WORKOUT STRATEGIES IN A DIFFICULT ECONOMY

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Difficult economic times breed trouble with leases. Such trouble often leads to lawsuits or workout negotiations. This presentation begins with the assumption that the parties have chosen workout negotiations instead of litigation.

Why bother with a workout? The answer is almost always perceived risk. Both sides fear something. The landlord may fear some potential defense, the uncertainty of finding a new tenant, the bad publicity of vacant space, or a Chapter 11 bankruptcy. The tenant typically fears loss of the leased premises and liability for damages. In such an environment, both sides have something to trade. If they do not, there will be no workout negotiations.

A good workout requires due diligence, proper timing, the right mediation structure, and some imagination. The due diligence component requires the assembly of a number of complex documents and a diligent analysis of the facts and law. The timing and structure components require an awareness of the psychology of negotiations: what timing and procedural structure is most conducive to reaching agreement? Imagination, also an important component, requires the ability to craft a solution that will sufficiently satisfy the needs of all parties.

We will begin with due diligence, then discuss timing, some typical procedural alternatives, some typical plan types, the impact of bankruptcy rights, and finally the role of imagination.

I.
DUE DILIGENCE

The landlord and the tenant have different concerns, and must therefore conduct different kinds of due diligence. The landlord's focus is on the lease documents, the necessary approvals of others (typically lenders, guarantors, sureties, tenants, and subtenants), the risks of litigation, and the presence or absence of realistic workout alternatives. The tenant's focus is on understanding the causes of its default, the limits of its financial resources available to cure the default, and alternative solutions such as Chapter 11 bankruptcy or a reduction in the amount of leased space. We will begin with the landlord's due diligence.

A. *The Landlord's Focus.*

The first step for the landlord is to assemble all lease agreements, loan documents, amendments, side agreements, and guaranties. This will typically be a large collection of documents. The landlord's counsel will be reviewing these documents throughout the workout process, so he or she should place copies into tabbed and indexed notebooks for convenient use throughout the workout process. Once that task is accomplished, counsel should perform the following due diligence:

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1. Check if the documents are properly executed (signed copy of everything).

2. Identify and list all defaults.

3. Identify monetary and non-monetary defaults

4. Review relevant correspondence (including email) with the tenant and any guarantors.

5. Review any relevant loan documents. Loan covenants are often an important factor in any lease workout. Make sure that the client will not create a loan default by terminating a lease or having the vacancy rate rise. It may be that a few concessions to keep a tenant will prevent a default scenario.

6. Contact lenders and guarantors (if appropriate or required). Most commercial leases will be in properties subject to one or more loans. Make sure all lenders have actual notice of any proposed modifications, and consent in writing to the lease workout modifications. Don't just accept oral approvals from a loan officer.

7. Some major tenants have the clout to create leasing/occupancy obligations in their leases. Make sure to consider the effect of other leases on the situation. Also know any use restrictions in effect.

8. If a subtenant is involved, make sure to review the sublease agreement to determine if concurrent rights of the subtenant are impacted.

9. In a similar vein, agreements with property management companies should be reviewed to make sure that the lease workout does not negatively impact the management agreements.

10. In certain types of leases (such as shopping centers), there may also be rules relating to the merchant association and impositions on tenants which need to be considered in any workout.

11. The tenant may be a franchisee under a franchise agreement operating a restaurant or hotel. If the lease changes modify the obligations of the tenant radically (such as decreasing maintenance obligations), the franchise agreement may be violated and/or

terminated. The resulting loss of the franchise "flag" may result in the tenant's business being unable to fulfill its workout agreement obligations.

12. Obtain and review the following:

    a. UCC Search.

    b. Credit reports on tenants and guarantors.

    c. Verification of Insurance Coverage.

    d. Up-to-date financial reports required under any agreements.

    e. Historical statements of cash flow.

    f. Statements of projected cash flow.

B. *The Tenant's Focus.*

The first step for the tenant is an objective look in the mirror. The tenant, to have any hope of a successful workout, will need to convince the landlord that it understands the causes of its distress, has the necessary accounting and management skills, and has a realistic solution to the existing problems. For the tenant's counsel, due diligence essentially means obtaining the detail needed to make a realistic workout proposal. The key steps in the tenant's due diligence are therefore:

1. Determine the underlying cause of the problem. Is it a temporary problem, subject to repair? If the problem is unsolvable, better to know that at the outset. If the problem is subject to repair, then it makes sense to move to the next step.

2. Assemble the necessary historical financial documents – past balance sheets, income statements, and statements of cash flow. If the tenant does not have such key management reports, or the reports are poor, tenant's counsel needs to know this at the outset.

3. Consider retaining a workout professional to conduct an independent analysis of the historical financial documents, prepare projected financial statements, and develop a detailed workout plan. This can be a key step. Many management teams lack the skills needed to prepare such materials. Also, a workout professional with a detailed plan tells the landlord that the tenant understands the problems, is serious about fixing the problems, and has the resources to consider a Chapter 11 alternative if necessary.

4. Analyze potential defenses and counterclaims. These may be key components to convince a landlord to consider a workout, and will be valuable bargaining chips to trade for concessions from the landlord. Conduct legal research to locate favorable law, collect witness statements to establish the key facts – both are often necessary to persuade the landlord of your seriousness.

5. Of course, the tenant's lawyer will also need to conduct the same review of the relevant documentation as the landlord's lawyer. See the discussion above for an outline of the key steps in such a review.

II.
THE STRUCTURE OF WORKOUT NEGOTIATIONS

A. *Timing.*

Workout negotiations should begin when the parties are ready, but not too far into the litigation process. Identifying the proper time involves some consideration of the "psychological grief cycle". The typical stages are as follows:

1. *Denial.* The first reaction to a breach is often denial. A tenant's initial reaction is often, "There's not a problem! I can turn this thing around." At this stage, however, a tenant is rarely ready to discuss details.

2. *Anger/Blame.* After the denial phase wears off, anger often sets in. Some tenants react to a business failure with an attack on the landlord. "There wouldn't have been a problem if..."

3. *Acceptance.* At some point, acceptance kicks in. At this stage, the tenant starts thinking about realistic solutions.

4. *Resolution.* By now, the tenant has developed a realistic plan. With luck, the landlord is still willing to consider negotiations. It is only when the parties get to the resolution stage that they can actually negotiate a workout. Obviously, in the lease setting the sooner the tenant reaches this stage the better.

Not every business goes through the process the same way. Some have longer cycles, and some never progress all the way through the four steps. Those who fail to progress to the last step usually proceed to litigation. One thing you can count on is that the longer it takes to reach the resolution stage, the less the chances for a successful workout.

The reality of these psychological stages, combined with more hard-headed tactical considerations, explains why the commencement of litigation often precedes workout negotiations. The commencement of a lawsuit helps end the denial stage. The initial pleading

process plays some role in moving the parties through the anger stage. A realistic analysis of the claims, defenses, and counterclaims in the pleadings often helps the parties move on to the acceptance stage. The growing litigation expenses and the perceived risks of litigation push the parties on to the resolution stage. At that point, workout negotiations begin.

B. *Setting the Ground Rules - The "Pre-Workout" Agreement.*

1. *Basics.* Many landlords like to use a pre-workout agreement prior to commencing serious workout negotiations. The pre-workout agreement is designed to describe the past history of the lease, describe the status of the landlord and tenant, and establish ground rules and procedures for conducting future negotiations.

2. *Landlord's Perspective.*

a. *When do you want one?*

i. Before the first substantive discussion with the tenant concerning a possible lease restructure.

ii. When the parties desire to document their intent to work in good faith to resolve the defaults and restructure the lease.

iii. When the parties believe that the tenant's non-performance of the lease is temporary and the tenant is capable of performing the lease going forward.

b. *Why do you need one?*

i. To obtain a general release from the tenant up front. Why waste your time negotiating a restructure if the tenant is going to sue you?

ii. To establish ground rules for negotiation.

iii. To make clear that you are in discussions only - no agreement until set forth in writing; no oral agreements; avoid claims by the tenant that the landlord agreed to something when it did not.

iv. To obtain an acknowledgment from the tenant that the lease documents are in full force and effect, and are enforceable in accordance with their terms.

v. To obtain an acknowledgment from the tenant of the existence of defaults.

vi. To obtain an acknowledgment from the tenant that the landlord is under no obligation to restructure the lease or grant any concessions.

vii. To identify the individuals who are authorized to negotiate for the landlord and for the tenant.

viii. To permit orderly termination of discussions if they are not productive.

c. *Who should be a party to it?*

i. The landlord

ii. The tenant

iii. All guarantors

iv. Possibly other parties who have rights that can be modified (*i.e.*, subtenants).

d. *What do you do if the tenant refuses to sign one?*

i. Make it clear that without it, your client's alternatives are limited and may affect your ability to be candid with the tenant.

ii. Conclude that the tenant is not acting in good faith and proceed to exercise rights and remedies on default.

iii. Proceed with negotiations without one and document every discussion you have with the borrower.

e. *Key Provisions of a Pre-Workout Agreement.*

i. A schedule of all lease documents and an acknowledgment from the tenant that all are in full force and effect, and remain in full force and effect during the negotiations.

ii. A schedule or listing of the defaults with both <u>required</u> and

actual performance.

iii. An acknowledgment by the tenant of the existence of the defaults and that the landlord has not waived them.

iv. An acknowledgment by the tenant of the amount of the debt owed to the landlord.

v. An acknowledgment by the borrower/tenant that any extensions of credit and/or acceptance of partial payments during the negotiations do not constitute a waiver of the defaults.

vi. During negotiations the landlord will forbear from exercising remedies with respect to known defaults.

vii. The landlord is not obligated to negotiate or modify the loan documents or lease agreements.

viii. The workout discussions are not binding until reduced to a written agreement signed by authorized signatories.

ix. Any restructure is subject to formal credit approval.

x. The tenant pays the landlord's expenses, including attorneys' fees, for negotiations, documentation, etc.

xi. There will be an end to discussions and negotiations if an agreement is not reached by a date certain.

xii. General release by the lenders and guarantors.

xiii. Negotiations are to be kept confidential.

xiv. Negotiations are settlement discussions and inadmissible (Oregon Evidence Code 408; Rule 408 of the Federal Rules of Evidence).

xv. Bring-down of the tenant's representations and warranties in the lease agreements. (Everything warranted on day 1 should be repeated).

f. *Enforceability of Pre-Workout Agreement - Do they add anything?*

i. *Travelers Ins. Co. v. Corporex Properties, Inc.,* 798 F Supp 423 (ED Ky 1992). Pre-workout agreement entered into between Travelers and the borrower was enforceable. The court rejected the borrower's claims that Travelers had waived its right to foreclose because of its acceptance of partial payments of interest post default. The court quoted the pre-workout agreement which provided that Travelers was not waiving its rights by acceptance of partial payments while attempting to negotiate a workout.

3. *Tenant's Perspective.* The pre-workout agreement offers little to the tenant other than an opportunity to move further along the path toward a workout solution. Tenants usually prefer a simple forbearance or standstill agreement that merely preserves the status quo of the parties during the pendency of the negotiations. When presented with a pre-workout agreement, tenants should carefully assess whether it is worth it to "pay to play" by giving up potential defenses to obligations under the lease documents and possible affirmative claims against the landlord.

Some tenants agree to the landlord form of a pre-workout agreement with an eye toward subsequently invalidating the agreement if the workout negotiations are not successful. State law defenses to enforceability include failure of consideration, economic duress, and unconscionability. Additionally, if the tenant ends up in bankruptcy, it may seek to avoid a pre-workout agreement as a fraudulent transfer (11 USC § 548) or a preference (11 USC § 547). Alternatively, the tenant may try to use the pre-workout agreement as part of a fact pattern showing control over the tenant to support a claim to equitably subordinate the claim of the landlord. 11 USC § 510(c).

A standstill agreement simply acknowledges the defaults and requires the landlord to "standstill" (not take further action) so long as the tenant is not in default under the standstill agreement. These are usually short term arrangements where workout negotiations are expected to progress quickly.

C. *Three Types of Mediation to Consider.*

1. *Informal.* The parties may simply meet privately to negotiate a workout. Or, in the alternative, the lawyers may meet to negotiate a workout without the parties. This type of negotiation is likely to succeed only when the deal is relatively simple, only when the lawyers work in an area of law (such as real estate transactions or bankruptcy) where deal-making is common, and only when there are as yet no hard feelings from the

litigation process. The principal advantage is that such informal negotiations can be quick and cheap.

2. *Court Mediation.* Most circuit courts in Oregon now require mediation in civil cases. My experience with such mediations has not been good, unless the parties are exhausted and very ready to settle. Typically, circuit court mediations are scheduled late in the litigation process, the settlement judge has little time to devote to preparation, and often lacks the necessary experience to handle complex business issues. Some courts do a better job. The bankruptcy court, in particular, does a much better job. In bankruptcy cases, upon request you can have disputes referred to a settlement judge who will schedule mediation early in the process, devote substantial time to preparing for the mediation, and bring substantial business expertise to the table.

3. *Private Formal Mediation.* In many complex workouts outside of the bankruptcy process, the parties hire a private mediator to facilitate the workout negotiations. The downside is expense, which is typically divided evenly between the parties. In my opinion, however, a good mediator is well worth the expense. Typically, the mediator structures the negotiations to avoid confrontation and facilitate agreement. One common approach is for the mediator to shuffle back and forth between the two sides, which are kept in separate rooms, conveying proposals to each side. A good mediator is able to analyze the strengths and weaknesses of the parties' positions, and to comment on the proposals being made, in an effort to push the parties toward agreement. All of this, unfortunately, is likely to be a waste of time and money unless the two sides have done the due diligence discussed above, are psychologically ready to consider a workout resolution, and arrive with detailed workout proposals.

D. *Five Types of Workout Plans to Consider.*

1. *The Cure Plan.* In the lease setting, the cure plan is the most common type of workout agreement. The basic structure is usually that the tenant waives all existing defenses and counterclaims, reaffirms the lease, and agrees to some kind of payment plan to cure existing defaults. The cure is rarely a lump sum payment. Typically, the cure is to pay accrued arrearages over time. There are often new lease terms to protect the landlord if the tenant again defaults, and often the grant of additional collateral and additional guaranties. The tenant rarely obtains an unconditional release of existing defaults in this type of workout.

2. *The Assignment Plan.* Occasionally, either the landlord or the tenant will locate a better prospect to act as the tenant. The workout agreement then takes the form of an assignment plan. The basic structure is usually that the tenant waives all existing defenses and counterclaims and consents to the assignment of its rights and obligations as tenant. The tenant may or may not remain liable to cure any arrearages, and may or may not obtain an unconditional release, depending on the circumstances involved.

3. *The Surrender Plan.* This is the most common type of plan where the tenant, after conducting its due diligence, realizes that it has unsolveable problems. There are bargaining chips such a tenant may still have, including the landlord's desire for a prompt and trouble-free surrender of the leased premises. The basic structure is usually that the tenant waives all existing defenses and counterclaims and obtains some time to vacate the premises in an orderly manner. Depending on how much the landlord wants the premises, there may be full or partial releases of the tenant and even releases of guaranties in exchange for the prompt surrender.

4. *The Space Reduction Plan.* This is a common variation of the Surrender Plan. The tenant may agree to vacate a portion of the premises. The lease is restructured to produce lower costs, and there are typically reductions in tenant liability for breach damages, and full or partial releases of old guaranties in exchange for new guaranties. Landlords usually consider such plans when they have a new tenant waiting in the wings for vacated space.

5. *The Space Exchange Plan.* This is a somewhat more rare variation of the Surrender Plan. A tenant which concludes that it cannot prosper in the present space, may conclude that it can prosper in another location owned by the landlord. The old lease liability is resolved, typically with some concessions by the landlord, and the parties enter into a new lease for the new space. Landlords usually consider such plans when they have alternative space they need to fill, and usually when they have a new tenant waiting in the wings for the old space.

Within these basic plan types, the possible variations are legion. The particular terms depend on the existing economic conditions and the relative strengths and weaknesses of the parties' claims, defenses, and counterclaims. The economic condition of the tenant and the guarantors also plays a major role, as does the landlord's need to keep space filled and the availability and needs of replacement tenants.

III.
DRAFTING THE WORKOUT DOCUMENTS

Because each workout is unique, there is no one standard set of documents that fits all situations. For example, in addition to the main workout document, there may also be a new lease, a guaranty modification, a promissory note, or a letter of credit as additional collateral. I have already suggested some pre-negotiation documentation, and there may be intermediate memorandums or term sheets as well. When the parties have agreed to all the deal points, the final deal should be described in a separate agreement which may be characterized as a "workout agreement," "restructuring agreement," "settlement agreement," "compromise agreement," or "lease modification." Regardless of how it is titled some document drafting tips are in order.

A. *Confirm that you have incorporated the Workout Terms into the Lease.* (And not inadvertently created a "free standing" document which doesn't incorporate the lease default terms).

B. *Remember Basic Contract Modification Principles.* A modification must satisfy the elements of contract: a meeting of the minds supported by consideration.

C. *Make Sure that all the Workout Documents are Executed Contemporaneously.* Pay particular attention that if a new lease guaranty is signed, it is signed simultaneously with the other workout documents.

D. *Secure Representations.* The workout is an opportunity to confirm and receive various representations from the tenant. For example, if there have been disputes over non-financial issues which have not been previously resolved, get a representation in the workout. Since a delinquent tax bill on a triple net lease can ruin a workout, take the opportunity to get a representation that all of the taxes have been paid.

E. *Beware Assignments.* If the workout involves the assumption by another party of the existing lease, make sure that the lease obligations assumed by the new tenant include the unfulfilled obligations of the prior tenant.

F. *Taxes.* While a detailed analysis of the tax consequences of a lease workout are beyond the scope of this presentation, practitioners should keep in mind the potential federal income tax consequences of any lease workout. For example, if the workout provides that an existing tenant indebtedness be forgiven, the tenant will be impacted by the forgiveness of debt rules.

G. *Post-Workout Considerations.* Signing the documents and recording them is not necessarily the end of the workout process. There are some additional considerations to think about:

1. *Communicate the Deal.* Make sure that the management company and accountants who will be trying to keep track of the numbers, have a copy of the workout documents and, more importantly, understand the deal.

2. *Impress on your Client to Keep Good Records Post-Workout.* Keep in mind that if the tenant has gone into financial difficulties once and the economy continues to slump, there is a strong likelihood that the tenant will not be able to fulfill its obligations under the workout. Keeping a careful watch is important.

PRACTICE TIP: When the closing binder for the workout documents is sent to the client, include a letter that not only references the transmittal of the documents, but also outlines the specific changes which accountants and managers should include in their records.

IV.
THE SHADOW OF BANKRUPTCY

Workout negotiations are sometimes driven by perceptions of what will happen to the lease if the tenant seeks to reorganize under Chapter 11 of the Bankruptcy Code. An understanding of the parties' rights in bankruptcy is thus essential for ascertaining the true bargaining position of the parties in the workout. Workout negotiations, not bankruptcy, are the topic of this presentation. What follows is only a sketch of the most important bankruptcy rules relating to leases.

A. *Assumption of the Lease.* The first and foremost question the landlord faces in every case is "will the bankrupt tenant remain in the property?" Bankruptcy Code section 365 gives the debtor-in-possession in a Chapter 11 proceeding the option to "assume...any...unexpired lease of the debtor" and to sell and assign the debtor's interest in the lease. 11 USC §§ 365(a), (f). The debtor-in-possession has such a right even though:

1. The debtor was in default under the lease at the time of filing for bankruptcy. (To assume the lease, however, the debtor must cure the default. 11 USC § 365(b).)
2. The debtor failed to perform the lessee's obligations under the lease after the filing of the bankruptcy case.
3. The lease provides that it can be terminated because of:
   a. the insolvency or financial condition of the debtor before or during the bankruptcy case;
   b. the filing of the bankruptcy case; or
   c. the appointment of, or the taking possession by, the debtor-in-possession or a Chapter 11 trustee.

(Such provisions become ineffective if the lease has not been terminated before the bankruptcy case is filed. 11 USC § 365(e).)

4. The lease prohibits, restricts, or conditions assignment.
(Such provisions are not binding on the debtor-in-possession. 11 USC § 365(f).)

B. *Rejection of the Lease.* A debtor may expressly reject a lease, but more often the debtor will simply let the time for assumption or rejection expire, in which case the lease is deemed rejected. With regard to leases of nonresidential real property, the time is 120 days after the date of the order for relief or the date of the entry of an order confirming a plan. 11 USC § 365(d)(4). With regard to leases of residential real property or personal property in Chapter 7, the deadline is 60 days from the order for relief. 11 USC § 365(d)(1). With regard to leases of residential real property or personal property under any Chapter other than 7, the trustee may assume or reject the lease at any time before confirmation, but a party may request the court to order the trustee to make a determination within a specified time. 11 USC § 365(d)(2). Rejection constitutes a breach of the lease which relates back to the date of the filing of the petition. 11 USC §§ 365(g)(1), 502(g). The lessor is then entitled to file a proof of claim as a pre-petition nonpriority creditor for whatever damages it incurred as a result of the breach. Unless the lessor has rights other than a landlord's statutory lien, the claim will be unsecured. It is sharply limited in amount by Bankruptcy Code section 502(b)(6).

The formula in 11 USC § 502(b)(6) is complex. As a rough rule-of-thumb, if the remaining lease term is less than 80 months (6.6 years), the landlord's claim will be capped at one year's rent. If the remaining lease term is greater than 240 months (20 years), the landlord's claim will be capped at three years' rent. If the remaining term is between 80 months and 240 months, the landlord's claim will be capped at the damages for 15% of the remaining term. This rough rule of thumb will not work where the rent is not constant. Also keep in mind that this is a statutory <u>cap</u> on the claim – the landlord must prove <u>actual</u> damage (including proper mitigation) to establish the claim amount. Moreover, there are complex issues as to whether the cap applies if the damages flow from property damage rather than breach of the lease. *See In re El Toro Materials Co.*, 504 F3d 978 (9th Cir 2007). Some courts even refuse to apply the cap where the claim arises from the debtor's rejection of the lease. *See In re Austin Development Company*, 19 F3d 1077 (5th Cir 1994).

C. *Terminated Leases*. The debtor can assume a lease only if the lease is in existence at the commencement of the bankruptcy case. If the lease has expired by its own terms or has been terminated under applicable law before the commencement of the bankruptcy case, there is nothing left for the trustee to assume or assign. *See Vanderpark Props., Inc. v. Buchbinder (In re Windmill Farms, Inc.)*, 841 F2d 1467, 1469 (9th Cir 1988). However, the termination process must actually be completed and not be subject to reversal, a determination that will require reference to applicable state law. *City of Valdez v. Waterkist Corp.*, 775 F2d 1089 (9th Cir. 1985). The lease itself should define when a lease termination event has occurred.

D. *Incurable Nonmonetary Defaults.* Section 365(b)(1)(A) of the Code requires all monetary defaults to be cured prior to assumption of an executory contract, but excepts incurable nonmonetary defaults, such as breach of a continuous operation clause in a real property lease. *See In re Hathaway*, 401 BR 477 (Bankr WD Wash 2009).

E. *If the Tenant Files a Chapter 11, Can the Landlord Enforce its Rights Against a Guarantor?*

Upon the filing of a bankruptcy by the tenant, Section 362 of the Bankruptcy Code enjoins the landlord from enforcing its collection remedies against the tenant. However, if a member or officer of the tenant has guarantied the lease or loan obligations, the bankruptcy will not stay collection efforts by the landlord against the guarantor. While courts have in some cases issued preliminary injunctions under Section 105(a) of the Bankruptcy Code staying collection efforts against principals or officers of the debtor-in-possession, such injunctions are rare and extremely difficult to obtain in a single-asset real estate Chapter 11. *See In re Regency Realty Associates*, 179 BR 717 (Bankr MD Fla 1995); *In re Third Eighty-Ninth Associates*, 138 BR 144 (Bankr SDNY 1992); *In re Otero Mills, Inc.*, 25 BR 1018 (Bankr D NM 1982).

Additionally, under Section 524(e) of the Bankruptcy Code, the discharge of a debtor in bankruptcy does not discharge a third-party nondebtor. Some debtors have tried to craft provisions in plans of reorganizations that discharge claims against guarantors. However, the Ninth Circuit has been decidedly hostile to such plans. *In re American Hardwoods, Inc.*, 885 F2d 621 (9th Cir 1989); *In re Lowenschuss*, 67 F3d 1394 (9th Cir 1995). In short, when there is a significant personal guaranty present, the threat of a bankruptcy of the business entity alone is likely to be less effective (unless the guarantor is insolvent as well, which is not unusual).

F. *If the Workout Agreement Contains a Waiver Relating to Relief from the Automatic Stay, Will that be Enforced in Bankruptcy?*

During the late 1980s and early 1990s, a handful of bankruptcy courts enforced provisions in workout agreements that provided for a waiver by the tenant of the right to contest a motion for relief from the automatic stay. *See In re Citadel Properties, Inc.*, 86 BR 275 (Bankr MD Fla 1988); *In re Club Tower LP*, 138 BR 307 (Bankr ND Ga 1991); *In re Powers*, 170 BR 480 (Bankr D Mass 1994). As a result, the "stay relief waiver" has become a standard landlord request in nearly all workout agreements drafted today. Bogart, *Games Lawyers Play: Waivers of the Automatic Stay in Bankruptcy and the Single Asset Loan Workout*, 43 UCLA LAW REV. 1117, 1266, fn21 (1996).

Notwithstanding the ubiquitous presence of the "stay waivers" in workout agreements, several published decisions have refused to enforce such waivers, particularly where there are significant creditors (other than the landlord) present. *In re Jenkons Court Assoc.*, 181 BR 33 (Bankr ED Pa 1995); *Farm Credit v. Polk*, 160 BR 870 (Bankr MD Fla 1993); *In re Sky Group International, Inc.*, 108 BR 86 (Bankr WD Pa 1989).

G. *Preferences*

1. *Elements*. The elements of a preference that must be proven by the trustee or debtor under 11 USC § 547(b) are:

a. A transfer;

b. Of an interest of the debtor in property;

c. To or for the benefit of a creditor;

d. For or on account of an antecedent debt;

e. Made while the debtor was insolvent;

f. Within 90 days before bankruptcy; and

g. Because of the transfer, the creditor received more than it otherwise would have received without the transfer.

2. *The Ordinary Course of Business Defense*. Even monthly lease payments made by the debtor within the time frames set out in the written lease may meet the elements of a preference, especially if the debtor is not pre-paying rent a month (or day, week, quarter, year) at a time. The landlord will likely prevail if the payment was made according to ordinary business terms, according to the ordinary course of business between the landlord and tenant, or according to the terms of others in similar industry relationships. Some courts have held that payments under workout agreements are per se non-ordinary payments. Here in the Ninth Circuit, however, payments made pursuant to a forbearance agreement can be ordinary course payments. *See, e.g., Arrow Elecs., Inc. v. Justus (In re Kaypro)*, 218 F3d 1070 (9th Cir 2000). Moreover, in deciding what is ordinary, the courts consider the broad range of possible arrangements used by debtors and creditors when dealing with debtors under financial stress. *See, e.g., Ganis Credit Corp. v. Anderson (In re Jan Weiler RV, Inc.)*, 315 F3d 1192 (9th Cir 2003), *amended by* 326 F3d 1028 (9th Cir 2003). The longer the workout has been in place before bankruptcy, the better. *Id.*

3. *The Subsequent New Value Defense*. This defense is better described as the landlord's right to offset any preferential payments received against any new unpaid credit that was granted to the debtor after the payment was in fact received. Thus, when a landlord extends more credit (by allowing the debtor to remain in the space) after receiving a clearly past-due remittance, the landlord will have a defense up to the amount of the unpaid new credit extended.

V.
IMAGINATION

Few workouts succeed unless the parties break out of the litigation "box" in the way they perceive the dispute. For a moment, forget about the strengths and weaknesses of your legal arguments. Forget about the justice of your client's cause. Forget about the other party's lack of good faith. Break out of the "good guy/bad guy" mindset that can develop in litigation.

Remember, if you have decided to participate in workout negotiations at all, you have already decided that the strict enforcement of your client's rights are no longer the goal. You are looking to craft a deal. Focus on what, as a practical matter, your client really needs. If you are on the landlord's side, that may be retaining a tenant with temporary problems, obtaining a cure of existing defaults as soon as possible, obtaining additional security and new guarantors, and avoiding entanglement in a Chapter 11 case.

As the tenant's lawyer, do not focus exclusively on what your client needs. That takes no imagination. You will know that. Focus on what the landlord needs. It may be that the landlord needs a performing lease on its books, additional security, or new guarantors. It may not really want the property back, especially in a down market. Also, devote some thinking to litigation alternatives which the landlord may fear more than trial – especially the threat of a Chapter 11 filing. If the landlord perceives a serious threat of bankruptcy, it may be more willing to accept a consensual workout. The key is to move beyond the arguments of the moment and to focus on the landlord's practical needs and fears of the future.

Both sides should give some thought to the five basic types of workout plans discussed earlier in this chapter. Often, the solution will be one of those plans, or a combination of the features of one or more of those plans.

VI.
CONCLUSION

A workout is not always the right solution. If a workout is the right solution, it still requires the right approach to have a good chance of success. If you decide to attempt a workout, do your due diligence first, carefully consider the best time to commence negotiations, select the appropriate procedure, and use your imagination to craft potential solutions acceptable to both parties before you arrive for the negotiations.

LANDLORD BANKRUPTCY

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- A landlord debtor has 120 days after the petition date to assume or reject a lease of nonresidential real property . 11 U.S.C. § 365(d)(4)(A). This deadline may be extended for another 90 days by timely-filed motion, and for additional periods by stipulation. 11 U.S.C. § 365(d)(4)(B).

- Until it assumes or rejects the lease, the landlord debtor must timely perform all of the landlord's obligations, subject to provisions allowing a short delay (60 days) on timely motion. 11 U.S.C. § 365(d)(3).

- If a landlord debtor assumes the lease, it must cure any defaults. 11 U.S.C. § 365(b)(1)(A). The tenant should have analyzed the defaults ahead of time, to be in a position to press for the full cure it is entitled to.

- If the lease or applicable law so provides, upon rejection the tenant may treat the lease as terminated. 11 U.S.C. § 365(h)(1)(A)(i). The tenant must analyze the lease and applicable nonbankruptcy law to determine if it has the option to terminate the lease upon breach.

- If the tenant decides to treat the lease as terminated by the rejection, it may file a claim for breach of the lease as if the breach had occurred immediately before the petition date. 11 U.S.C. § 365(g)(1). This will be a prepetition general unsecured claim, not a postpetition priority administrative expense claim.

- Alternatively, if the lease term has already commenced as of the rejection date, then the tenant may elect to treat the lease as continuing on the existing terms for the balance of the lease term and, to the extent of any extension rights enforceable under the lease and applicable nonbankruptcy law, for any extension period. 11 U.S.C. § 365(h)(1)(A)(ii). *See In re Churchill Properties III Ltd. Partnership*, 197 B.R. 283, 288 (Bankr. N.D. Ill. 1996).

- The primary function of rejection, from the landlord debtor's perspective, is to escape the burden of providing services – typically, common area maintenance and other such expenses.

- The tenant's protection is 11 U.S.C. § 365(h)(1)(B). The tenant can offset the value of the landlord's nonperformance against the tenant's lease obligations. But, the tenant has no other claim against the estate. The tenant must be playing heads-up ball – it must promptly quantify the value of the landlord's nonperformance and offset that amount

against the lease payments owed. It has no other remedy.

- Watch out if the landlord/debtor files a motion to sell the property. The relevant statute is 11 U.S.C. § 363(f). That statute authorizes sales free and clear of "any interest." The Code does not define the term "any interest." Case law has interpreted that term to include a tenant's possessory interest. *Precision Industries Inc. v. Qualitech Steel SBQ LLC (In re Qualitech Steel Corp.),* 327 F.3d 537, 545 (7th Cir. 2003).

- In *Qualitech*, the leased property was sold free and clear of all interests. The tenant in possession under a 10-year lease failed to object. After the sale, the new landlord locked the tenant out. On appeal, the Seventh Circuit held that the tenant, upon request, must be granted "adequate protection." But that does not necessarily guarantee the tenant's continued possession. It does, however, mean that the tenant must be compensated for the value of its leasehold interest from the proceeds of sale. *But see In re Haskell LP*, 321 B.R. 1 (Bankr. D. Mass. 2005) (tenant cannot be forced to accept a money satisfaction of its claim). *Contra MMH Auto Group*, 385 B.R. at 362 (tenant can be compelled to accept a money satisfaction in some circumstances). Given the tenant's failure to object, the sale in *Qualitech* terminated the tenant's possessory interest.