COX CASTLE NICHOLSON

RETAIL PERSPECTIVES

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Your Tenant Has Filed For Bankruptcy - Now What?

A growing number of retail tenants are filing bankruptcy due to lingering problems in the economy. This article provides an overview of some rights and remedies available to both a landlord and a tenant when the tenant files bankruptcy. As an illustrative example, assume that the tenant and landlord enter into a lease with rent due on the first day of each month. The tenant misses two months of rent. The landlord serves the tenant with a 3-day notice to pay rent or quit (or such other notice for non-payment of rent as may be set forth in the lease). The tenant then files bankruptcy on the fifteenth day of the third month.

1. Automatic Stay.

When the tenant files bankruptcy, an automatic stay immediately goes into effect. The automatic stay is a statutory injunction that prohibits actions by creditors, landlords and others to obtain possession or control of the tenant's property or to assert claims against the tenant. In the above example, when the tenant files bankruptcy, the landlord is automatically stayed from bringing an unlawful detainer action against the tenant after the 3-day notice to pay rent or quit (or other default notice) has run.

2. Post-Petition Rent.

If the tenant stays in possession of the leased premises after filing bankruptcy, the tenant is required to pay post-petition rent to the landlord and to keep those rent payments current as long as the tenant occupies the leased premises. Unpaid pre-petition rent is classified as an unsecured claim which is paid with other unsecured claims after secured and priority claims. Unpaid post-petition rent while the tenant occupies the leased premises is entitled to be paid as an administrative claim before general unsecured claims.

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Top 10 Issues in Common Area and Common Area Expense Provisions in Retail Leases

When negotiating a retail lease, the provisions relating to the Common Areas of the Shopping Center and the tenant's obligation to contribute its respective share of Common Area Maintenance Expenses ("CAM Expenses") are among the most heavily debated topics. The following is a "Top 10" list identifying some of the key points (not necessarily in order of importance) for discussion relating to Common Area and CAM Expense provisions in retail leasing. Of course, when reviewing the following issues, it is important to keep in mind that essentially all issues in commercial leasing (including the following) come down to the respective bargaining leverages of the parties, which involves a number of factors including the tenant's financial statement, operating experience, effect on the "tenant mix" or customer traffic within the Shopping Center, size of the premises leased, availability of alternative tenants for the same location, and desirability and existing success of the Shopping Center without the lease to the tenant.

1. Defining the Common Areas.

It is typical for a retail lease to allow the landlord the right to designate and change, from time to time, the "Common Areas" of the Shopping Center (which may generally be described as those portions of the Shopping Center made available by the landlord for non-exclusive use by occupants of the Shopping Center and their customers and invitees). From the landlord's perspective, the landlord wants to be careful to allow (i) flexibility in development and remodeling of the Shopping Center, particularly in the context of new development, where outparcel or "pad" buildings are not yet established, and (ii) rights to establish certain use rights within the Common Areas, which may restrict access to some (but not all) Shopping Center occupants, notwithstanding the

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designation of the same as "Common Areas", such as "drive-thru" aisles, truck loading areas, "short term" parking areas and outdoor patio seating areas. From the tenant's perspective, the tenant has bargained for being a part of a Shopping Center that looks like the one shown on the site plan which the landlord has marketed to the tenant, and the tenant may have legitimate concerns about changes that would adversely affect the tenant's use, operation, visibility or parking. Accordingly, the parties may compromise on the issue of Common Area changes by establishing "Permitted Building Areas" or "building envelopes" within which the landlord may place buildings, or "No-Build Areas" within which the landlord may not place structures, thus preserving the tenant's view corridors, main access drives or parking areas. Alternatively, particularly in the context of a larger Shopping Center, the parties may establish a "Primary Common Area" outside of which the landlord may make any changes it desires, but within which the landlord shall not make changes which would materially adversely affect the tenant's use, operation, visibility (which may include visibility of the tenant's signage) or parking without the prior approval of the tenant.

2. Caps on CAM Expenses.

From the tenant's perspective, the best mechanism when seeking to avoid unanticipated CAM Expenses is to obtain a "cap" or limitation on the tenant's obligation for payment of CAM Expenses (which is typically structured as a maximum limit on first year CAM Expenses with a percentage-based limit on subsequent annual increases). From the landlord's perspective, such a cap is very difficult to accept, since the prospect of a subsidy of the tenant's CAM Expenses is directly in conflict with the typical notion of the retail lease as a "triple net" lease. For this reason, such caps on CAM Expenses are fairly unusual and, when granted, often relate only to "controllable" items of CAM Expenses (which typically exclude, at a minimum, real property taxes, insurance costs, security costs and utility costs). Also, from the landlord's perspective, any such caps should be calculated on a "cumulative and compounding" basis, such that the landlord gets the benefit of the full amount of any "unused" cap room from prior years when calculating the applicable cap amount for the current year. This makes sense, since while caps on CAM Expenses satisfy the tenant's desire for outside limits on additional rent obligations, they are not intended to penalize the landlord who in any given year is able to keep CAM Expenses below the applicable cap amount.

While landlords sometimes will agree to cap increases in CAM Expenses, they typically will do so only with respect to "controllable" CAM Expenses.

3. Inclusion of Management Fees in CAM Expenses.

The landlord typically expects to include both third party management fees and an administrative fee (usually calculated as a percentage of other CAM Expenses) in CAM Expenses. While the tenant may view this as "double dipping", it is worth noting that an administrative fee alone (*e.g.*, 10-15% of other CAM Expenses) is usually far less than a typical third party management fee (usually structured as 2.5-4% of gross project revenues). However, in anchor tenant lease transactions, landlords may be forced to accept the administrative fee (often reduced from 15% to 10% and calculated exclusive of real property taxes and insurance, on the often inaccurate theory that these items do not require much management time) in lieu of any other management fees in CAM Expenses.

4. Inclusion of Capital Expenditures in CAM Expenses.

The issue of limitations on inclusion of capital expenditures in CAM Expenses is often the subject of lengthy lease negotiations. From the landlord's perspective, the landlord is simply the steward of the Common Areas and whatever costs are incurred should be passed on to the tenants. From the tenant's perspective, the landlord's capital expenditures are long term investments that are already effectively reflected in the base rental rate (and if not, are a "risk of ownership") and are not properly chargeable to the tenants (at least not in a lump sum). When resolving this issue in a major tenant lease, the parties often agree to "split the baby", such that some items are wholly excluded (capital repairs or replacements during the initial 5-7 years of the Lease Term in the context of new development upgrades or new acquisitions), while others (capital repairs and/or replacements of existing items) are included, but (maybe to the extent costing more than some minimum threshold in cost) are amortized over their respective useful lives (note that the amortization period when using federal income tax rules is likely to be considerably longer than when amortizing over an item's reasonably anticipated useful life) with interest at some specified rate, and only annual amortization is included in CAM Expenses in each year of such amortization period. Note that such amortization is not likely to make the landlord "whole" as to such capital expenditures, as many leases are likely to expire prior to the end of the amortization period and new leases are not likely to allow inclusion in CAM Expenses of amortization of capital expenditures incurred prior to the applicable new lease commencement date.

5. Inclusion of Building Related Expenses in CAM Expenses.

Although CAM Expenses by name relate to Common Areas, it is customary in retail leasing for the landlord to include certain costs relating to upkeep of building improvements (*e.g.*, roofs, common utility systems and/or exterior building

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painting) in CAM Expenses. Although the landlord may be willing to exclude certain categories of such building-related costs from CAM Expenses (*e.g.*, structural repair work or, in certain major tenant leases, roof membrane repairs), such building-related costs are typically included in CAM Expenses.

6. "Laundry List" of Other Exclusions from CAM Expenses.

In recent years, borrowing from the approach of office building tenants when negotiating Operating Expense provisions, major retail tenants have been seeking to add to the Lease a lengthy list of items that will not be included in CAM Expenses. Examples of such excluded items include ground lease rent, debt service payments, costs of casualty repair (note that the landlords should be sure to allow for inclusion of at least commercially reasonable deductible or self-insured retention amounts), costs of tenant improvements, brokers' commissions and attorneys' fees for new leases or renewals, costs of services not available to the tenant or for which the tenant is separately charged, and costs for goods or services to the extent in excess of fair market value therefor paid to affiliates of the landlord. Although most of the items on a typical list would not be included in any event (*e.g.*, costs of casualty repair covered by insurance proceeds), landlords must carefully review any such list of exclusions in light of typical practices to ensure that the items are not so broadly worded as to unintentionally require exclusion of costs fairly and customarily included in CAM Expenses.

A tenants's audit of CAM Expenses should be kept confidential and performed by a non-contingency fee auditor or examiner.

7. Cost Pooling.

While a non-food use tenant may often require an exclusion from CAM Expenses for costs relating to operation of a food court or patio eating area or similar expenses benefiting only certain of the occupants of the Shopping Center, the landlord must conversely remember to allow for cost pooling, whereby the landlord retains the right to allocate certain CAM Expenses only among those occupants of the Shopping Center benefiting from the applicable expense. Otherwise, the landlord risks not being able to fully recapture the cost of such line items, since some tenants may legitimately argue that they should not contribute to cost items incurred solely for the benefit of certain other tenants, but the landlord's provisions as to CAM Expenses require using a denominator (when calculating the fraction which is the tenant's share) based on the entire Shopping Center.

8. Calculation of Tenant's Share.

The customary manner of calculation of the tenant's share of CAM Expenses varies greatly depending upon the context of the applicable lease. For example, in a regional mall, it is customary to (i) exclude anchor tenants occupying more than a specified square footage from the denominator used to calculate the fraction which is the tenant's share (although the contributions of such anchor tenants are first "backed out" of CAM Expenses to reach the "net" CAM Expenses to which the tenant contributes), and (ii) base such denominator on the square footage of the store floor area which is occupied and open for business (although the tenants may be able to negotiate some minimum percentage of store floor area included in such denominator). In power center or neighborhood center leasing, it is more customary to base the tenant's share more strictly on the ratio of the tenant's floor area to the floor area of other buildings in the center (however, tenants may seek to negotiate some minimum denominator based upon a percentage of the floor area shown on a pre-approved site plan, so as to avoid "subsidizing" unbuilt outparcels or other proposed buildings in a new development). In a ground lease, if the ground leased premises includes not only the tenant's building pad but also an equitable share of the Common Areas (particularly in the case of a restaurant user, which requires more parking area than typical retail use), the tenant's share is generally calculated based on the ratio of the land area of the leased premises to the total land area of the center.

9. Contributions Based on an Approved Budget.

Occasionally, when dealing with a significant anchor tenant, the landlord is forced to agree to bill for CAM Expenses each year based on a budget approved in advance by such anchor tenant. In such circumstances, the landlord should be careful to (i) establish the first year's budget initially, so as to avoid the situation of Lease commencement without an approved budget amount, (ii) allow for deviations from the budget for force majeure events (*e.g.*, emergency expenditures that are funded separately from the budget) or line items not within the landlord's control (such as taxes, insurance, security and utility costs), and (iii) require reasonable and timely tenant approval of each year's budget, with an arbitration or other expedited dispute resolution mechanism built into the Lease, and with procedures established to address the situation of starting a new lease year without an approved budget (*e.g.*, based on the prior year's actual costs with adjustment for taxes or other items known to increase and/or with increase in same percentage as CPI until new budget approved).

10. Tenant Audit Rights.

While it is not unreasonable for a tenant to request an audit right to ensure that the landlord is accurate in its billings for CAM Expenses, the landlord has legitimate concerns to

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In the above example, whether the tenant's obligation to pay post-petition rent begins on the fifteenth day of the month in which the bankruptcy is filed or on the first day of the following month depends on where the tenant files bankruptcy. Some bankruptcy courts hold that rent due on the first day of the month is for the entire month. If the tenant files bankruptcy on the fifteenth day of the month, the rent for the entire month, including the remainder of the month after the tenant files, is considered pre-petition rent. In these courts, in the above example, the tenant would owe three months of unpaid pre-petition rent and would be required to pay post-petition rent commencing the first day of the month following the month in which tenant files bankruptcy.

Other courts prorate the rent based on the bankruptcy filing date with the tenant paying post-petition rent from the date the tenant files bankruptcy. In those courts, in the above example, the tenant would owe two and one-half months of unpaid pre-petition rent and would be required to pay post-petition rent commencing with the fifteenth day of the month in which tenant files bankruptcy.

If the tenant fails to pay post-petition rent or perform other lease obligations on a timely basis, the landlord can file a motion with the bankruptcy court seeking either relief from the automatic stay in order to evict the tenant or an order compelling the tenant to pay such rent or reject the lease.

3. Assumption/Rejection.

The tenant has two options in bankruptcy with respect to its lease: assumption or rejection. Rejection is simply a breach of the lease. Assumption means that the lease continues in full force and effect in accordance with its terms.

When the tenant rejects the lease, the tenant must vacate the premises and turn over possession to the landlord. The landlord then has an unsecured claim in the bankruptcy for the landlord's damages caused by the tenant's breach of the lease. This claim is determined according to state law, subject to certain limits imposed by the bankruptcy code. The bankruptcy code caps the landlord's claim for breach of the lease at an amount equal to the rent required to be paid under the lease for the greater of one year ***or*** 15% of the remaining term of the lease, not to exceed three years.

So when a tenant files bankruptcy and rejects its lease, the landlord must first determine its damages for breach of lease under state law. Once state law damages are determined, the bankruptcy cap is applied. If the state law damages are less than the bankruptcy cap, the landlord has a claim in the bankruptcy equal to its state law damages. If the state law damages are greater than the bankruptcy cap, then the landlord has an unsecured claim in the bankruptcy equal to the bankruptcy cap. The landlord is entitled to add unpaid pre-petition rent and damages to its claim. The landlord also may have an administrative claim for unpaid post-petition rent if the tenant remained in possession of the lease premises post-petition without paying rent. In addition, the landlord's claim may be reduced by any security deposit held by the landlord.

A tenant assumes a lease if the tenant wants to remain in possession of the leased premises or it wants to assign the lease to a new tenant. In order to assume the lease, the tenant must cure all defaults under the lease (with certain non-monetary exceptions). In addition to complying with the other terms of the lease, the tenant must pay all pre-petition and post-petition rent owing under the lease to the landlord. In the example above, the tenant would have to pay the unpaid pre-petition rent, as well as any rent due post-petition, to the landlord in order to assume the lease.

4. Assignment.

Even if the lease expressly provides that it cannot be assigned, the bankruptcy code permits the tenant to assume the lease and assign it, provided that the assignee provides adequate assurance that it can perform the terms of the lease after the assignment. This situation usually arises when the rent is below market and the tenant does not intend to continue to occupy the premises. In that situation, an assignee may pay the tenant in order to take over the lease. A landlord can object to assignment on the ground that the assignee is not creditworthy; however, such objections are typically difficult to win.

5. Use.

Shopping centers are given special treatment under the bankruptcy code with respect to use restrictions. Use restrictions in a lease are honored, for the most part, if the lease is in a shopping center. If the lease is not in a shopping center, generally speaking, a use restriction will not be enforced by the bankruptcy court, absent extraordinary circumstances.

6. Time in Which to Assume or Reject.

Prior to the 2005 amendments to the bankruptcy code, a tenant in bankruptcy had ninety days to decide whether to assume or reject a lease. This initial 90-day period could be and routinely was extended by the bankruptcy court. There was no limit on how many times an extension could be granted or how long the extensions could last.

The 2005 amendments to the Bankruptcy Code imposed overall limits on the time for a tenant to decide to assume or reject a lease. The tenant has an initial 120-day period in which to decide to assume or reject the lease. This initial 120-day period can be extended for up to another ninety days; however, no further extensions can be granted without the express consent of the landlord. Unless the landlord consents, the tenant now has a maximum of 210 days to assume or reject a lease. At the end of this 210 days, the lease is deemed automatically rejected if it has not been assumed.

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avoid unreasonable interference with its business operations as a result of a tenant audit. Accordingly, the landlord will typically require that any such audit be made upon a certain minimum amount of prior notice, at the landlord's offices, not more often than once per year, and within a specified time frame following the landlord's delivery of the applicable annual statement of CAM Expenses for such year (and the tenant will want to provide that the landlord must maintain its books and records as to CAM Expenses for a given year at least until the time period for such a tenant audit with respect to such year has passed). In order to avoid "nuisance" auditing by those who might be self-motivated to uncover "errors" by the landlord, landlords also typically require that any such audit be performed only by a reputable national or regional CPA firm which is not being compensated on a contingency fee basis. The landlord will also typically request that any information obtained from an audit be kept confidential by the tenant. Of course, this may prove difficult for the landlord to enforce, particularly in the event of an audit sponsored by more than one of a Shopping Center's tenants. The tenant will also request that the landlord reimburse the reasonable costs of the audit if the audit shows an overstatement of annual CAM Expenses by the landlord in excess of a certain percentage (which typically ranges from 3-5%). Note also that when the Lease calls for payment of Percentage Rent, the tenant may look to the landlord's audit rights relating to the tenant's annual reporting of Gross Sales as the governing standards for the conduct of a tenant audit of the landlord's records relating to CAM Expenses, although they are not identical situations.

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7. Designation Rights.

Below market leases may be a valuable bankruptcy asset of the tenant. A practice has evolved of tenants selling sell "designation rights" early in the bankruptcy case. This practice allows a tenant to receive an early cash payment for its leases, rather than waiting to receive payments as it assumes and assigns each lease.

Sales of designation rights generally occur with leases that the tenant no longer intends to use in its operations or are part of a sale of all of the tenant's assets. A third party pays the tenant for the right to tell the tenant whether to assume or reject the lease, and if a lease is assumed, to whom the lease is to be assigned. The purchaser of the designation rights then receives whatever compensation the tenant would have received upon the assumption and assignment of the lease. If an assignee is willing to pay money in order to take over a below market rate lease, the purchaser of the designation rights receives the rent payment, instead of the tenant. The landlord retains its rights under the bankruptcy code to object to any proposed assignee.

8. Conclusion.

This article discussed some of the basic bankruptcy principles applicable to landlords and tenants when the tenant files bankruptcy, however, the rights and obligations of landlords and tenants in bankruptcy are complex and continue to evolve after the 2005 amendments to the bankruptcy code.

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practice summary of the retail group

The Retail Group of Cox, Castle & Nicholson LLP has extensive experience in acquiring, developing, constructing, leasing, financing and disposing of all types of retail projects, including regional enclosed malls, lifestyle community centers, neighborhood centers, and mixed-use projects. Members of the Retail Group include attorneys who are experts in sales and acquisitions, design, engineering, and construction contracts, reciprocal easement agreements, development and management agreements, and leasing.

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