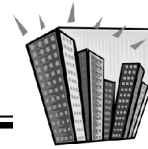


# PROPERTY MANAGEMENT



## Landlords should exhibit flexibility, avoid bankruptcy court headaches

In my area of expertise, that of corporate restructurings and reorganizations, the news of late is increasingly replete with stories of adversity affecting many well-known retail chains across the land. Think Kmart and Eddie Bauer, to name just two. This on the heels of a decade or more of Montgomery Wards, Ames, Bradlees, and others too numerous to mention.

Landlords may now be ruefully more than familiar with issues that arise in connection with landlord-tenant relationships once an insolvency looms. Rest assured that, given the current state of the economy and lack of prospects for a near-term recovery, a persistent tightening of the retail markets will likely continue, raising the prospect of many more national and regional chains — not to mention single-outlet proprietorships — either seeking bankruptcy court protection or simply closing their doors.

By now, many of you unfortunately possess a working knowledge of the bankruptcy court process as it relates to insolvent tenants and, just as understandably, may be less than enthusiastic about any given tenant's likely sojourn through these proceedings. My comments herein are in response to the headaches (as well as the pains lower on the backside of the anatomy) that can customarily result as one spends months trooping to court to see how the case for a tenant finally turns out. I suggest that you absent yourself from the process entirely by initially exhibiting a greater degree of flexibility at the first sign of a tenant's financial instability.

Ordinarily, you have two basic choices in the event of a prospective bankruptcy by one of your tenants. The first and most desirous of outcomes, assuming the tenant attempts a Chapter 11 reorganization, is to hope for a successful restructuring that will leave the tenant in place with no further rent concessions on your part and with the tenant reaffirm-

ing the lease and "curing" any outstanding arrearages due. Generally, should a Chapter 11 end successfully, the bankruptcy code provides that the tenant must cure all amounts due in order to "assume" the lease and return to good standing under it. Importantly, this cure is not simply limited to just the rental amounts outstanding, but picks up CAM charges, real estate tax charges, and the like.

### A practical benchmark

However, as can be seen from the way in which many of the current and rather notorious retail chain bankruptcies are going, the prospect of naively assuming that the Chapter 11 process will work for your tenant — and that a happy outcome will be obtained — may be somewhat far fetched given recent experiences.

The practical benchmark that should be used in connection with the process of negotiations is conveniently situated in the bankruptcy code and is known as Section 502(b)(6). This portion of the bankruptcy code sets forth a formula for what are essentially the liquidated damages that a landlord may receive in connection with a tenant's demise and subsequent vacation of the premises. This section in the bankruptcy code provides what is known as the "cap" to landlords' claims, and generally sets forth a formula by which the landlord's claim is maximized at either the rent due for the greater of one year or 15%, not to exceed three years, of the remaining term of the lease.

Simply put, what this all means is that if your tenant successfully navigates the distressed waters of insolvency and then returns to financial health — should the tenant elect in that process to vacate your site as one among many it may shrink from — then your claim in its reorganization will be limited to the mathematical formula stated

### GUEST COLUMN



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above. Beyond this, there are other issues that landlords deal with on a daily basis in the bankruptcy process that cause one's appreciation of the proceedings to be diminished measurably.

In addition to the "cap" on the maximum recovery by the landlord, there can also be difficulty in showing the property to an alternative tenant while the present tenant continues to occupy it in the throes of its insolvency. There can also be an ability on the part of the bankrupt tenant to schedule a "Going Out of Business" sale at the site, even in defiance of what would be the customary practices for specific retail locations. Combine this with the reality that retail bankruptcies can often go on for some time — and that the oft-claimed ability of landlords to get a tenant to assume or reject the lease within the first 60 days of a bankruptcy can be measurably extended by bankruptcy judges — and one begins to question whether participating in the process for an illusory reward is really worth the work.

Top this off with the fact that — should the tenant choose to vacate the premises and should the lease be considered a potential valuable asset within the bankruptcy estate — the tenant can offer the leasehold for sale even over the landlord's objections. All of this gives you a virtual cauldron of reasons why the bankruptcy court is not necessarily a landlord-friendly place.

### Negotiating a solution

Truly, on second thought,

you don't want to be involved in this process (maybe even on first thought). So how to respond when you get the first whiff of a tenant's financial instability? How do you proceed in such a manner as to avoid prolonged entanglement with the bankruptcy process?

As noted, the bankruptcy code itself gives you the formula by which you can deduce your maximum liquidated damages should the tenant elect to continue in operation but vacate your site, and that formula can and should be used as a benchmark for further negotiations.

For example, should the tenant initially contact you with word of its financial plight, the difficulty of getting them to quickly vacate the premises — rather than holding on to it through a prolonged bankruptcy or, even worse, trying to offer the leasehold for sale during that process — may be avoided if the landlord and the tenant can quickly come to terms with respect to a financial settlement which provides for a quick departure. Obviously, there is an upside and a downside to this: upside, in that some revenue will come in and the landlord will regain control of its premises, and downside in the fact that there will be a vacancy.

Nevertheless, the starting point is the formula under the bankruptcy code. A landlord's representative can quickly compute the likely parameters of the value to be obtained from the formula. Given the fact that most enterprises facing insolvency have a desperate need for funds, the prospect of "settling up" with a landlord for a fixed amount early on — and vacating the premises while an out-of-court scenario is maybe still being debated — may prove almost irresistible to certain retail tenants. My rule of thumb suggests that a figure between 15% and 25% above what the landlord would receive under the cap is not

an unreasonable place to start the negotiations, although given the tenant's financial resources, some flexibility seems well in order. If all works as it should, the landlord may get a reasonable financial settlement in exchange for a termination of the lease (which consideration may be important in order to avoid a possible preference issue) and may get the return of its location well before it has to sit through endless proceedings in the bankruptcy court.

Alternatively, if the negotiations do not proceed apace, do not sit on your rights once a bankruptcy is filed. The landlords who appear in the court quickly, and incessantly, are more likely than not to be dealt with on a prompt basis than those who wait to see how the case may play out.

All things considered, prudent landlords should consider two rules for living. First and foremost, at the initial sign of financial instability, negotiate an early exit package with the tenant using the formula provided in the bankruptcy code as the baseline valuation against which ultimate recovery may be measured. Start higher, and leave room to negotiate. Second, if all else fails and the tenant enters the bankruptcy process, be insistent and frequent in your trips to the bankruptcy court early on, as the more that you prove to be a distraction to all of the others early in the proceeding, the more likely you are to be dealt with quickly and with finality.

In either case, vigilance and initiative are in order for the prudent landlord — for in the field of insolvency, good things do not come to those who wait.

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