LEASE TERMINATION PAYMENTS: HIDDEN RISKS FOR LANDLORDS

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What's worse than a tenant with a long-term lease bailing out on the landlord and only paying a lease termination fee that's a fraction of the landlord's loss? If you answered, "Getting sued by the tenant's future bankruptcy trustee and having to repay that termination fee to the bankruptcy estate," you'd be right. This is the consummate double-insult to a landlord faced with defaulting tenants and is occurring with a fair degree of frequency in this economic climate, particularly for large retail tenants with multiple leases.

What Went Wrong??

A recent case reviewed by the 11th Circuit Court of Appeals involved a tenant that paid the landlord a lease termination payment, and then promptly filed bankruptcy. The bankruptcy trustee sued the landlord for the return of the lease termination payment. The Court ruled against the landlord and required the return of the lease termination fee because it had been paid to the landlord within 90 days prior to the filing of the tenant's bankruptcy. The trustee's contention was that the termination fee was a "preference," the essential elements of which are:

(1) a payment by the tenant to or for the benefit of the landlord,

(2) within 90 days prior to the filing of the bankruptcy petition,

(3) while the tenant was insolvent,

(4) on account of a pre-existing debt,

(5) that enables the landlord to receive more than it would have if the tenant had filed a chapter 7 liquidation.

For tenants in precarious financial conditions, none of these criteria is difficult to prove factually,

and in the case reviewed by the 11th Circuit Court, the only element in question was whether the lease termination fee was a payment on account of a "pre-existing debt."

The Arguments…

The trustee argued that yes, the payment was on account of a pre-existing debt, the lease. The lease had been signed and entered into well before the payment of the termination fee, and the liability under the lease constituted the "debt" which was settled by the payment of the fee. The debt pre-existed the payment; hence, argued the trustee, it's a preference. The landlord argued instead that the debt was the monthly accrual of each month's rent, and since the termination fee was paid on account of future as-yet-unaccrued obligations (and not past arrearages), it wasn't paid on account of a pre-existing debt. The appellate court wasted no time in ruling in favor of the trustee and ordered the landlord to repay the full amount of the termination fee to the bankruptcy estate.

While this was a case of first impression for the 11th Circuit (which covers Florida, Alabama and Georgia), the holding of that court has been the law in the 9th Circuit (which includes California) for many years. Indeed, the 11th Circuit based its opinion in part upon the holding in a prior 9th Circuit Bankruptcy Appellate Panel case. However, it isn't where the lease is located – or even where the debtor is located — that governs what Court's law is applicable. Rather, it's the location of the Court where the tenant files its bankruptcy petition. For most cases, that is the famously pro-debtor forum of the Delaware bankruptcy courts, which are part of the 3rd Circuit Court of Appeals. The 3rd Circuit has not definitively ruled on this issue, but given the liberal bent of that jurisdiction, it is not difficult to predict which way it would go, particularly with two other circuit decisions siding against the landlord. It is safe to say that the 3rd Circuit would join the other two Circuit Courts to rule against the landlord.

The Alternatives

So what's a landlord to do when faced with the need to evaluate whether to enter into a lease termination agreement with a tenant? First, understand that there is a distinct possibility that if the tenant files a bankruptcy petition within 90 days after the payment, you're at risk of having to disgorge the payment. You cannot contractually preclude the tenant from filing a bankruptcy petition, as such provisions are against public policy, so there is no way to completely draft

around the risk. Similarly, a recital in the termination agreement that the tenant is solvent doesn't protect the landlord if the recital is, in fact, false. Changing that recital into an affirmative representation and warranty by the tenant that it is solvent may give you a basis for suing the bankrupt tenant for fraud when it turns out to be false, but it won't give you a defense vis-à-vis the trustee.

A more successful avenue might be to create a financial incentive designed to keep the tenant from filing a petition within the 90-day period following the payment (i.e., specify that if the landlord is compelled to disgorge any portion of the payment to a bankruptcy trustee, the landlord can file a claim for the entire amount of the debt that would otherwise have been recoverable under the lease). For a tenant at real risk of bankruptcy, however, that incentive won't be much of a discouragement to filing, particularly given the one-year cap on damages imposed on landlord claims and the fact that such claims are classified as bottom-of-the-barrel, general unsecured claims. It's nonetheless an important provision to include protecting the landlord from being limited to a claim for just the amount of the termination fee.

Another alternative would be to require the lease termination fee to be paid with an unconditional, presently negotiable letter of credit. That option is out of the question for most tenants facing bankruptcy, who do not have sufficient liquid assets to secure a letter of credit.

As a third alternative, landlords can attempt to require that the lease termination fee be paid by a source other than the tenant, but even this approach is not foolproof, particularly if the payment is made by a guarantor of the lease.

As a final alternative, consider not releasing the guarantor from its guarantee obligations until 90 days after the lease termination payment is made provided the tenant has not filed bankruptcy.

Summary

Does this mean that a landlord should never enter into a lease termination agreement? By no means! If the alternative is walking away from a termination fee and just waiting for the tenant to file a bankruptcy petition, take the money and run the risk! Attorneys' fees incurred by the trustee to prosecute preference actions are not recoverable against the landlord, so the trustee

has to discount the value of the case by the amount of the fees it will take to try the case. Additionally, lawsuits take time to try, even in bankruptcy courts, and there's always the risk that one of the elements of the case can't be proved. Those factors combine to cause most trustees to settle preference cases for about 50-70% of the original amount demanded, meaning that you get to keep the rest, and those odds, though ugly, are still better than not taking the payment in the first place.

[Midwest Holding #7, LLC v. Anderson [In re Tanner Family, LLC], 556 F.3d 1194, 11th Cir. 2009.]