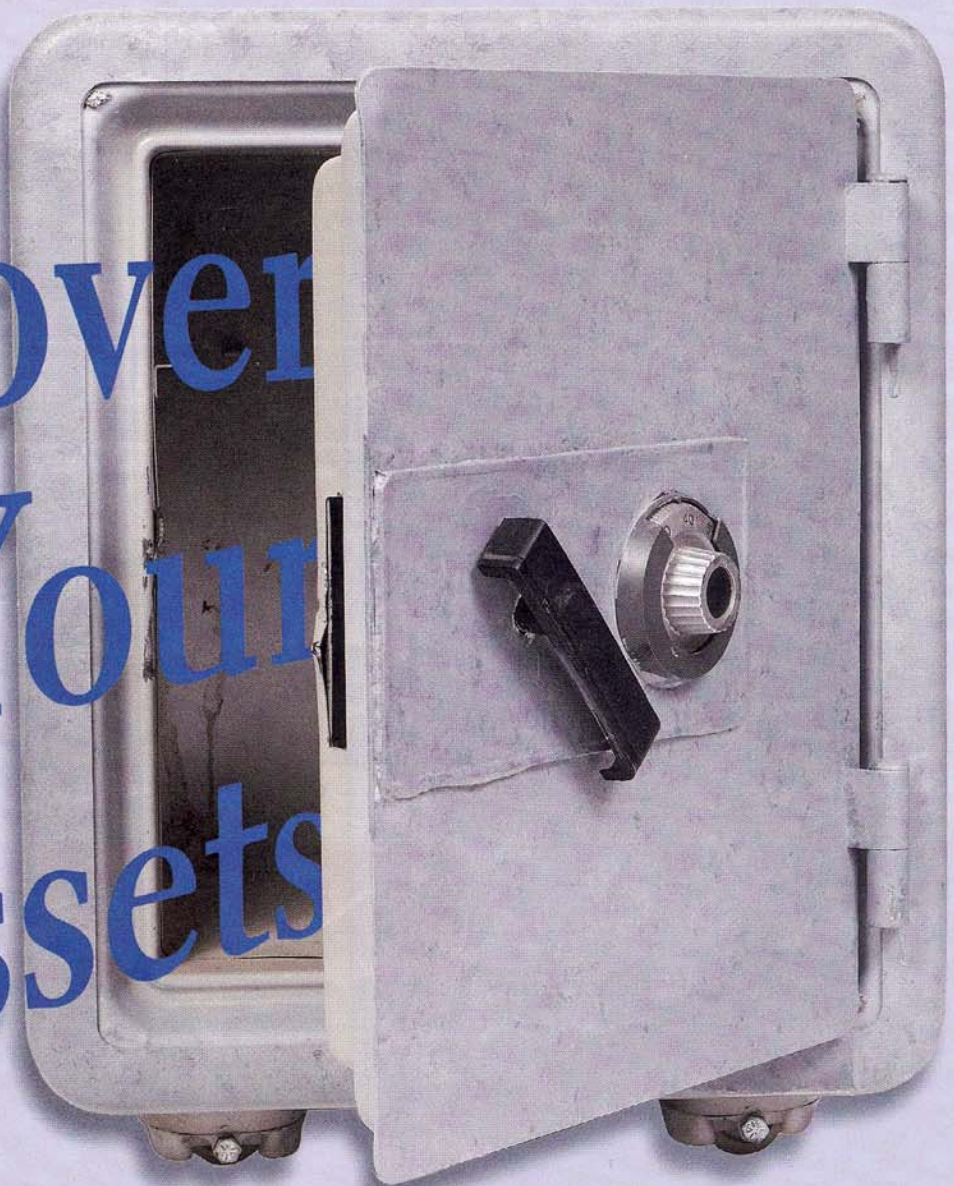

Cover Your Assets

Protection for Landlords and Tenants

FOR THE LANDLORDS:

Despite a landlord's best efforts, some commercial tenants will file for bankruptcy protection. Bankruptcy can tie up valuable square footage for long periods of time, limit rental revenue, reduce control over tenant lease compliance and significantly increase legal fees. Here are some general principles that apply to these situations:

- The Automatic Stay: If you receive notice of a tenant bankruptcy, do not take any further collection or eviction action without legal advice, as violating the bankruptcy automatic stay can result in stiff consequences.
- Getting Paid Going Forward: The tenant must pay rent post bankruptcy petition, and the post-petition rent is payable on a higher priority, "administrative" basis. Administrative claims have a higher priority than general unsecured claims and are paid first. If the rent is not paid within two to three months post-petition, several of local judges will entertain motions that effectively compel the tenant to pay the rent owed, or reject the lease and vacate the premises.
- Lease is Assumed or Rejected: Once a tenant is in bankruptcy, they must choose whether to assume or reject the lease.

If the tenant assumes the lease, the landlord-tenant relationship remains intact under the watchful eye of the bankruptcy court. If the tenant is in default under the lease at the time of

the petition and decides to assume the lease, it must cure the default, promptly compensate the landlord for pecuniary loss and provide adequate assurance of future performance.

A tenant can reject a lease either by getting bankruptcy court approval, or by failing to act within the deadline to assume or reject set by the bankruptcy court. By rejecting the lease, the tenant is considered to have breached the lease. This gives the landlord an unsecured claim for damages capped at one year's rents. Subject to some exceptions, once a lease is rejected, the landlord can move forward with re-letting the premises.

- Deadlines to Assume or Reject: Since 2005, tenants have been required to assume or reject a commercial lease within the earlier of 120 days from the petition date, or the confirmation date of the plan of reorganization. The bankruptcy court can grant one 90-day extension "for cause." Further extensions cannot be granted without the consent of the landlord.
- Effect of Default After Assumption: If the tenant assumes the lease and subsequently rejects it, the landlord is entitled to an administrative claim capped at two years' rent.
- Assignment of the Lease: Once a lease is assumed, a tenant has broad latitude to assign the lease with bankruptcy court approval to a third party, notwithstanding provisions in a lease that limit a tenant's ability to assign the lease. To do so, the tenant must provide adequate assurance of future performance by the assignee and the assignment must comply with the other provisions in the lease, including the use clause. Landlords should make sure they evaluate the proposed new tenant and discusses with their lawyers the costs and benefits of objecting to the assignment.

Ultimately, Congress has streamlined the procedures for dealing with commercial tenants in bankruptcy, making them less onerous than they have been historically. There remain numerous pitfalls, however, and the landlord should make sure to contact his lawyer in the event of a tenant bankruptcy to ensure that a short-term annoyance does not turn into a long-term headache.

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FOR THE TENANTS:

Commercial tenants these days have more to worry about than paying their rent. A thriving business could make every lease payment and still lose its space if the commercial landlord defaults on its loan. This risk can be eliminated through a non-disturbance agreement between the tenant and the lender.

A lease may look like a two-party agreement, but it's a risky commercial instrument if there is a third party lurking in the shadows — the landlord's lender. When a landlord defaults under its loan, the lender may step in and foreclose, effectively wiping out all leases signed after the loan was made.

To protect itself against an involuntary loss of its lease, a tenant negotiating for space or renewing its lease should inquire from the landlord about whether there is currently a loan on the property. If a loan exists then, as a precondition to lease term commencement, the tenant should seek to enter into a non-disturbance agreement with the landlord's lender.

The landlord may also be a party to the non-disturbance agreement between the tenant and the lender. By including the landlord in the non-disturbance agreement, the tenant formalizes its knowledge of the landlord's financial condition, thus minimizing risk before it is locked into a lease. The tenant may decide to move forward and lease the space without a non-disturbance agreement if the lender is unwilling, but at least this will be a risk the tenant has consciously assumed.

A non-disturbance agreement — also known as a subordination, non-disturbance and attornment agreement — will typically involve three interrelated concepts. The first is subordination —

> To ensure both parties are not affected by the other's circumstances, landlords and tenants should take certain measures to protect their assets.

the lender wants the tenant to agree that its leasehold interest in the property is secondary to the lender's lien.

Tenants agree to this because of the second concept — non-disturbance. Since the tenant is agreeing to subordinate its leasehold, the lender agrees that it will not disturb the tenant's possession provided the tenant is not in default under its lease obligations. This agreement overrides the automatic

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Virtual Bus Tour
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Golf Tournament
Wildfire at Desert Ridge
November 13th, 2008
10:00 am

Trend Watch
The Arizona Biltmore
December 11th, 2008
5:00 pm

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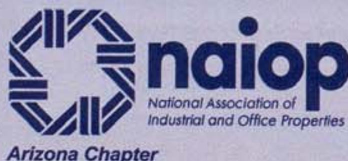

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wipeout of subordinate interests should the lender foreclose on the landlord.

As long as the tenant recognizes the lender as its landlord under the lease following a foreclosure, the tenant gets to stay, according to the terms of the lease. This is the attornment concept.

The take away here is that lenders generally do not want all tenancies to automatically terminate following a foreclosure. Good tenants enhance the value of the asset, and most of the time there will be little reason for a lender to shut off a source of income.

As a practical matter, not every tenant will be successful in securing a non-disturbance agreement with the lender. Tenants leasing 1,000 SF of shop space in a large mall will not likely get the attention of the lender. If the lender is unwilling to negotiate a non-disturbance agreement and circumstances result in a foreclosure of the landlord's ownership, there is nothing preventing either the tenant or the lender from approaching each other with a proposal for a new lease. The terms of the new lease may favor the tenant or the lender; hence, a non-disturbance agreement is a tool to minimize this risk.

The size of the risk for a tenant not protected by a non-disturbance agreement will be proportional to the amount of capital invested in its leased space and good will the tenant has built with its client base at that location — not to mention the interruption of business resulting from the tenant having to box up its inventory and find a new, suitable space. In a tight economy, a simple non-disturbance agreement can be the difference between success and failure of one's business.

FOR THE LANDLORDS:

Cathy Reece, a director at Fennemore Craig in Phoenix, practices in the areas of bankruptcy, creditors' rights, workouts, restructures, and banking and lending. She can be reached at 602-916-5343 or creece@fclaw.com

Nicolas Hoskins is an associate at Fennemore Craig in Phoenix. He practices in the areas of bankruptcy and creditors' rights, as well as commercial and real estate litigation. He can be reached at 602-916-5419 or nhoskins@fclaw.com.

FOR THE TENANTS:

David Vieweg practices law with Fennemore Craig in the areas of real estate acquisition and development, real estate finance and commercial leasing. He can be reached at 602-916-5358 or at dvieweg@fclaw.com.

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