

News & Alerts

June 20, 2018

Bankruptcy Protections for Retail Landlords

In 2017, two national retailers, Gymboree and Toys “R” Us, filed Chapter 11 bankruptcy cases in the United States Bankruptcy Court for the Eastern District of Virginia. While the pace of retail bankruptcy filings has slowed in the first half of 2018, most experts believe that more retailers will file for bankruptcy protection, as the shift from brick and mortar stores to an on-line presence continues to gain momentum.

A retail landlord should consider the following steps to protect and preserve its interests and maximize recovery in the event that a tenant files for Chapter 11 bankruptcy protection:

- **Identify Troubled Tenants** – Retail tenants often show clear warning signs when they are in trouble, such as (i) partial, delayed, or irregular payment, (ii) inaccessibility of senior management or failure to return phone calls, (iii) request for reduction in rent or a rent moratorium, and (iv) refusal or delay in updating previously provided financial information;
- **Perfect Your Security Interest** – A bankruptcy trustee has the authority to avoid certain statutory liens, including a landlord’s lien. A landlord can decrease this risk by requiring a tenant to execute a separate security agreement (or including a contractual grant of a security interest in the lease itself) pledging as collateral items which would typically be included in a statutory landlord’s lien and by filing a UCC-1 financing statement to perfect its security interest. The tenant’s secured lender may require that the landlord’s security interest be subordinated; however, a subordinated security interest is better than no security interest at all;
- **Obtain Additional Credit Assurance** – If a troubled tenant seeks to modify its lease, a landlord may require the tenant to provide additional credit assurance, in the form of a third-party guaranty, a standby letter of credit from the tenant’s bank, or a pledge of supplemental collateral. If a landlord obtains a guaranty, the landlord should make sure that the guaranty is truly from a third party. A guaranty by the tenant’s affiliate or parent is worthless if the entire enterprise seeks bankruptcy protection;
- **Be Aware of Preference Exposure** – The Bankruptcy Code allows a debtor to avoid payments, known as “preferential transfers”, made to non-insiders within 90 days of the bankruptcy filing. A landlord may assert several statutory defenses to an action to recover preferential transfers, including that the rent was incurred in the ordinary course of business and according to standard industry terms. A landlord can implement best practices to reduce preference exposure; and
- **Minimize Preference Risk** - To minimize preference risk, a landlord should (i) continue the same billing and collection procedures as before the tenant experienced financial

difficulty, (ii) apply any payment to the most recent rent due and not to old amounts due, and (iii) cash checks promptly. If a landlord agrees to modify a troubled tenant's lease, the landlord may require the tenant to provide certain assurances in the modification, such as a solvency representation or preference indemnity. If the modification involves the one-time payment of a lump sum in exchange for the forgiveness of past due rent, the modification should include an agreement that the landlord's forgiveness of debt is not effective until 91 days after the lump-sum payment is made (at which time the payment is no longer within the statutory preference period).

Experienced counsel can help you understand the risks of a tenant bankruptcy and implement measures to protect the landlord's financial position. Please contact the Hirschler Fleischer Bankruptcy and Creditors' Rights Group for more information.

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