

How to Reduce Impact of Tenant Bankruptcies

The number of tenant bankruptcies is rapidly increasing—and no matter how financially sound your tenants seem at the start of the lease, there's no guarantee they won't become part of this trend. So it's important to take all possible steps to protect yourself. Once a tenant files for bankruptcy, bankruptcy laws control what you can collect from the bankrupt tenant or its court-appointed trustee and what it can do with the tenant's lease. As a result, you could end up losing a lot of money or having to deal with an undesirable third party in the tenant's space.

If your lease is like many we've seen, it may not offer any protection if a tenant goes belly-up. Chances are, it contains only a boilerplate bankruptcy cancellation clause that lets you terminate the lease if the tenant files for bankruptcy—but that clause is usually unenforceable (see box, p. 3).

That's why *CLLI*, with the help of New York City bankruptcy attorneys Jeffrey N. Rich and Michael P. Richman, New York City real estate attorney Nancy A. Connery, and Santa Monica real estate attorney Susan Fowler McNally, has put together a list of nine bankruptcy protections you should try to negotiate with all your tenants. You want these protections in place and available to use if you later become concerned with the financial well-being of a tenant. The more protections you can negotiate, the better the odds of reducing the financial impact of tenant bankruptcies.

Bankruptcy Basics

When a tenant files for bankruptcy, federal bankruptcy law (found in the federal bankruptcy code) lets the tenant's trustee or the tenant itself either assume or reject the tenant's unexpired lease, depending on which is more advantageous to the tenant, says Richman. If the trustee or tenant assumes the lease, the tenant must correct its lease violations, continue to pay rent, stay in the space, and assure you that it will meet its lease obligations, he says. The trustee or tenant will also have the right to assign the lease to a third party—but if that happens, you must get adequate assurance of continued, future performance of the lease obligations, he adds.

If the trustee or tenant rejects the lease, the tenant will stop paying rent and move out of the space, says Richman. You'll want to get compensated for the lease's early termination. But all you'll be allowed to do is make an unsecured claim for your damages, which can't exceed the greater of: 1) one year's rent, or 2) 15 percent of the rent for the remaining lease term (not to exceed three years), he says. And, if you expected to get reimbursed for certain expenses or improvement allowances that you made, you may be out of luck if the tenant doesn't have enough money to pay you back.

There's also a question of whether you're entitled to rent from the bankrupt tenant or its trustee for the period after the tenant files the bankruptcy petition and before it rejects or assumes the lease. Virtually all courts say that you are, says Connery, although some kinds of additional rent—particularly attorneys' fees—can be hard to recover.

CHECKLIST OF BANKRUPTCY PROTECTIONS

Since the federal bankruptcy code can severely limit the money that you can get from a bankrupt tenant or its trustee, consider seeking the following bankruptcy protections whenever you negotiate a lease or related documents (for example, a letter of credit) with a tenant. Having the first three protections available can help you *before* a tenant files for bankruptcy. The rest can help you *after* the tenant files for bankruptcy.

Call Decline in Tenant's Net Worth a Lease Default

A big drop in the tenant's net worth could be a signal that the tenant is becoming financially shaky and may be on the verge of filing for bankruptcy. So protect yourself by having the lease call a big drop in the tenant's net worth a material lease default, says Richman. In most leases, a material—significant—lease default will let you terminate the lease, so you can get the space back and rent it to a more financially stable tenant, he says.

You may benefit significantly if you can terminate the lease before the tenant files a bankruptcy petition, says Richman. Then, the lease won't be considered part of the bankrupt tenant's assets, he explains.

Add the following language to the lease where you list the tenant's "Events of Default":

Model Lease Language

(x) If Tenant's net worth is reduced to an amount less than \$[insert #].

PRACTICAL POINTER: If the tenant balks at giving you this protection, you can suggest this compromise: If the tenant's net worth has dropped considerably, the tenant must give you additional security, such as another guaranty or another letter of credit, by a certain deadline, says Rich. If the tenant fails to give you the additional security in time, it will have defaulted under the lease and you can evict it, he says.

❑ Get Tenant's Financial Information on Request

Since a tenant could go bankrupt quickly, stay on top of the tenant's financial situation by making sure that you get the right in the lease to periodically check its financial information—such as financial statements, profit and loss statements, bank references, and Dun & Bradstreet report, says Rich. Getting this financial information will let you know if the tenant's net worth has dropped low enough to trigger a lease default.

Model Lease Language

Any time and from time to time, upon not less than [insert #, e.g., 10] days' prior written request from Landlord, Tenant shall deliver to Landlord: (i) a current, accurate, complete, and detailed balance sheet of Tenant (dated no more than [insert #, e.g., 30] days prior to such request), including profit and loss statement, cash flow summary, and all accounting footnotes, all prepared in accordance with generally accepted accounting principles consistently applied and certified by the Chief Financial Officer of Tenant to be a fair and true presentation of Tenant's current financial position; (ii) a current, accurate, complete, and detailed financial statement on Tenant audited by an independent certified public accountant; (iii) current bank references for Tenant; and (iv) a current Dun & Bradstreet report about Tenant. Tenant agrees that its failure to strictly comply with this Clause shall constitute a material Event of Default by Tenant under the Lease.

Expect a savvy tenant to demand a limit on the number of times you can request this information—say, no more than twice in any 12-month period.

❑ Get Sufficient Security

Get enough security from the tenant to cover at least your up-front lease costs—such as brokerage fees and tenant improvements—as well as eviction costs, says Connery.

Otherwise, you'll remain out-of-pocket for these costs if the tenant goes bankrupt, she explains. Although it would be nice to get security to cover rent payments too, a strong tenant probably won't agree to that, she says. And a smaller tenant probably won't have the money. You'll be able to make a claim for some of the outstanding rent payments in bankruptcy court.

❑ Avoid Cash Security

Regardless of how big a security deposit you require, consider having the lease require the tenant to give you a letter of credit as security rather than cash, says Connery. The benefit of this kind of security is that if the tenant goes bankrupt, you won't have to go through the bankruptcy court to draw on it. With a cash security deposit, you would have to wait to get the bankruptcy court's permission to draw on it, she explains. Also, questions could be raised as to whether you've got a perfected—that is, enforceable—security interest in the cash security, she adds.

PRACTICAL POINTER: As an additional bankruptcy protection, Connery suggests getting a guaranty from the tenant's principals, such as its officers, and making sure that the guaranty will keep the guarantors on the hook even if the tenant is discharged—that is, released—from its debts in bankruptcy.

❑ Don't Link Letter of Credit to Rent Demand

If you get a letter of credit as security, beware of a possible obstacle. The tenant's letter of credit may require that, if it doesn't pay its rent, you must send it a notice of default before you can draw on the letter of credit. Then you must certify to the bank that issued the letter of credit that you sent the notice but the tenant didn't correct the nonpayment. Here's the obstacle: When a tenant files for bankruptcy, bankruptcy laws bar you from sending a notice of default to it, says Richman. So you wouldn't be able to collect on the letter of credit.

There are two approaches to avoid this obstacle: The hardball approach is to simply refuse to agree to giving the tenant a notice of a default before you can draw on the letter of credit, says Richman. If the tenant won't accept that, you can suggest this compromise: Have the letter of credit say that you agree to certify to the bank that you either sent a notice of default to the tenant demanding the unpaid rent or you were unable to send the notice because it was barred by law, he says. Then, if the tenant files for bankruptcy, you can still draw down on the letter of credit, he explains.

To use this compromise, ask your attorney about including the Model Language below in your letter of credit. The term "Landlord's draft" used in the Model Language refers to the owner's request to the bank to draw on the letter of credit.

Model Language

Landlord's draft must be accompanied by a signed certificate stating either:

- a. Tenant has defaulted in its obligation to pay rent under the Lease, and Landlord has transmitted to the tenant a notice required in respect thereof under the Letter of Credit ("Notice of Default"), but Tenant has failed to pay the sums demanded within in the time period set forth in the Lease; or
- b. Tenant has defaulted in its obligation to pay rent under the Lease, and the transmittal of a Notice of Default by Landlord is barred by applicable law.

❑ Make Tenant Pay Improvement Costs

Be careful when giving a tenant improvement allowance (TIA), warns Richman. If you expect to get the TIA paid back through the rent, but the tenant goes bankrupt, you may not recover any of it, he says. To protect your wallet, consider requiring the tenant to pay for all of its tenant improvement costs, including soft costs—that is, engineer and architect fees, says McNally. If you make the tenant pay for these costs, you'll typically charge a lower rent. But you won't have to worry about being out of pocket for these costs.

❑ Sign Separate Loan Agreement for TIA

If the tenant doesn't have enough funds to pay all of its improvement costs, you can consider loaning the tenant part or all of the amount that it's deficient. But do it through a separate loan agreement—not the lease, say McNally and Richman. If you put the loan arrangement in the lease, it may be subject to the bankruptcy law's limitations on what you may collect in "rent"—that is, one year's rent, or 15 percent of the rent for the remaining lease term (not to exceed three years). This could occur even if you spell out that it's a loan.

❑ Make Lease Rejection a Default

Say in the lease that if the bankrupt tenant or its trustee rejects the lease, the rejection will cause a lease default, recommends Connery. Although the law isn't settled on this point, this language may help you terminate the lease and get the space back, she suggests. Otherwise, if there's a subtenant in the space, the subtenant might argue and a court might agree, that the lease, even though rejected, isn't terminated, she explains. That's because the federal bankruptcy code says that a rejection of an unexpired lease constitutes a "breach," rather than a termination, of the lease, she adds. Then the subtenant might

argue that it has the right to continue subletting the space for as long as it pays the rent, explains Connery.

Consider adding the following language to the lease where it lists the "Events of Default," says Connery:

Model Lease Language

- (x) Tenant rejects this Lease after filing a petition in bankruptcy or insolvency or for reorganization or arrangement under Federal bankruptcy laws or under any State insolvency act.

❑ Restrict Assignments

If a bankrupt tenant or its trustee has assumed the lease, it can then assign it. If this happens, you may be forced to accept an assignment of the lease—with little say in deciding who the new tenant will be. This can be especially troublesome if you're concerned that an assignee will have a negative impact on your building or center. Although the federal bankruptcy code does impose some restrictions on whom a bankrupt tenant in a shopping center can assign to, it won't let you completely block assignments. Also, any restrictions on assignments in your lease will be carefully scrutinized by a bankruptcy court and might be set aside.

Even so, here are two ways that you might be able to control assignments to some degree:

1) Use radius restriction. You may be able to control assignments by adding a radius restriction to your lease, says Rich. A radius restriction stops the tenant from operating more than one store within a certain radius of its space, he explains. The restriction, in effect, limits the bankrupt tenant's or its trustee's assignment right by reducing who qualifies as an assignee. The tenant can't assign the lease to a store that already has other stores within the radius. But while the federal bankruptcy code recognizes radius restrictions in shopping center leases, be aware that radius restrictions can still be challenged by office tenants, Rich warns.

2) Call retail property "Shopping Center". If you've got a retail building, call it a "shopping center" in the first part of the lease, where it describes the building,

▶ Is Bankruptcy Cancellation Clause Useless?

Most leases have a bankruptcy cancellation clause. It typically says that it's an "Event of Default" if the tenant files a bankruptcy petition, or if involuntary proceedings under any bankruptcy laws or insolvency act are brought against the tenant and not dismissed within a certain number of days. The default could then allow you to terminate the lease. But this clause isn't enforceable. The current federal bankruptcy code bars holding the tenant in default or terminating the lease because it files for bankruptcy.

But it still may be a good idea to include this clause in the lease, says New York City bankruptcy attorney Jeffrey N. Rich. Why? Because you might be able to rely on it in situations where the federal bankruptcy code doesn't protect the tenant—for instance, if the tenant's bankruptcy case is dismissed, he explains. It could also be useful if the federal bankruptcy code is ever changed in the future to allow lease terminations when a tenant files for bankruptcy, he adds.

suggests Richman. You may then be able to get extra protections under the federal bankruptcy code that aren't available to other commercial property owners, he says. The federal bankruptcy code gives shopping center owners more control over what kind of businesses can qualify as assignees of the tenant's space so that the center's tenant mix won't be disrupted, he explains.

The federal bankruptcy code doesn't define a shopping center. So any retail property housing two or more retail tenants—even a retail concourse area of an office building—could qualify as a shopping center, says Richman. While there's no guarantee that a court will agree that your property is a “shopping center” just because you say so in the lease, it's worth a shot, he adds. ▲

CLLI SOURCES

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