

**NEGOTIATING LEASE WORKOUTS  
ON THE EDGE OF BANKRUPTCY**

First the rent comes in a day late and a dollar short. Then come the frantic calls from the CFO or CEO asking to talk. Then rent payments stop altogether.

Undoubtedly a wave, if not a tsunami, of tenant defaults and bankruptcies is heading our way. Since both the Federal bankruptcy code and case law have evolved since the tenant defaults of 2001-2003, I wanted to lay out a brief bankruptcy law refresher for landlords and tenants.

Plus, this article will suggest strategies for negotiating a lease workout or termination without a bankruptcy filing. A negotiated settlement is often a simpler and more efficient course.

**Why is today different from the last downturn?**

Although the last downturn greatly impacted the San Francisco Bay Area, today's economic crisis is more widespread across geographic and economic borders. With the stagnation of credit and the collapse of the equity markets, even viable, but cash-strapped companies may not be able to find credit, capital, or buyers and therefore may fail. Since DIP financing (financing obtained by a debtor post-bankruptcy filing) is tight, more failing companies will simply disappear and not reorganize.

Bottom line, this downturn will be broader, deeper and longer, but it will not last forever. It's time to hunker down and preserve cash.

**How a tenant bankruptcy affects a commercial lease.**

Automatic stay. When a tenant files for bankruptcy protection, whether voluntarily or involuntarily, an automatic stay blocks any action to recover the tenant's property without the approval of the Bankruptcy Court. Since this stay may stop pending eviction actions and may even prohibit the delivery of default notices and the application of security deposits, do not take any action or deliver any default notices to the tenant without consulting bankruptcy counsel. The Bankruptcy Court may impose painful sanctions for violations of the automatic stay.

Executory Contracts. A debtor/tenant in bankruptcy has the right to assume, to assume and assign, or to reject any executory contract in the exercise of its business judgment. This includes its unexpired commercial leases. The tenant must assume or reject the lease AS IS. Neither the tenant nor the Bankruptcy Court has the power to force the landlord to rewrite the lease.

Assumption/ Assumption and Assignment. If the tenant assumes, or assumes and assigns/sells the lease, it must cure all pre- and post-filing defaults and/or provide “adequate assurance” of its or its assignees ability to cure such defaults and to perform future obligations.

Many landlord-favorable assignment provisions are ignored in a bankruptcy assignment. The landlord loses its right to share in excess rent and to recapture the space. The landlord has limited rights to withhold its consent to the assignment or assignee. (Note, shopping center landlords have some additional rights to object to an assignment which may affect tenant mix or percentage rent.)

Rejection. If the lease is above-market, the tenant is likely to reject it. Rejection is a “breach” of the lease, but does not necessarily terminate the lease. If a tenant rejects the lease, the landlord may want to take the necessary steps to formally terminate the lease as well.

Limits on Landlord Damages. Following a rejection, the landlord is entitled to damages, including future rent, but its damages resulting from the lease rejection are capped at the greater of one year’s rent or 15% of the remaining lease obligation not to exceed three year’s rent. A landlord may also recover tort claims, such as environmental clean up costs, above the cap.

Any security deposit is applied to the capped damages and reduces the remaining capped claim. As to draws on a letter of credit, the trend in the courts has been towards including such draws within the capped damages. Even though payments under a letter of credit are made by the issuing bank and not the tenant, courts have generally treated the draws as though they were paid by the tenant.

A landlord should not presume it will receive the entire capped claim; there may not be sufficient cash in the bankruptcy estate. A landlord has a secured claim to the amount covered by the security deposit or letter of credit, so it will receive that entire amount so long as it does not exceed the cap. Any remaining claim is unsecured. So if unsecured creditors receive ten cents on the dollar, the landlord will receive ten cents on the dollar on its unsecured claim. A landlord, however, generally retains its claims against any guarantors of the tenant’s lease.

If within 90 days prior to the tenant’s bankruptcy filing, the landlord had received any payments from the tenant outside the ordinary course of business (such as catch up payments for past due rent), the landlord may have to pay those amounts into the bankruptcy estate since they may be deemed “preference payments”.

A tenant is suppose to keep rent current after the bankruptcy filing, but if it does not, and it rejects the lease, the landlord has a preferred administrative claim to those rental payments. That may be of small comfort if the tenant’s estate falls short.

Timing. One major change in the 2005 amendments to the Bankruptcy Act is that tenants must elect to assume or reject their leases within 120 days after filing, although the Bankruptcy Court may extend that to 210 days upon a showing of cause. Any extension beyond that requires the landlord’s consent. Prior to the 2005 amendments, the Bankruptcy Court could grant endless extensions, and landlords’ hands were tied for years.

This is a BRIEF SUMMARY, and almost every statement could be qualified and explained further. Experienced counsel should be engaged to give advice specific to the situation.

## **Negotiation strategies for the landlord**

**Delay.** When a tenant calls to discuss a workout, the first tactic used by most landlords is delay. After all, every month of rent paid is one less month of rent in default. A landlord will ask the tenant for financials, for proposals, for comps, then delay delay delay. Since delay is not a solution to the problem, a landlord should use the delay period to engage experienced counsel and other advisors to evaluate its position and options.

Delay is not without risks. If the tenant is in a position to make a sizeable payment to terminate its lease, a delay may erode its ability to make that payment. Further if the tenant files bankruptcy, and the landlord will be entangled in the bankruptcy process.

**Non-disclosure Agreements.** Prior to any discussion, the parties should enter into a mutual non-disclosure agreement. The landlord agrees to maintain the confidence of the tenant's financial information (although be sure to permit disclosures to the landlord's lenders, investors, attorneys and financial consultants), and the tenant agrees to maintain the confidence of its discussions with the landlord. After all the landlord does not want other tenants to know that it is open to renegotiation of leases. A tenant's breach of this non-disclosure agreement should be a default under the lease.

**Pre-conditions to negotiation.** Most landlords require the tenant to be current and to sign an estoppel certificate stating that no landlord default exists. Some landlords require tenants to waive certain rights, such as the automatic stay, notice and cure rights, and extension options. (Warning: Not all these waivers may be enforceable). If a tenant is in default, the landlord may require the tenant to acknowledge its default, execute a stipulated judgment, deliver a promissory note for past due amounts, or enhance the security for the lease by adding a guaranty or increasing the security deposit. And all this is prior to sitting down at the table to discuss the workout.

**Engage lender(s) in discussion from the start.** Most likely, any lease modification or termination is subject to the approval of the landlord's lender. If the landlord's loan or lender has changed hands, it may take a while to locate someone with the authority and willingness to make decisions on the matter.

**Evaluate alternatives and consequences.** A landlord should remain open to the possibility that the tenant may survive. It should evaluate the difficulty of re-leasing the space and ask itself whether receiving some rent from the tenant is better than no rent and a dark space. I suggest that the landlord evaluate the tenant's prospects as if it were an investor. Is the additional risk worth the potential reward?

**Terminate the Lease.** If the survival of the tenant is doubtful and the likelihood of a significant recovery through the bankruptcy process is small, the parties may want to negotiate an orderly termination of the lease, which may include converting the lease to a month to month lease. The tenant typically delivers some termination payment, which may be as simple as relinquishing the security deposit. The termination agreement should provide that if the tenant files bankruptcy within the preference period, the landlord has the right to void the termination agreement and to seek to recover its entire claim. While a lease termination compromises the landlord's monetary recovery, it should allow the landlord to recover possession of the space sooner and with less legal process. That may be worth the tradeoff. A sample letter of intent for such an agreement is attached to this article.

## **Negotiation strategies for the tenant**

*Face the facts.* Too many companies wait too long to acknowledge and deal with financial deterioration. Executives hold on to the belief that the “big deal” is around the corner. By the time the executives give up on miracles, the staff, assets and morale of the company are so depleted there is nothing much to sell and there are insufficient funds to pay respectable severances or manage an orderly wind-down. As soon a tenant realizes that it is likely to run out of cash, then it should commence the work-out or wind-down analysis and process.

*If turnaround is possible, court the landlord as an investor.* A tenant will have to convince the landlord that working with it to reduce its burn rate will be financially more beneficial than losing the tenant. A tenant should be willing to offer to reduce its space in exchange for extending its term, to backload rent, to issue warrants or equity, to increase the security deposit or provide additional guaranties. It should expect to meet with some resistance. After all, the landlord is in the real estate business, not the tenant’s business, so it may take a lot of convincing. A tenant should not expect the landlord to make the first move or proposal. Offering a reasonable solution to the problem is the tenant’s responsibility.

*Calculate landlord’s recovery under bankruptcy.* The tenant should perform a “liquidation analysis”. It should be prepared to show the landlord what it would recover after a bankruptcy filing. As discussed above, the landlord’s recovery is capped by statute. And in reality, the landlord is unlikely to recover even that capped claim if the lease obligations are unsecured and the tenant does not have sufficient assets to pay unsecured creditors 100 cents on the dollar.

*Know your limits.* Determining the termination payment is the most difficult part of the workout. Many tenants feel they should not pay a penny more than the landlord would receive under the bankruptcy liquidation analysis. Most landlord expect a premium above that amount. The negotiation becomes a game of chicken, which hurts the tenant because it wastes time.

My analytical principle is the following: **What is the tenant willing to pay NOT to file bankruptcy?**

**What is it worth to the tenant to maintain control over its future, to pay employees back wages and a reasonable severance, to hold onto its intellectual and other property for a potential sale and to pay creditors something so that its executives retain a reasonable reputation in the business community?**

Since this principle involves non-economic and non-quantitative factors, it is not a formula for setting an exact dollar amount. But by thinking through these issues, a tenant should be able to determine if the premium it is willing to pay is one dollar, \$100,000 or \$1,000,000. It will have a sense of the relative value of its options.

In my view, a tenant should be willing to pay that premium on top of what the landlord would recover in bankruptcy and nothing more. If the landlord insists on a premium which compromises the tenant’s other goals, then the tenant might as well take its chance with the bankruptcy process. If a tenant is clear as to its limits and the reasons why, the parties are more likely to reach a compromise solution.

**Sample Letter of Intent  
for early termination of lease**

Addressee

Re: **[Identify Lease, Premises, Landlord and Tenant]**

Dear \_\_\_\_\_:

As of the date of this letter, Tenant is in default in excess of \$\_\_\_\_\_ in base rent and additional rent, plus interest and late fees. Further, as of the date of this letter, Landlord has the right to terminate the Lease and recover from Tenant all past due rent and the present value of future rent, less amounts which Tenant may prove could have been reasonably avoided.

Notwithstanding the above, Landlord is willing to forbear on exercising such rights and remedies, subject to the satisfaction of the conditions set forth below. This letter summarizes the proposal from Landlord and shall be superseded by an Amendment to the Lease setting forth the terms and conditions herein in further detail.

1. **Partial Payment of Past Due Rent.** Upon execution of the Amendment, and as a condition to Landlord's obligations therein, Tenant shall deliver to Landlord a payment in the amount of \$\_\_\_\_\_. Landlord shall apply this payment to Rent most past due under the Lease.
2. **Security Deposit.** Upon execution of the Amendment, Tenant shall relinquish any claim to the Security Deposit to Landlord and agrees that Landlord may apply the Security Deposit to Rent most past due under the Lease.
3. **Lease Term.** Upon execution of the Amendment, the Lease Term shall be converted to a month-to-month term, and the Lease term shall be terminable by either party, as of the last day of any calendar month, following not less than \_\_\_\_ days prior written notice.
4. **Partial Payments of Future Rent.** Commencing on \_\_\_\_\_, Tenant shall deliver to Landlord partial payments of Base Rent of \$\_\_\_\_\_ per month. The payment obligation with respect to remaining Base Rent shall be suspended until the earlier of either (i) a Transfer, as defined below, or (ii) the breach by Tenant of its obligations under the Amendment, but in any event all Suspended Rent shall be due and payable no later than \_\_\_\_\_. Suspended Rent shall not accrue interest at a rate of \_\_\_\_% per annum, compounding quarterly.
5. **Pass-Through and Direct Charges.** Tenant shall pay for all utilities, water, garbage and other services provided to the Premises as set forth in the Lease.
6. **Insurance.** Tenant shall maintain all insurance coverage as provided in the Lease. Upon execution of the Amendment, and at any time thereafter within three days following Landlord's request, Tenant shall deliver to Landlord a current certificate of insurance evidencing that all such insurance is then in place.

7. **Marketing.** Commencing upon the parties' execution of this letter, Tenant and Landlord shall cooperate in marketing Tenant's business for sale and/or marketing the Premises for leasing (any such transaction being referred to as a "Transfer"). Tenant shall engage the broker for such marketing, at Tenant's expense. Landlord reserves the right to deal directly with any proposed transferee as a direct tenant.
8. **Further Payments.** Upon the closing of any Transfer, Tenant agrees to pay to Landlord \$\_\_\_\_\_/\_\_\_\_\_% of the proceeds of such Transfer. In the event the Transfer does not occur by \_\_\_\_\_, or either party terminates the Lease, Tenant agrees to pay to Landlord, as liquidated damages for its breach of the Lease, an amount equal to (fixed amount or \_\_\_\_\_% of total rental obligation which would have been payable for the Lease Term under the original Lease).
9. **Release of Tenant.** Provided Tenant satisfies all the obligations set forth above, Landlord shall release Tenant from any further liability under the Lease.
10. **Bankruptcy.** In the event that any payment made by Tenant or release granted by Tenant is subject to a preference claim under any Bankruptcy Laws, then the Amendment will be deemed void and of no force and effect.

Please indicate your agreement to this provisions by executing a counterpart to this letter.

Sincerely,

(Landlord)

ACCEPTED AND AGREED:

\_\_\_\_\_ (Tenant)

*The article above was prepared by Helen Sedwick of Bennett Valley Law.*

*After more than 20 years of practicing law with major firms in San Francisco, Helen Sedwick founded her own firm, Bennett Valley Law, in 2007. She continues to specialize in commercial real estate transactions, primarily sales and acquisitions, leasing, entity formation, financing and management. Clients include developers, investors, start up companies, bio-tech companies, solar technology companies, wineries, restaurant franchisees and owners, and individuals. For more information, please visit [www.bennettvalleylaw.com](http://www.bennettvalleylaw.com).*

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