

LANDLORD-TENANT LAW

The Distressed Tenant: What's a Landlord To Do?

All real estate is unique. Ultimately, the relationship of the tenant to the property, the neighborhood and the landlord may determine the outcome. Should you allow a tenant to reduce their footprint? Should temporary rent concessions or a renegotiation of the lease term occur? Each of these issues needs to be addressed on a case-by-case basis.

By **Jack J. Rose**

Rumors are swirling that National Widget Co. is having financial troubles. Their stores average 30,000 square feet and are designed to highlight an assortment of widgets. Unfortunately, this multi-tier, custom lighted scheme does not serve other tenants well.

An email just arrived. National Widget would like to meet. In a follow up phone call, National Widget emphasizes how important your space is to them, how you as a landlord are the best landlord they could ever hope to work with and how they hope the meeting can help find a successful path forward.

The meeting begins with National Widget assuring you they are not going out of

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business. But, they may—well, probably, will be filing bankruptcy. The good news is that they would like to keep your space. But the bad news is that they cannot afford to keep it at the current rent. And, the escalations that you were counting on in the final 15 years of the lease

will need to be sharply reduced if they are to remain in the premises. And, the really bad news is the current rent will need to drop by approximately 2/3. Or, if it's better for you, they will give you the space back.

As the meeting ends, the National Widget Team reiterates

how much they enjoy working with you, love your space and hope to continue the relationship. Take your time. They need your answer by the end of the week, or they will be forced to assume you want the space back.

National Widget also owes two months back rent. You mention this.

The answer? *Sorry.*

The Bankruptcy. When you arrive in the office a week later, you learn that National Widget filed for bankruptcy. Senior management had decided not to respond to the offer. National Widget filed a number of “first day motions” including one that moved to reject your lease.

You immediately call your tenant. The tenant tells you: “We didn’t think you wanted to accept our offer. We are willing to talk. We really like you and your space.”

Did the Landlord Make a Mistake in Not Accepting the Earlier Offer? Not necessarily. There is an ongoing conversation. Certain locations are non-core and will be closed. These locations will have their leases rejected. In this case, the location is marginal or good, but the rent appears to be high for the revenue that is generated. The tenant is willing to negotiate, so the landlord read the situation properly.

Isn’t It Better To Take an Offer and Avoid Risking Rejection in Bankruptcy? This is a difficult decision and depends on the tenant, the property and

the landlord. If the leasehold is below market, under the Bankruptcy Code, the debtor could sell the leasehold and retain the sale proceeds. Thus, if a tenant can use the threat of its bankruptcy to negotiate concessions, a landlord could find itself having given away a valuable asset in the form of a leasehold which is ultimately transferred to a solvent tenant that could have paid market rent.

What’s the Answer? All real estate is unique. Ultimately, the relationship of the tenant to the property, the neighborhood and the landlord may determine the outcome. Should you allow a tenant to reduce their footprint? Should temporary rent concessions or a renegotiation of the lease term occur? Each of these issues needs to be addressed on a case-by-case basis, looking at the financial condition of the tenant, their industry, the property, the lease and the landlord’s short and long-term goals.

Time to Call a Bankruptcy Lawyer. Upon retaining bankruptcy counsel, you will probably learn that the courts tend to defer to the debtor’s business judgment in deciding whether or not to permit rejection of a lease of non-residential real property. You will also learn that most of your damages will be treated as general unsecured claims. Of course, depending on when the debtor vacates the premises and the order authorizing rejection, a landlord may have an administrative claim in addition to its pre-petition claim as well

as a claim for rejection damages. You will also learn that under the Bankruptcy Code, your rejection damages claims are going to be capped under the provisions of the Bankruptcy Code.

Tenant tells you how much they would like to stay in the space. They also tell you that they need rent concessions. Your lawyer says that the debtor can simply assume the lease, but debtor’s counsel explains that given the cost, this does not fit in the current business model. You have a hard choice. Do you take the property back? Or, do you accept the concession? Ultimately, a landlord could elect to wait and see if the tenant elects to assume or reject the lease. If the tenant were to assume the lease, it must cure all prepetition defaults and assume the lease in its entirety. Of course, if the tenant rejects the lease, the landlord faces dark space.

This scenario is increasingly being faced by landlords as retailers continue to feel the pressure from rising labor costs and online competition. Landlords will need to evaluate how best to respond. Act too early or give too much and, in a subsequent bankruptcy, you may find your lease being sold to the highest bidder. Wait too long or ask for too much, and you may end up with dark space.