

IN THE SPOTLIGHT

The Impact of Landlord Bankruptcies on Commercial Tenants*These Are Tough Times for Landlords***By Lars Andersen**

The current “Great Recession” has created massive amounts of work (and billable hours) for bankruptcy attorneys. Retailer bankruptcies and store closings (Circuit City, Linens n’ Things, *et. al.*) have resulted in historically high vacancy rates at strip centers and malls, and the worst may be yet to come. Landlords of retail centers anchored by “big box” tenants are especially likely to suffer increases in empty space, resulting deterioration of cash flow, and difficulty in making debt service payments on their mortgages.

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Adding to a bad situation is the fact that a large number of commercial landlords refinanced — and took equity out of — their properties during 2005-2007 in the midst of the bubble of high valuations. Many of those borrowers signed five-year mortgage notes for which balloon payments become due in years 2010–2012. In the worsening capital environment those landlords will simply not be able to refinance, especially given severely depressed values and their lack of access to additional equity. The result is a glut of “distressed assets” and “maturity defaults.”

IT’S A NATIONAL AND A LOCAL PROBLEM

Increasing numbers of landlords will likely file for bankruptcy. Opus South and Opus West (major, long-standing commercial real estate operators in certain U.S. sub markets) have already taken that path, as has

General Growth Properties (a huge institutional landlord with over 220 malls across the U.S.). Many smaller and regional landlord groups that have not already declared bankruptcy will follow this lead. Just like their tenant counterparts, landlords entering bankruptcy protection have the opportunity to reject (and elect to terminate) leases on their properties per the range of debtor rights under the U.S. Bankruptcy Code.

Here are some questions tenants may have to deal with:

- Do you know what your risks are if your landlord goes into bankruptcy?
- How do you protect your occupancy rights when your landlord goes bankrupt?
- How do you deal with a foreclosing lender?

WHAT DOES THIS MEANS TO YOU AS A TENANT?

Obviously, any tenant whose lease has been rejected by its bankrupt landlord is very concerned about its continuing right, if any. Fortunately, § 365(h)(1) of the Bankruptcy Code affords some protection; the tenant in that situation has the right to remain in the premises for the dura-

tion of its lease term, plus any extension or renewal period, as long as that tenant continues to pay the required rent. The potential problem, though, is that while the tenant can stay in the space, the landlord's rejection of the lease ends that landlord's obligation to provide services (maintenance, trash collection, services, utilities, etc.) under the lease terms. The tenant will then have to fend for itself and procure the necessary services elsewhere and can then apply a rent offset for the related costs. For retail tenants this function (and cost) can sometimes be taken over by a merchants' association, with assessments flowing through to the member tenants.

Successfully dealing with the landlord's rejection of the lease, however, does not fully get the tenant "out of the woods." The tenant of a bankrupt landlord must be diligent in monitoring the bankruptcy proceedings to learn of any proposed landlord sale of the property "free and clear" of encumbrances (which could include free and clear of the tenant's lease). The reality is that tenants do not always get early notice of their landlord's bankruptcy as do the landlord's creditors, and if the tenant is "asleep at the switch," the risk is that it may still lose its occupancy rights due to the bankruptcy court's approval of a "free and clear" sale. Upon receiving notice of such an impending sale, it is critical that the tenant file a motion with the court objecting to that sale and seeking "adequate protection" for its continued occupancy under its lease.

WHAT ACTIONS SHOULD YOU TAKE?

- Always try to get a SNDA Agreement in place with the lender.
- Engage in a dialogue with the foreclosing lender to preserve your occupancy.
- Make sure to pay your rent timely, even if the maintenance on the property deteriorates.
- Engage a bankruptcy attorney immediately to file an objection if you receive a sale notice from the bankruptcy estate of the landlord.

Where a landlord has defaulted on its mortgage, the lender will likely pursue its rights to take over ownership and operation of the property (at least for the period prior to sale of the property to a new landlord). Note that lenders try to avoid holding such assets, even if the alternative is selling at a price far below the amount owed on the mortgage. It is important to establish a dialogue with a foreclosing lender to emphasize the benefit of your continuing rent stream and occupancy and to learn early what the lender's next steps will be. Sometimes a foreclosing lender will not actually take title to the property, but will arrange to have a successor landlord take over the property (a "deed in lieu").

However, if the lender does take actual ownership of (title to) the property, it will be bound under your lease terms to provide the required-provided services; provided that and only if, the foreclosing lender does not have "superior rights" over your lease. Thus, an extremely

important protection for tenants is afforded by having a "Subordination and Non-disturbance Agreement" in place signed by that mortgage lender.

Without the benefit of a Subordination and Non-disturbance Agreement (a "SNDA"), to the extent that your lease was signed after the date of the recording of the mortgage on the property, that lender could elect to terminate your lease abruptly because of the lender's "superior" rights. Leases with below-market rental rates, those for space with substantial tenant-paid improvements, and those of smaller tenants are particularly in jeopardy of an early termination by a foreclosing lender.

CONCLUSION

Even if the mortgage was recorded after you signed your lease, you may still have agreed (per the lease language) to "subordinate" your rights to those of the mortgage lender. Thus, you will still be "over a barrel" and may be forced to contend with having to find other space and relocate immediately, or be compelled to enter into a replacement lease at a higher rent just to stay where you are. Careful review of relevant lease provisions during the negotiation phase is a must, and it bears repeating that a signed SNDA is critical to avoid such potentially catastrophic situations for a tenant.