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Retail Bankruptcy: How to Prepare and Survive

March 25th, 2009





CORPORATE FINANCE

Retailer's Perspective on Dealing With Recession

March 25, 2009

ADVISORY

CURRENT MARKET DYNAMIC

Statistics:

- GDP
- Housing market
- Unemployment rate
- Consumer confidence
- Retail sales
- Stock market

Real estate market

- Few if any retailers expanding
- More retailers contracting or going into bankruptcy



FIRST MEETING WITH RETAILER – BUSINESS ISSUES

Comp store sales

Liquidity

Debt maturities

Bank covenants

Restructuring activities to date

Go forward business plan



FIRST MEETING WITH RETAILER – LEASE ISSUES

Profitable vs. unprofitable stores

Identify tenant

Corporate guarantees

Security deposits

Lease expirations

Kick-out rights

Co-tenancy requirements



WHAT SHOULD LANDORD AND ITS MORTGAGEE EXPECT

Financial statements

Store performance: top line revenue and bottom line ebitda

Projections

Restructuring proposal: varies based upon negotiating leverage



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Dealing With a Struggling Tenant

- Retain or replace the tenant?
 - Retain: strengthen lease documentation and protect against tenant bankruptcy risk
 - Replace: maximize recovery and minimize “clawback” risk



Deciding to Retain or Replace

- Consider:
 - Recent payment history
 - Strength and amount of security deposits and/or guarantees
 - Ability to obtain larger security deposit and/or new guarantees
 - Availability of replacement tenants and current market rental rates



Retaining the Tenant

- Consider:
 - Obtaining current financial information and periodic financial statements
 - Acknowledgement by tenant of any defaults and waiver of defenses and counterclaims
 - Landlord right of termination upon default
 - Other modifications of lease terms



Replacing the Tenant

- Consider:
 - Sending default notice
 - Seeking to terminate lease and recover possession
 - Recovering past due rent payments
 - Entering into lease termination agreement
 - Pursuing remedies against guarantors



Tenant Partial Payments

- Some tenants have begun to send in partial rental payments
- Landlord's response:
 - Limit reduced rent to a specific time period
 - Have tenant acknowledge rent will be due at lease termination
 - Send reservation of rights letter to protect against waiver
- Basis to terminate lease



“BANKRUPTCY - PROOFING” a Tenant’s Security Deposit

	Security Deposit Posted under the <u>Lease</u>	Security Deposit Posted under a <u>Non-Recourse Guaranty of the Lease</u>
Landlord’s State Law Damage Claim	\$1,300,000	\$1,300,000
Landlord’s Capped Damage Claim in Tenant’s Bankruptcy Case	500,000	500,000
Tenant’s Security Deposit	700,000	700,000
Amount of Security Deposit Permitted to be Used by Landlord	500,000	700,000
Amount of Security Deposit Required to be Returned to Tenant’s Bankruptcy Estate	200,000	-0-
Landlord’s Allowed Unsecured Claim in Tenant’s Bankruptcy Case	-0-	500,000
Unusable Balance of Landlord’s State Law Damage Claim	800,000	100,000



Tenant Bankruptcy

- Automatic stay effective when tenant files
- Tenant is prohibited from paying any pre-petition claim outside of a plan of reorganization unless it obtains bankruptcy court approval
- Can pursue guarantors
- Can seek payment under letter of credit if partial draws are allowed



Obligation to Pay Rent Pending Decision to Assume or Reject Lease

- Debtor must pay rent at the contract rate until it decides to assume or reject lease
- Treatment of other lease claims
 - Taxes, CAM charges, etc. may constitute pre-petition or post-petition claims
 - Cases are fact-specific and decisions are not uniform
- Courts require tenant to prorate the rent for the month in which the bankruptcy occurs – stub rent
- Bankruptcy Code gives debtor 60 day window before it has to pay



Leasehold Assumption or Rejection

- Debtor can assume or reject its executory contracts, which includes leases
- 2005 bankruptcy amendments strengthened landlords' rights
 - A commercial lease is rejected if not assumed within 120 days of the petition date
 - o Period may be extended for up to 90 days
 - o Time can be further extended with landlord's consent



Leasehold Assumption

- All monetary defaults must be cured
- Leases can only be assumed as a whole
- In a debtor sale of business, sale motion often provides procedures for determining cure amount
- Adequate assurance of future performance



Lease Assumption and Assignment

- Anti-assignment clauses generally not enforceable in bankruptcy other than in shopping centers
- Landlord rights different in shopping centers
 - Consideration of radius, use, location, tenant mix and exclusivity provisions of lease
- But landlord entitled to adequate assurance of future performance, including:
 - Information about financial strength of proposed assignee
 - Percentage rent protection
 - Cases are fact-specific and non-uniform



Leasehold Rejection

- Debtor must immediately surrender property to landlord
- Landlord cannot prevent lease rejection
- Landlord may not be able to enforce “broom clean” and “ordinary wear and tear” provisions
- When does rejection occur?
 - Tenants seek rejection to be motion date
 - Landlords seek rejection no earlier than hearing date



Lease Rejection Damages

- Landlord's claim capped at greater of one year's rent or 15% of remaining rent due, but not to exceed three years' rent (11 U.S.C. § 502(b)(6))
- Tenant may be liable for additional damage to premises, but issue is whether acts occurred pre-petition or post-petition
- Landlord's claim against guarantor or letter of credit are not subject to § 502(b)(6) limitation
- Security deposits applied to damage claims



Security Deposits and Letters of Credit

- Security deposits may or may not be property of the estate
- Letters of credit are not property of the estate
- Bankruptcy court approval needed to draw on letters of credit or apply security deposit?
- Beware the clawback
- Application to lease damage claims



Liquidating Retailers: GOB Sales

- Outside bankruptcy, GOB sales are subject to numerous legal requirements that establish license requirements and impose conditions on such sales
- Bankruptcy courts hold that such state laws do not apply to debtors or their assets when they are liquidating
- Landlords should study debtor GOB sale proposals and try to persuade courts to apply limits where the impact may be harmful to landlord's business

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