partner, **Tannenbaum Helpern Syracuse & Hirschtritt LLP**, New York

A.J. Webb, Attorney, **Frost Brown Todd LLC**, Cincinnati

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1.**

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

Program Materials

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

Commercial Leases In Economic Distress: Pre- and Post-Bankruptcy Strategies for Landlords

Presented by:

Michael J. Riela, Tannenbaum Helpern Syracuse & Hirschtritt LLP

A.J. Webb, Frost Brown Todd LLC

Topics

- Automatic Stay
- Treatment of Pre-Petition and Post-Petition Lease Obligations in Bankruptcy
- General Unenforceability of Bankruptcy Termination Provisions
- General Unenforceability of Anti-Assignment Clauses in Bankruptcy
- Assumption, Assignment or Rejection of Leases by the Tenant
- Modification of Leases
- Credit Support for Landlords
- Going Out of Business Sales
- Strategies

The Automatic Stay

- Section 362(a) of the Bankruptcy Code (11 U.S.C. § 362(a)) provides that upon the commencement of the bankruptcy case, an automatic stay goes into effect.
- It stays, among many other things:
  - the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the bankruptcy case.
  - the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the bankruptcy case.
  - any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.
  - the setoff of any debt owing to the debtor that arose before the commencement of the case against any claim against the debtor.

The Automatic Stay

- Absent relief from the automatic stay, a landlord may not take any action to collect, assess or recover on a claim under a commercial lease that arose before the bankruptcy case.
- This includes commencing or continuing an eviction action, or attempting to collect pre-petition rent.

Relief From the Automatic Stay

- Section 362(d) of the Bankruptcy Code provides that the bankruptcy court shall lift the automatic stay if (a) "cause" exists, or (b) the debtor does not have equity in the property and the property is not necessary to an effective reorganization, and a landlord requests that the stay be lifted.
- There is a special rule that provides creditors more leeway to obtain relief from the automatic stay for acts against "single asset real estate." See Section 362(d)(3).
- "*In rem*" relief is available under Section 362(d)(4), if the court finds that the bankruptcy filing was part of a scheme to delay, hinder, or defraud creditors that involved either (a) transfer of all or part ownership of, or other interest in, such real property without the consent of the secured creditor or court approval; or (b) multiple bankruptcy filings affecting the same real property.

Automatic Stay's Impact on Landlords' Credit Support Mechanisms

- If the landlord had obtained a cash security deposit from the tenant before the tenant's bankruptcy filing, the landlord cannot set off the security deposit against its claims against the tenant, absent relief from the automatic stay or except as set forth in the tenant's eventual Chapter 11 plan.
- On the other hand, if the credit support is in the form of a letter of credit from a bank or other third-party issuer (with the landlord as the beneficiary), the automatic stay would generally not prevent the landlord from drawing down on the letter of credit to obtain the proceeds to apply to unpaid lease obligations.

Treatment of a Tenant's Pre-Petition and Post-Petition Lease Obligations in Bankruptcy

- Pre-Petition Claims vs. Post-Petition Claims.
- Treatment of landlord's pre-petition claims - Landlord's pre-petition claim for unpaid amounts due under the lease will be treated as:
  - A secured claim to the extent the landlord holds collateral (such as a cash security deposit); and
  - A general unsecured claim to the extent the amount due from the tenant exceeds the value of the collateral that the landlord holds.
  - If a landlord holds a pre-petition claim, it must make sure to file a proof of claim in the bankruptcy case by the bar date.
- Treatment of landlord's post-petition claims:
  - Section 365(d)(3) of the Bankruptcy Code requires a tenant to perform all *post-petition* obligations under the lease, until the tenant either assumes or rejects the lease.

Extension of Time for Tenants to Perform Lease Obligations

- The bankruptcy court may extend the tenant's deadline to perform the lease obligations that arise during the first 60 days of the bankruptcy filing.
- *See* 11 U.S.C. § 365(d)(3), which provides, in relevant part
  - "The trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title. **The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period.**"

Extension of Time for Tenants to Perform Lease Obligations

- The bankruptcy court in the J. Crew bankruptcy case (*In re Chinos Holdings, Inc.*) granted the debtors/tenants a 60-day extension of their deadline to perform their lease obligations expressly because of the COVID-19 pandemic. *In re Chinos Holdings, Inc.*, Case No. 20-32181 (Bankr. E.D. Va., May 26, 2020) [Docket No. 323].
- Tenants could even try to seek further extensions of that deadline under the bankruptcy court's equitable powers. *See* 11 U.S.C. § 105(a).
- In "Subchapter V" Chapter 11 cases, the time for performance of an obligation arising under an unexpired lease of non-residential real property currently may be extended by the court for an *additional* 60 day period (for a total of 120 days after the order for relief), if the debtor is experiencing or has experienced a material financial hardship because of the COVID-19 pandemic.

Possible Suspension of Chapter 11 Cases

- Tenants may ask the bankruptcy court to suspend their bankruptcy case, and thereby also suspend the tenants' obligation to pay post-petition lease obligations.
- The legal bases for this type of request are:
  - Section 105(a) of the Bankruptcy Code (which codifies the bankruptcy court's equitable powers); and
  - Section 305 of the Bankruptcy Code (which provides that the court may dismiss or suspend all proceedings in a bankruptcy case at any time, if "the interests of creditors and the debtor would be better served by such dismissal or suspension").

Ipso Facto Clauses

- Leases commonly include so-called "*ipso facto*" provisions, which provide that the lease will be terminated or be modified if the tenant commences a bankruptcy case.
- Because of Section 365(e)(1) of the Bankruptcy Code, however, these *ipso facto* provisions are generally unenforceable against debtors in bankruptcy.
- That Code section overrides lease language that provides for lease termination or modification on the tenant's commencement of a bankruptcy case, the insolvency or financial condition of the tenant at any time before the closing of its bankruptcy case, or the appointment of a trustee in the tenant's bankruptcy case.

Exception to the *Ipso Facto* Rule: Valid Termination of Lease *Before* Bankruptcy Filing

- The *ipso facto* rule does not apply if a lease was *validly* terminated *before* the tenant's bankruptcy filing
- Section 365(c)(3) of the Bankruptcy Code provides that a tenant cannot assume or assign any lease of nonresidential real property that was properly terminated before the commencement of the bankruptcy case.
- A lease will be deemed terminated if all final hurdles to termination have been satisfied and the lease is not subject to any form of equitable redemption or statutory grace period.
  - Tenants may try to contest the validity of any pre-bankruptcy lease terminations as part of their bankruptcy litigation strategy.
  - Some states have anti-forfeiture statutes that permit a tenant to revive a terminated lease, while other jurisdictions have equitable principles that permit an otherwise-terminated lease to be resurrected.

Anti-Assignment Clauses in Leases

- In addition to termination provisions, leases commonly contain provisions that prohibit the tenant from assigning the lease to a third party or restrict the tenant's ability to assign the lease.
- Section 365(f) of the Bankruptcy Code overrides almost all of these provisions, specifying that notwithstanding any anti-assignment language in the lease, the tenant may assign the lease as long as certain statutory requirements are met.

Tenant's Choices Regarding Its Leases

- In connection with its bankruptcy case, a tenant can make one of three elections with respect to its unexpired leases, subject to the approval of the bankruptcy court and so long as the tenant satisfies certain applicable requirements under the Bankruptcy Code. The tenant can:
  - Assume the lease in accordance with Sections 365(a) and (b) of the Bankruptcy Code;
  - Assume and assign the lease to a third party in accordance with Section 365(f) of the Bankruptcy Code; or
  - Reject the lease.
- Tenant does not need to obtain the landlord's consent to do any of these three things.

Deadline for Debtor to Decide Whether to Assume or Reject Leases

- Under Section 365(d)(4)(A) of the Bankruptcy Code, the tenant has an initial period of up to 120 days after the bankruptcy case is filed to decide whether to assume, assume and assign, or reject its unexpired commercial real property leases.
- That initial period can be extended by up to 90 additional days if the bankruptcy court approves that extension, pursuant to Section 365(d)(4)(B) of the Bankruptcy Code.
- Any further extension (*i.e.*, beyond the initial period plus the possible 90 additional days) requires the consent of the landlord.

Consolidated Appropriations Act

i. A temporary (2-year) change of Section 365(d)(4), extending the maximum 210 days to assume or reject to 300 days.

ii. A temporary (2-year) change to Section 365(d)(3), permitting the potential rent deferral for the first 60 days of a case for "cause" to be expanded in SBRA cases for an additional 60 days on a specific showing of "material financial hardship" due to the impacts of COVID-19.

iii. An amendment to Section 547 that exempts payments under rent deferral agreements (defined as "covered payment of rental arrearages") from potential preference exposure. This amendment protects rent deferral agreements going back to March 13, 2020 and payments under such agreements received over the next two years. The amendment is structured such that payments under such agreements (not including interest, late fees and penalties) do not qualify for inclusion in a trustee or debtor's prima facie case.

Assumption of Leases

- If the tenant elects to *assume* the lease, then it will be required to:
  - Cure virtually all types of outstanding defaults (including unpaid rent) under the lease; and
  - Provide adequate assurance to the landlord that it can continue performing its future lease obligations.
- If the tenant decides to assume the lease, it must assume the entire lease *cum onere*. The tenant cannot pick and choose which provisions of the lease it wants to assume or reject. Any modifications of the lease require the landlord's consent. *See, e.g.*, *In re Fleming Companies, Inc.*, 499 F.3d 300, 308 (3d Cir. 2007).

Assumption and Assignment of Leases

- If the tenant elects to *assume* the lease and *assign* it to a third-party assignee, then:
  - Either the tenant or the assignee will be required to cure virtually all types of outstanding defaults under the lease; and
  - The assignee will need to provide adequate assurance to the landlord that the assignee can continue performing the future lease obligations.
- Tenants often assume and assign their leases as part of a sale of the tenant's assets to a third party, or when the rental rate under the lease is below market. To assume and assign a lease, the tenant must file a motion with the bankruptcy court and provide notice to the landlord. The landlord may then object to the tenant's request. *See* 11 U.S.C. § 365(f).
- A number of courts have held that a tenant can assume and assign leases without giving effect to any lease clause that requires the tenant to share with the landlord a portion of any net profits that the tenant receives in connection with the assignment.

Assignment of Shopping Center Leases

- For landlords of shopping center leases, the Bankruptcy Code defines "adequate assurance" to include requirements that:
  - the "financial condition and operating performance" of the proposed assignee and its guarantors are similar to those of the tenant and its guarantors;
  - the percentage rent due under such lease will not decline substantially;
  - the assignee's proposed use of the leased premises will not violate any radius, location, use, or exclusivity provisions of the lease or any such provisions contained in any other agreements related to the shopping center; and
  - the assignee's proposed use of the lease premises will not disrupt any tenant mix or balance in the shopping center.

Treatment of Rejection Damages Claims

- The landlord's claim for rejection damages will be treated as a pre-petition general unsecured claim, even for rejection damages that relate to the period of time after rejection.
- Pursuant to Section 502(b)(6) of the Bankruptcy Code, the landlord's claim for rejection damages is capped at an amount equal to the greater of one year's rent, or 15% of the remaining rent due under the lease, up to a maximum of three years of rent.

Rejection of Leases

- If the tenant rejects the lease, it will be deemed to have breached the lease. In that case, the landlord may assert:
  - an administrative expense claim for any unpaid post-petition rent relating to the period between the bankruptcy filing date and the rejection date; and
  - a general unsecured claim for damages arising out of that rejection (*e.g.*, lost post-petition rent, the costs of re-letting the premises and attorneys' fees, all to the extent such amounts are specifically provided under the lease).
- *See* 11 U.S.C. § 365(g).

Modification of Leases (With the Landlord's Consent)

- Tenants can only *modify* the terms of their leases with the landlord's consent.
- If the landlord and the tenant agree to modify the terms of the lease, the tenant must then request bankruptcy court approval to assume the lease as modified by the parties' agreement.
- What happens if a particular lease is part of a group of other documents that is considered an inseverable whole?

Cash Security Deposits as Credit Support

- Cash security deposits are not the best credit support mechanism from a bankruptcy perspective.
- Traditional cash security deposits are normally deemed to be property of the tenant's bankruptcy estate (even though the landlord holds the deposit).
- Landlord will only be able to set off the deposit against unpaid amounts due under the lease after it obtains relief from the automatic stay or if the tenant's Chapter 11 plan permits it.
- If the amount of the security deposit exceeds the landlord's claim amount, the tenant may seek "turnover" of the excess.

Letters of Credit as Credit Support

- Letters of credit typically provide that a third-party issuer will pay the landlord directly upon demand, with the landlord being permitted to make such demand if the contractual conditions to payment under the letter of credit are met.
- Because of the "independence principle," the automatic stay in the tenant's bankruptcy case should not prevent the landlord from drawing on the letter of credit, so long as the lease and the letter of credit do not obligate the landlord to take any action *vis-à-vis* the tenant (such as providing notice to the tenant).

Third Party Guarantees as Credit Support

- Another form of credit support is a guarantee by either an entity that is affiliated with the tenant, or one or more principals of the tenant.
- If the tenant files bankruptcy, but the guarantor does not, in most cases the landlord will be free to collect on the guarantee without ever having to go to bankruptcy court.
  - The automatic stay generally only applies to the specific entity or individual that has actually filed bankruptcy.
  - However, in a few cases, the tenant will be able to obtain a bankruptcy court order extending the automatic stay to affiliates and principals that have *not* filed bankruptcy.

“Going Out of Business Sales”

- Landlords that have retail tenants may also need to contend with “Going Out of Business” (“GOB”) sales.
- Despite lease provisions that prohibit GOB sales, tenants will often seek (and receive) bankruptcy court approval to run GOB sales during the bankruptcy case.
- Even though landlords typically cannot wholly prevent a GOB sale, they can try to minimize the sale’s negative impact on the premises.

Some Strategies for Landlords

- Familiarize yourself with the applicable loan documents. When can you declare a default?
- If a default has occurred, send a default notice in accordance with the procedures specified in the lease.
- Gather information about financially-troubled tenants and their situations as quickly as possible.
- Consider terminating the lease (the tenant cannot resuscitate a lease that the landlord *properly* terminated pre-petition.)

Some Strategies for Landlords

- In lease workout negotiations, tenants usually threaten to file bankruptcy and reject the lease.
- Try to assess the likelihood of the tenant actually filing.
  - Is your lease a particular cause of the tenant's financial stress?
  - Is the tenant generally paying its other debts as they come due?
  - Did a principal (human being) of the tenant personally guarantee the tenant's lease obligations?
- Determine what your likely financial outcome would be if the tenant were to file bankruptcy and reject the lease.
  - Is the rent above-market or below-market?
  - Is there enough of a supply of suitable replacement tenants?
- Compare that bankruptcy outcome to potential negotiated resolutions.

Restructuring of Leases

- In connection with a negotiated restructuring of a lease, the landlord may request:
  - Additional credit support, such as a letter of credit or a third-party guaranty;
  - Increased rent in future periods, particularly if the rent under the lease is currently below market;
  - Extension of the term of the lease, particularly if the tenant has complied with its lease obligations until now and the landlord would otherwise like to keep the tenant in place; and
  - Reduction in the term of the lease or landlord early termination right, if the landlord would prefer the tenant to vacate soon.

Restructuring of Leases

- In connection with a negotiated restructuring of a lease, the landlord may also request:
- Elimination of any rights of first refusal or rights of first offer, or options to extend, on the part of the tenant;
- The restructuring of any economic terms, such as lease assignment profit-sharing provisions, that may be unenforceable in the tenant's bankruptcy case;
  - for example, the landlord may negotiate to receive more rent in the future, in exchange for removing the profit-sharing provision;
- Modification of the existing default notice and cure provisions to the extent they can be made to be more favorable to the landlord;
  - for example, a default can be self-executing, without the requirement of notice by the landlord.

Preference Risk for Landlords

- Beware of preference risk in connection with any negotiated resolution that calls for the tenant to pay overdue arrearages.
- Under Section 547 of the Bankruptcy Code if the tenant pays the overdue arrearages and subsequently files bankruptcy. Section 547(b) of the Bankruptcy Code provides that a debtor-in-possession or a bankruptcy trustee may avoid a pre-bankruptcy transfer of the debtor's property (*e.g.*, a payment to a landlord) that is:
  - made to a creditor;
  - on account of an antecedent debt;
  - while the debtor was insolvent;
  - within ninety days before the bankruptcy filing (or one year before the bankruptcy filing if the transfer was made to an insider); and
  - that made the landlord better off than it would have been if the transfer had not been made and the debtor had liquidated in Chapter 7.
- Statutory defenses.
- New Section 547(j) to the Bankruptcy Code.

Landlord Acquisitions of Tenants (or Buying Out Leases) in Bankruptcy

What is the idea?

Is this a trend?

Strategy for Tenants – The Bankruptcy Threat

- For financially-stressed tenants, it might make sense to threaten bankruptcy.
- Even financially solvent tenants can file bankruptcy, because insolvency is not a requirement for a bankruptcy filing. As a general matter, the tenant will be allowed to remain in bankruptcy if:
  - It is suffering some sort of financial distress that can be ameliorated through the bankruptcy process (even if it is solvent);
  - It is not filing bankruptcy simply to obtain a tactical litigation advantage; and
  - The bankruptcy filing serves a legitimate bankruptcy purpose.

Strategy for Tenants – The Bankruptcy Threat

- If the lease is at an above-market rent, then the tenant's threat to file bankruptcy could leave the landlord at risk of obtaining limited damages if the lease is subsequently rejected in a bankruptcy case.
- If the lease is at a below-market rent, the tenant likely can assume and assign that lease, and thus recover the "equity in that lease.
  - Any lease clause that requires the tenant to share with the landlord a portion of any net profits that the tenant receives in connection with the assignment is likely ineffective in bankruptcy.

Thank You!

Michael J. Riela

Tannenbaum Helpern Syracuse & Hirschtritt LLP

900 Third Avenue, 13th Floor

New York, NY 10022

Telephone: (212) 508-6773

Email: riela@thsh.com

A.J. Webb

Frost Brown Todd LLC

Great American Tower

301 East Fourth Street, Suite 3300

Cincinnati, OH 45202

Telephone: (513) 651-6842

Email: awebb@fbtlaw.com

DISCLAIMER

THE MATERIAL IN THIS PRESENTATION IS FOR INFORMATIONAL PURPOSES ONLY. IT SHOULD NOT BE CONSIDERED LEGAL, FINANCIAL, OR OTHER PROFESSIONAL ADVICE. YOU SHOULD CONSULT WITH AN ATTORNEY OR OTHER APPROPRIATE PROFESSIONAL TO DETERMINE WHAT MAY BE BEST FOR YOUR INDIVIDUAL NEEDS.