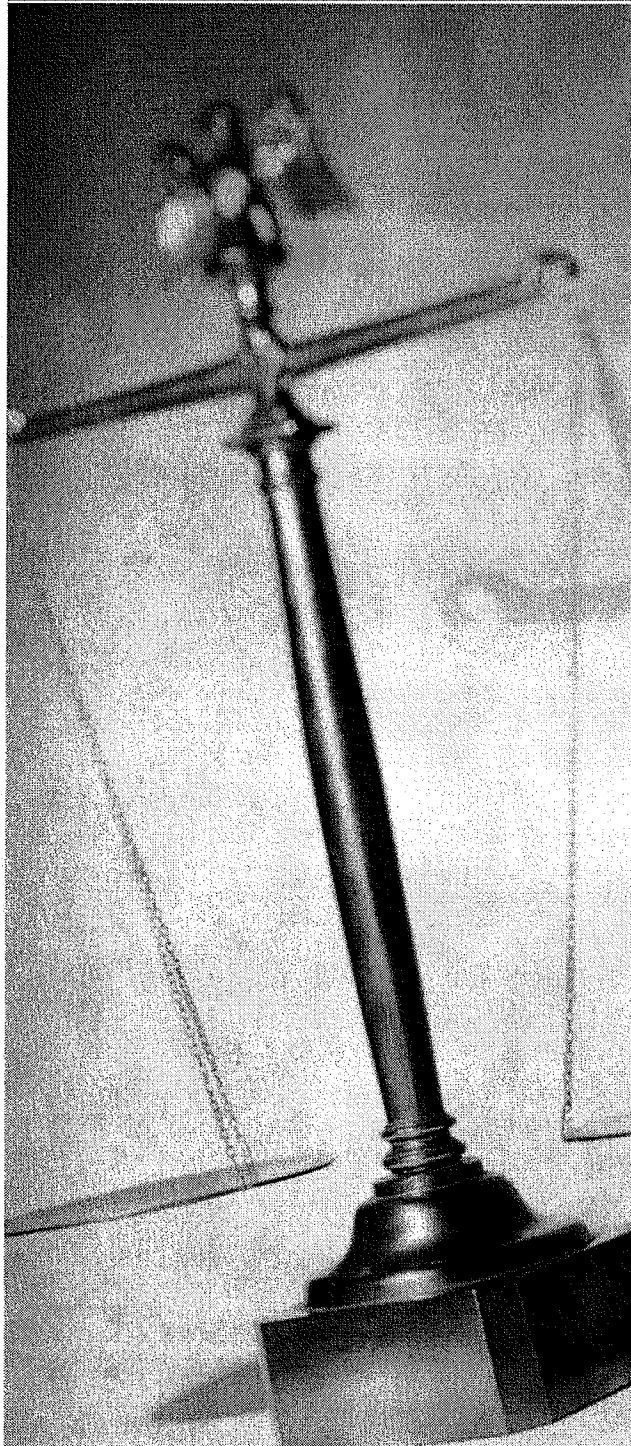




Shopping Center Legal Update

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The Landlord's Bankruptcy: How to Prepare for It and What to Expect

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Survival of the fittest has taken on a new meaning for landlords in recent months.

In the 2008 year-end annual reports for 15 leading property investment companies filed with the SEC, accountants issued "going concern" doubts (i.e., the companies are expected to have difficulty operating in the foreseeable future).¹ The holdings of these 15 companies include controlling interests in at least 618 shopping centers with 230.5 million square feet (sq. ft.) of space, more than 800 hotels/resorts/casinos with more than 122,000 rooms, 36 office properties totaling 4.8 million sq. ft. and 33 multifamily complexes with more than 2,280 units.²

These survival doubts are based on the current realities of maturing debt obligations with the inability to refinance, frozen credit markets, declining real estate values, inability to raise new capital, decreased cash flow and increased costs that have absolutely crippled landlords. For owners who are unable to adapt to the current market conditions, it is likely that reorganization in bankruptcy will be the survival strategy.

Reorganization is the strategy of two well-known real estate property investment companies—General Growth Properties, Inc. ("GGP"), and Meruelo Maddux Properties, Inc. ("MMP")—both of which filed for bankruptcy protection in the Spring of 2009. GGP is one of the nation's largest REITs (real estate investment trusts) with ownership and/or management interests in more than 200 regional shopping malls totaling approximately 200 million sq. ft. of retail space.³ MMP owns the largest portfolio of industrial, mixed use and residential properties in downtown Los Angeles.⁴ MMP and 53 of its subsidiaries were forced into bankruptcy because they were unable to satisfy various debt covenants and meet current payments and maturities. GGP and approximately 166 of its regional shopping centers stated the inability to refinance maturing debt obligations as the primary cause of bankruptcy protection filing.⁵ On their websites, both companies confidently state that the purpose of filing for bankruptcy was to "preserve and strengthen" the companies, and both expect to emerge successfully with a plan of reorganization.⁶

For tenants whose landlords have filed for bankruptcy protection, the uncertainties are plentiful, and the main concern is how their leases will be impacted. Also, tenants will invariably question whether they could have been prepared for such a situation. This article addresses both of these issues.

Tenant Preparations

Today, a prudent tenant will ensure that its lease provides protection in the case of the landlord's bankruptcy. Tenants should require their landlords to provide notice of their bankruptcy filings and all actions relating to the bankruptcy proceeding, particularly with respect to unexpired leases. Notices should be given in an expedited manner—for example, electronically, as opposed to mail. The tenant should proactively obtain as much information on its landlord's viability as possible. Information may be easily obtained from the Public Access to Court Electronic Records (PACER) system, which is an electronic public access service whereby users may obtain case and docket information from bankruptcy courts.⁷ PACER should be monitored frequently by tenants, as it is an inexpensive, quick way for tenants to stay up-to-date with respect to their landlords' bankruptcy status.

Additionally, major tenants can demand some form of credit enhancement to reduce the risk associated with a landlord default.⁸ The options include a letter of credit, personal guaranty, rent offset or grant by the landlord to the tenant of a mortgage encumbering the fee estate, which would provide assurance of the fulfillment of the landlord's duties under the lease.⁹ Of course, there will be a great deal of resistance to credit enhancements from landlords, who very likely have never agreed to such arrangements. However, the world has changed, and many expect the market to worsen before it improves, so that landlords must recognize that the risk of bankruptcy is very real.

Throughout the term of the lease, and especially after a tenant becomes aware that bankruptcy by its landlord is imminent, the tenant should carefully record in detail all instances of landlord breaches. This will ensure that, at the appropriate time, the bankruptcy trustee will be required to remedy these specific breaches.

Business as Usual

The filing of a bankruptcy petition triggers an automatic stay under § 362 of the Bankruptcy Code (the Code), intended to give the debtor a "breathing spell from his creditors."¹⁰ The automatic stay permits a debtor to continue business as usual while restructuring its company. This means that landlords are maintaining their properties, paying employees, performing required build-outs and paying vendors for necessary services.

Fortunately for tenants, § 366 of the Code specifically prohibits utility service providers from altering, refusing or discontinuing service to, or discriminating against a debtor based solely upon the commencement of a bankruptcy case, pro-

vided the debtor gives a cash deposit or other security to adequately assure the utility company of continued payment.¹¹ While many retail tenants will have direct utility meter service, some may have sub-meters or other arrangements that would result in serious disruption to the business if utility providers are permitted to cut off service to debtor-landlords.

Will My Lease Be Assumed or Rejected?

In general, under § 365(a) of the Code, all unexpired leases of the debtor entity are subject to assumption or rejection.¹² In simple terms, "assumption" means that the lease is reaffirmed, while "rejection" means that the lease is terminated.

Perhaps the most significant question asked by tenants is whether the debtor-landlord will reject their leases and wipe out their interests. Thankfully for tenants, § 365 provides the tenant with critical protections, allowing a tenant to retain its rights under the lease for the balance of the term and for any renewal or extension periods, even if the lease is rejected.¹³

It is interesting to note that the Code is silent as to the deadline by which a debtor-landlord must assume or reject a non-residential lease (unlike the strict time periods imposed when the debtor is a tenant).¹⁴ This is an indication that Congress was not previously concerned about circumstances in which the debtor is the lessor.¹⁵

If a landlord rejects an unexpired lease, § 365(h)(1)(A) permits the tenant to retain its possessory interest in the property under the same terms of the unexpired lease, for the balance of the term and for any renewal or extension periods provided for under the lease.¹⁶ The tenant may continue to enjoy its rights under the lease, and the statute specifically mentions "those relating to the amount and timing of payment of rent...any right of use, possession, quiet enjoyment, subletting, assignment...."¹⁷ Once the landlord rejects the lease, however, the landlord's obligations to perform under the lease cease. So, for example, how does a retail tenant ensure that a bankrupt landlord performs its obligations regarding common areas?

The Code provides the tenant with a remedy for landlord defaults if the tenant remains in possession despite the rejection of its lease. The tenant may offset against rent any damages caused by the landlord's non-performance after the date of rejection.¹⁸ Note that this is the tenant's only remedy, and it is capped at the amount of rent accrued under the lease.

When it comes to shopping center leases, the Code provides for additional tenant protections. A tenant that decides to retain its interest under a shopping center lease that has been rejected by its landlord is permitted to enforce, under applicable non-bankruptcy law, clauses that relate to "radius, location, use, exclusivity, or tenant mix or balance."¹⁹ These rights are often critical for retail tenants and should be enforced vigorously in the bankruptcy proceeding.

In the current economic climate, however, where replacement, creditworthy tenants are scarce, it is likely that debtor-landlords, who plan to emerge through a plan of reorganization, will assume their leases. The leases are probably at above-market rents; by assuming these leases, landlords are able to maintain rent levels that would be unobtainable in the open market today.

In the case of assumption, the Code provides tenants with certain protections as well. Before a court permits a lease to be assumed, the bankruptcy trustee must come into compliance with the lease terms on behalf of the landlord.²⁰ This means that the trustee must "cure" existing defaults under the lease, "compensate" the tenant for actual pecuniary losses and provide "adequate assurance of future performance" under the unexpired lease.²¹

In practice, assumption and rejection decisions can be made rather quickly. Tenants should monitor all developments in the bankruptcy proceeding vigilantly, including motions to assume or reject leases. Court approval is required before a lease can be assumed or rejected, and tenants may want their voices to be heard before a court order is issued.²²

Sale of the Bankrupt Landlord's Property Under § 363

Tenants may be surprised to learn that § 363(f) of the Code permits the debtor to sell its property free and clear of any interest in such property.²³ Courts have interpreted "any interest," broadly, to include "a possessory interest as a lessee."²⁴

Practically, § 363 is intended to assist the debtor in generating cash to pay its debt obligations. The sale of property free and clear of any interest in such property makes it easier for the debtor to sell its property. While this may be great for the debtor-landlord, shouldn't tenants be concerned that their leases will be terminated if a debtor-landlord sells its property? Actually, no.

The sale of the debtor-landlord's property free and clear of any interest of another entity in such property is only permitted if one of the following requirements are met: (1) applicable non-bankruptcy law permits the sale of such property free and clear of such interest; (2) the entity consents; (3) the interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) the interest is in *bona fide* dispute; or (5) the entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.²⁵ Of these, (2) is probably the only requirement that a tenant will be able to control and thereby protect its lease.

The failure of the tenant to object to the sale of the landlord's property in *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*²⁶ resulted in the extinguishment of the lease upon the landlord's sale of the property, which was a draconian result. In *Precision*, the landlord, Qualitech Steel, leased land to Precision, the tenant, and within a year after the lease date, filed for Chapter 11 bankruptcy protection. Under § 363, Qualitech obtained a court order, after notice and a hearing, approving the sale of its property. Precision had notice of the hearing, but did not object to the court order, which directed Qualitech to sell its property "free and clear of all liens, claims, encumbrances, and interests...."²⁷ The property eventually ended up in the

hands of Qualitech's senior lender. Several months later, the new owner changed the locks on the building under the premise that the sale order extinguished Precision's interest. Precision argued that its interest in the property under § 365(h), which allows a tenant to retain its possessory rights under an unexpired lease when the lease is rejected, survived the court-approved sale under § 363(f).

Essentially, the appellate court concluded that Precision's silence resulted in the termination of its lease and sale of property, notwithstanding the statutory protection available to Precision. Additionally, the court concluded that the § 365(h) protection does not apply in § 363 sale cases; since § 365(h) is limited in scope to situations where the lease is rejected, the tenant remains in possession and the property is not sold.²⁸

Section 363(e) requires that the court, "upon request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased...to prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest."²⁹

What type of adequate protection may a tenant expect to receive? Adequate protection may be provided in the form of a cash payment or an additional or replacement lien, to the extent that there is a decrease in the value of the tenant's interest in the property.³⁰

Ultimately, adequate protection is fact and circumstance dependent. The simplest solution may be to condition the sale of the debtor's property on the recognition of the tenant's lease by expressly providing for this in the court order authorizing the sale.³¹ If this is not possible, given the nature of the sale, the parties will probably have to agree to some type of cash payment that would adequately compensate the tenant for the loss of its lease.³² This would require the parties to consider issues such as the value of tenant improvements, lost profits and damages relating to relocation.³³

Tenants can learn a great deal from Precision's silence. The key steps that a tenant must take when a debtor-landlord seeks to sell its property under § 363 are as follows: Pay attention. Object to the sale immediately. Ensure that the debtor-landlord has satisfied all of the requirements of §363(f) mentioned above. Finally, request adequate protection.

Conclusion

In the current economic climate, it should come as no surprise if a landlord files for bankruptcy protection. There are protections for tenants under the Code, provided tenants are prepared and act quickly.

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¹Mark Heschmeyer, *Updated: On The Brink: 15 Real Estate Firms Going, Going...*, CoStar Realty Information, Inc., April 22, 2009, <http://www.costar.com/news/Article.aspx?id=49A94B2EF23AAFF889436068FF14652A>.

²*Id.*

³*Customer Built for Your Since 1954*, <http://www.ggp.com/Company/Default.aspx> (last visited Sept. 27, 2009).

⁴History, <http://www.meruelomaddux.com/noflash/aboutHistory.php> (last visited Sept. 27, 2009).

⁵Reorganization, Why did you file for Chapter 11? <http://www.meruelomaddux.com/noflash/reorganization.php> (last visited Sept. 27, 2009); General Q&A, Who filed for Chapter 11? Why did the Company file Chapter 11?, <http://www.ggp.com/company/Default.aspx?id=103> (last visited Sept. 27, 2009).

⁶Reorganization, Does the filing mean you are going out of business? <http://www.meruelomaddux.com/noflash/reorganization.php> (last visited Sept. 27, 2009); General Q&A, Are General Growth Properties, Inc. and its subsidiaries going out of business? <http://www.ggp.com/company/Default.aspx?id=103> (last visited Sept. 27, 2009).

⁷Public Access to Court Electronic Records: Overview, <http://pacer.psc.uscourts.gov/pacerdesc.html> (last visited Sept. 27, 2009).

⁸Joshua Stein, *A Guide to Ground Leases (With Forms and Checklists)* 103-104, Mark T. Carroll, ed., American Law Institute-American Bar Association (2005).

⁹*Id.*

¹⁰11 U.S.C. § 362 (2005); H.R. Rep. No. 595, 95th Cong., 1st Sess. 340 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 54-55 (1978).

¹¹11 U.S.C. § 366(a) (2005).

¹²11 U.S.C. § 365(a) (2005).

¹³11 U.S.C. § 365(h)(1)(A)(ii) (2005).

¹⁴11 U.S.C. § 365(d)(2), (4) (2005).

¹⁵3 Collier on Bankruptcy, ¶ 365.04[5] at 365-49 (Alan N. Resnick and Henry J. Sommer, eds., 15th ed. rev.).

¹⁶11 U.S.C. § 365(h)(1)(A)(ii) (2005).

¹⁷*Id.*

¹⁸11 U.S.C. § 365(h)(1)(B) (2005).

¹⁹11 U.S.C. § 366(h)(1)(C) (2005).

²⁰11 U.S.C. § 365(b)(1) (2005).

²¹*Id.*

²²11 U.S.C. § 365(a) (2005).

²³11 U.S.C. § 363(f) (2005).

²⁴*Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 545 (7th Cir. 2003).

²⁵11 U.S.C. § 363(f) (2005).

²⁶327 F.3d 537, 545 (7th Cir. 2003).

²⁷*Id.* at 541.

²⁸*Id.* at 547.

²⁹11 U.S.C. § 363(e) (2005).

³⁰11 U.S.C. § 361 (1984).

³¹James R. Schroll, *Protecting Your Tenant Client When Its Landlord Goes Bankrupt—Don't Fall Asleep at the Switch*, Virginia State Bar, <http://www.vsb.org/sections/rp/articles/schroll.html> (last visited Sept. 28, 2009).

³²*Id.*

³³*Id.*

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