

It's Going To Rain Eventually, So Why Not Plan Now?

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280 Dark Locations

When Stein Mart put its 280+ stores into a Chapter 11 reorganization during the COVID-19 pandemic, it marketed its various locations around the country to potential bidders that might take over their leases and rent obligations. Anxious landlords closely monitored the process, also hoping new tenants would take the reins and keep the locations from going dark. After months of planning and several weeks in an expedited and court-approved auction process with seasoned professionals, Stein Mart finally filed its Notice of Bid Results: **A single qualifying bid was received for just one store (store #243)**. Stein Mart was forced to cancel its planned auction and reject (effectively terminate) its remaining 280+ leases. Below are key bankruptcy concepts that landlords, tenants, and investors should watch for during a potential insolvency or bankruptcy event.

Chapter 11 Leverage Points

The automatic stay: Chapter 11 allows debtor companies to operate in the ordinary course of business while they work to reorganize their debts. The bankruptcy filing creates an automatic stay (an injunction) against many typical collection activities that otherwise could be taken outside of a bankruptcy context. This stay allows breathing room for the debtor to put a pause on collection and a focus on restructuring.

Ipso facto clauses: Lease provisions that purport to automatically terminate or modify a lease in the event of a bankruptcy filing generally are unenforceable in bankruptcy. They conflict with the Bankruptcy Code's purpose of providing a forum for a tenant to restructure its debt while maintaining business operations. Unless the landlord has taken every step under the lease to terminate the agreement prior to bankruptcy, Chapter 11 likely remains available to the tenant notwithstanding ipso facto clauses claiming otherwise.

Assumption: A useful bankruptcy tool for debtor tenants is the ability to assume (or keep) their leases and even assign them to a third party in exchange for some immediate value to the tenant and/or reduction of the tenant's ongoing obligations. Tenants will avail themselves of this opportunity particularly when it comes to below-market leases, which can be assumed (and kept) or assigned to third parties for value and/or savings. If assumed, the tenant must provide assurance that it will cure all defaults in a timely manner and provide adequate assurance that it will meet its future lease obligations.

There is no specific legal definition of “adequate assurance.” Oftentimes, the assurance is the same as what the landlord required when the lease was signed. Therefore, landlords should clearly define these assurances in their leases.

Assignment: A debtor tenant also can assign its lease to a willing purchaser/assignee. Any prospective assignee must, as a prerequisite to the assignment, cure the full prepetition (pre bankruptcy filing) default and provide adequate assurance of the ability to abide by the lease provisions in the future. Landlords should conduct as much due diligence as possible of any proposed assignee to the lease and object if the landlord is not satisfied the replacement will be able to perform.

Rejection: Alternatively, debtor tenants can reject their leases that are of little use to them. This may happen to above-market leases or leases that are in areas where the tenant no longer wants to focus its post-bankruptcy business. If the tenant chooses to reject the lease, this constitutes a default that will allow the tenant to relieve itself of any further liability under the lease. The landlord, on the other hand, will receive an unsecured claim for the remainder of the lease term, up to a statutorily defined cap. General unsecured claims, however, are typically paid cents on the dollar because of their lower priority under the Bankruptcy Code.

Preparing for the Rainy Day

Given these issues, landlords, tenants, and investors may consider taking time now to clean up their business practices and form agreements.

Due diligence: While no amount of due diligence can fully guarantee a bankruptcy will not be filed, landlords should balance the short-term gains of filling vacant space with the potential pitfalls of bringing on financially risky tenants.

Financial wherewithal provisions: In assessing whether a potential assignee to a lease can satisfy the “adequate assurance” requirement for assignment, courts typically key off terms the debtor-tenant had to satisfy initially under its lease for commencement or assignment. Landlords should consider comprehensive due diligence requirements in their form leases for potential assignees, and tenants should be proactive in gathering this information when courting potential assignees.

Guarantees: Non-debtor guarantees and lines of credit survive the debtor tenant’s bankruptcy and may provide not just a means for collecting lease damages from the guarantor, but also negotiating leverage at the assignment/assumption/rejection stage.

Termination v mere breach: A landlord who wishes to avoid getting wrapped up in a defaulting tenant's potential bankruptcy must act quickly to terminate the lease *before* the tenant finds safe haven in Chapter 11. Alternatively, a tenant may consider Chapter 11 as a possible lifeline early into its financial distress before the landlord terminates the lease. A pre-filing termination likely cannot be revived even if the tenant is still in physical possession of the premises at the time of bankruptcy filing.

Termination provisions: Landlords in many of the recent retailer mega-bankruptcies have incurred massive cleanup bills after tenants rejected their leases. Once the tenant rejects a lease, its obligation to maintain or remove all the detritus of its tenancy is terminated too. For this reason, a landlord may want to protect itself by requiring hefty security deposits from retail tenants as the landlord may be able to use these to setoff its damages.

Weathering the Storm

A commercial tenant must decide within 60 days whether to assume or reject its lease. A tenant can request an extension if good cause is shown, including ongoing negotiations with a prospective replacement tenant or proof of strict compliance with all postpetition (post bankruptcy filing) lease obligations. Debtor tenants must still timely pay their postpetition lease obligations as they come due. Any unpaid postpetition rent may be entitled to administrative expense priority status that is entitled to a higher priority for payment than general unsecured claims. If the debtor tenant is not staying current on its postpetition obligations, the landlord may seek relief (e.g., an order compelling payment) from the bankruptcy court.

To successfully assume and/or assign the lease, any prepetition default must be cured and the party assuming the lease, whether it's the tenant or a prospective replacement, must provide adequate assurance of the ability to abide by the lease provisions in the future. The landlord should always conduct as much due diligence as possible of any proposed assignee to the lease and object if the landlord is not satisfied the replacement will be able to perform.

Landlords and tenants alike should carefully monitor the bar date for filing of proofs of claims in the bankruptcy case and be aware of the Bankruptcy Code's cap on claims for lease damages. In the event a tenant rejects its lease, a landlord's claim for damages is limited to the larger of one year's rent or 15% percent of the remaining term capped at three years total.

Finally, a landlord may file a motion to compel earlier assumption or rejection and/or a motion for relief from the automatic stay to terminate and evict a tenant, but the landlord faces a high bar in so doing and often must show the relief is necessary to avoid irreparable harm to the landlord.

Mutual Benefit

The ability to assume, assign, or reject leases is an opportunity for debtor tenants and non-debtor landlords or investors to negotiate a mutual resolve that is perhaps more reflective of current market conditions. This could provide both a reduced rent for the tenant and an uninterrupted revenue source for the landlord. Reviewing your business practices and forms now may provide you better leverage when needed later.