

INSOLVENCY IN COMMERCIAL LEASES

- I. Drafting leases to mitigate losses in event of lessee default
 - a. Review Credit of the Lessee:
 1. Financial Statements
 2. Credit Report: D&B Statements not very helpful
 - b. Security Deposits
 1. Cash
 2. Letters of Credit
 - a. Quality of Issuing Bank
 - b. Expiry Date vs. Automatic Renewal
 - c. Guarantees
 - i. Credit of the Guarantor
 - ii. Location of Guarantor and Difficulty of Pursuit: local venue, consent to jurisdiction clause, agent for service of process
 - d. Cure Rights vs. Recurring Defaults
 - i. Typically, Tenant has right to cure monetary (5-10 days after notice from Landlord) and non-monetary (typically 30 days after notice, with extension for Defaults not susceptible to cure if Tenant is pursuing in good faith), BUT
 - ii. Recurring Defaults: Three Strikes and you're out: If Tenant defaults and cures three times in any 12-month period, Landlord can declare a non-curable default.
- II. Remedies for landlords on lessee default
 - a. Convert the Security Deposit or Cash the LC
 - b. Terminate the Right to Possession, but don't Terminate the Lease
 - c. Sue for Possession: Forcible Entry and Detainer Laws; can go fast or take a long time!
 - d. Change the locks? Depends on Local Law—Can't Change Locks in Illinois
 - e. Sue for Rent Past Due, But What about Future Rent, and Landlord's Duty to Mitigate Damages?
- III. Renegotiation strategies for distressed lessees
 - a. Take an "open book" approach to financials: show the Landlord the tenant really is going broke!
 - b. Determine whether there is a viable survival plan—can a rent break save the day? For how long?

c. Is the landlord better off if the space is lit vs. dark?

IV. Bankruptcy issues in leasing [This is Dov's exclusive arena]

a. If the Tenant files:

Right to Reject the Lease, Landlord becomes an Unsecured Creditor;

b. If the Landlord files:

If the Tenant is performing, bankrupt Landlord can't reject.

UNEXPIRED LEASES IN BANKRUPTCY

V. General Rules – Applicable whether the Debtor is the landlord or the tenant.

- a. Section 365 of the Bankruptcy Code authorizes a debtor to assume or reject any unexpired lease. This allows debtors to shed leases for locations that are no longer profitable/necessary, while retaining those locations necessary for the business to continue. In sale cases, the buyer will make these decisions, which are made by the debtor in a reorganization setting.
- b. Assumption is basically a decision to retain a lease.
- c. Rejection is essentially a decision to terminate a lease.
- d. Debtor must cure monetary defaults to assume a lease.
- e. Special rules governing assignment of leases.

VI. Leases governed by Section 365

1. Must be lease transaction.
2. Sale or disguised secured transaction not governed by Section 365
3. Must be unexpired.
4. State law determines whether a lease has been terminated pre-bankruptcy.
5. Redemption period during which tenant may cure defaults.

VII. Timing Issues

1. Debtor has an initial 120 day period to determine whether to assume or reject a lease.
2. Debtor may obtain one 90 day extension by leave of bankruptcy court. These requests are generally granted.
3. Subsequent extensions require written consent of landlord.
4. Failure to obtain an extension in a timely manner may result in the lease being rejected by operation of law.

VIII. Assumption

1. Motion to assume filed with bankruptcy court.
2. Cure monetary defaults or provide assurance of prompt cure.
3. Compensate landlord for actual pecuniary losses.
4. Provide adequate assurance of future performance.

IX. Rejection

1. Motion to reject filed with bankruptcy court.
2. Vacate space and return to landlord
3. Broom clean condition, return keys, alarm codes.
4. Rejection of a lease may result in various claims to be asserted by landlords, including:
 - a. amounts owed pre-petition, which should be allowable in their entirety as an unsecured claim, but paid like all other unsecured claims..
 - b. postpetition rent claim, which is entitled to administrative expense treatment.
 - c. year lease rejection damages claim (unsecured), which is calculated pursuant to formula set forth in §502(b)(6).
5. If a landlord Debtor elects to reject a lease, tenants may opt to remain in possession of leased premises and reduce the amount of rent paid by amounts spent for services previously provided by the Debtor-landlord under the lease.

X. Assumption and Assignment

- a. Debtor may assign lease despite anti-assignment provision in lease.
- b. Comply with requirements for lease assumption regarding cure of defaults and adequate assurance requirements.
- c. Landlord can require deposit or other security from assignee.
- d. These rules also apply if a lease is sold by a debtor-tenant to a third party.

XI. Special Provisions for Shopping Centers

- a. Assurance that assignee has same ability to pay rent as original tenant.
- b. Any “percentage rent” will not decline substantially.
- c. Assignee subject to lease requirements regarding such as radius requirements, use of premises and exclusivity provisions, and will not breach any other lease, finance agreement or master agreement related to the shopping center. In the Toys R Us case, the bankruptcy court creatively found a way around these types of restrictions in connection with the sale of a lease to a third party.
- d. Assignment will not disrupt any tenant mix or balance in shopping center.