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Retail Tenant Bankruptcies

Commercial landlords must know their rights to limit their risks.

by David Folds

Despite a strengthening economy, the retail sector continues to face challenges. Since late 2014, several prominent retailers — including Brookstone, Coldwater Creek, Loehmann's, Crumbs Bake Shop, Wet Seal, and most recently, Radio Shack — filed for Chapter 11 bankruptcy.

While struggling retailers present risks, several strategies can help landlords protect their investments and minimize the effects of tenant bankruptcy filings.

Early Due Diligence

In general, commercial landlords can protect themselves by monitoring their tenants closely and promptly enforcing lease provisions when a tenant defaults. Along with seeking unpaid rent or pursuing other state law remedies, landlords can draw on a security deposit or letter of credit in accordance with lease provisions. Although the draw

on a security deposit may be challenged in a subsequent bankruptcy, depending on the timing, it could increase the landlord's overall recovery. Other landlord protections in default include lease provisions terminating tenant renewal rights and potential actions against guarantors.

By taking these proactive steps, a landlord may be able to terminate a lease, obtain pos-

session of its space, and avoid the bankruptcy process altogether. In the event of a subsequent bankruptcy, the following steps could improve the landlord's leverage and potential recovery through the process.

After a Tenant Files

A retail tenant gains a series of statutory protections and rights after it files for bankruptcy, including some protections that supersede lease provisions. Bankruptcy creates an automatic stay of any enforcement action against the tenant outside of the bankruptcy court and imposes penalties for violating this stay. Tenants may have authority to take actions that violate lease agreements. Despite enhanced tenant rights, a landlord can take steps to limit the disruption to its operations and minimize the loss resulting from a tenant filing.

Going Out of Business Sales. Tenants in bankruptcy often seek authority to conduct GOB sales at some or all locations, asking for court approval to hang banners, use sandwich board walkers in common areas, or pass out fliers — which may violate local ordinances or lease terms.

If objecting to the proposed GOB sale terms, the landlord should assert the objection in the bankruptcy court by the applicable deadline. Reaching an agreement with the tenant's bankruptcy counsel or the proposed liquidator also can minimize inconvenience to the landlord and other tenants.

Demand Rent. After filing for Chapter 11, a tenant is obligated to pay rent until it rejects the lease (discussed below) and surrenders possession of the leasehold premises. If a tenant does not promptly pay rent, a landlord can file a motion with the bankruptcy court to compel immediate payment. Depending on the jurisdiction of the filing, the landlord also may be entitled to post-bankruptcy per diem or "stub" rent for the remaining days in the month of the bankruptcy filing. This right can be important because retail companies frequently fail to pay rent in the month in which they file for Chapter 11.

Lease Assumption or Rejection. A tenant in bankruptcy has the right to reject, assume, or assume and assign a retail lease within 120 days of filing. The tenant can extend for a 90-day period without the landlord's con-

sent, but any further extensions require the landlord's consent. A landlord should monitor this process and assert its rights if necessary.

A tenant may reject a lease by filing a motion to relinquish possession on a specified date. The rejection constitutes a breach of the lease, and the landlord can obtain authority from the bankruptcy court to terminate the lease at that time.

When a tenant rejects a lease, the Bankruptcy Code imposes a cap on allowed damages. The landlord is entitled to a claim equal to the greater of (1) one year's rent plus additional rent due under the lease for items such as common area maintenance, real estate taxes, and insurance; or (2) 15 percent of the remaining lease term, not to exceed three years. In some instances, the landlord may be entitled to its legal fees or costs for repairing property damage.

In many cases, the recovery on this capped claim will be just pennies on the dollar. However, for retail tenants with substantial assets

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or that continue as a going concern following a bankruptcy reorganization or sale, the recovery can be substantial. A landlord must file a proof of claim by the established deadline.

A tenant may assume a lease, by curing all existing monetary defaults and providing "adequate assurance of future performance." The tenant identifies a proposed cure amount, but if this amount is incorrect, the landlord should file an objection stating the correct amount. A landlord may also seek financial information or additional security to provide assurance of future performance.

Finally, bankruptcy law provides a retail tenant with a statutory right to assume and

assign a lease to a third party. Although a landlord may not be able to prevent the assignment, it may be able to obtain an additional security deposit or guaranty from the prospective new tenant.

In each step of the bankruptcy process, a landlord may be required to assert its rights through timely filings in the bankruptcy court or negotiations with the tenant's bankruptcy counsel.

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