

Client Alert

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May 4, 2017





Commercial Landlord-Tenant Practice Group Kmart Bankruptcy, Part Deux

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It's no secret that Kmart is facing another liquidity crisis. Just over ten years after Sears rescued the discount retailer from bankruptcy in 2006, the pioneer of the "blue light special" is destined for another, and perhaps last, going out of business sale. Earlier this year, the company publicly disclosed its inability to avoid insolvency stating: "Our historical operating results indicate substantial doubt exists related to the Company's ability to continue as a going concern." In other words, Kmart knows its heading for that blue light special in the sky.

Landlords with Kmart leases should be pro-active to protect their portfolios and consider taking action *before* what may be an inevitable liquidating Chapter 11 bankruptcy.

In a Chapter 11 bankruptcy setting, Kmart may reject leases that are not profitable or are without value. In that event, the landlord is generally left with an unsecured claim in an amount that is limited by statute.

On the other hand, for more profitable leases and locations, Kmart would likely attempt to assume and assign the lease to another retailer. Under the Bankruptcy Code, Kmart would generally have the right to assume and assign the lease provided that any defaults are cured and adequate assurances are provided to the landlord as to the proposed assignee's future performance under the lease. In the shopping center setting, "adequate assurance of future performance" includes not only assurances as to payment of ongoing rent, but also assurances (i) that the proposed assignment will not breach any provisions contained in any other lease, financing agreement or master agreement relating to location,

use or exclusivity, and (ii) that the assignment of the lease will not disrupt any tenant mix or balance in the center.

Discussed below are the most common scenarios facing Kmart landlords and, in view of the general legal principals discussed above, some steps landlords may consider taking proactively to best position themselves for bankruptcy court.

Scenario 1: Kmart store still operating with significant term remaining at below market rent. Under this scenario, there is a high likelihood that Kmart will make every effort to "assume" the lease and sell it to another retailer, thereby capitalizing on the below market rate. Even in a liquidating bankruptcy, subject to the limited restrictions discussed above, Kmart can sell the lease to another retailer of its choice, forcing the landlord to accept below market rents from another tenant for the remainder of the lease.

Landlords with a below market Kmart lease may be better able to control their own destiny by attempting to buy the lease back from Kmart prior to bankruptcy. A lease buy-back enables the landlord to lease to a tenant of its choice, away from the oversight of a bankruptcy judge. Note, however, that such a transaction will receive scrutiny once Kmart is in bankruptcy. Therefore, it is important that the price paid for the lease buyback be reasonably equivalent to the value of the lease. If it isn't, the buyback may be subject to attack and potential avoidance through a claim against the landlord. Accordingly, be prepared to defend your valuation.

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Scenario 2: Kmart store is still operating in a declining center and paying rental rates at or above market. Landlords with these leases have perhaps the toughest decision to make. A market rate lease is just as likely to be assumed (and assigned) as it is to be rejected. A landlord with any of these leases should determine whether it is willing to make compromises today in order to have the best opportunity of retaining the Kmart lease in the long run. A landlord looking to maximize the likelihood that the Kmart lease will be assumed and assigned may consider approaching Kmart prior to bankruptcy and negotiating a pre-bankruptcy lease modification. Striking a deal now that is more favorable to Kmart, may give landlord the best opportunity to keep Kmart or its assignee as a tenant even after a bankruptcy. Kmart cannot guarantee in advance that the modified lease will not be rejected in bankruptcy, but a landlord who strikes a deal early with Kmart stands a better chance of keeping the store open in its center.

Scenario 3: Store is dark in a failing center, but debtor has been paying rent. Landlords in this scenario have been collecting rent on vacant space, often for many years, and being cautious not to provide Kmart any opportunity to terminate the lease early. Kmart will almost certainly put these leases on the bankruptcy chopping block in its first day motion filings. Landlords with these leases should not wait to market their locations. If there is a re-let prohibition provision in your lease, seek a waiver from Kmart beforehand.

Conclusion: Landlords must be pro-active in managing their Kmart leases before another bankruptcy is filed. The foregoing are just three examples of how landlords can proactively improve their position in bankruptcy or avoid being dragged into the proceedings altogether along with thousands of other creditors. Landlords with Kmart leases should conduct a thorough review of each of their leases and decide how best to position themselves before the last blue light goes out.

Shumaker has a team of seasoned attorneys in each of its offices who specialize in commercial landlord-tenant matters. We help landlords and tenants large and small resolve the problems they face in their respective industries. At Shumaker, our attorneys bring years of experience to each matter and understand that landlords and tenants have unique circumstances and goals requiring individualized attention. Shumaker's attorneys understand the business as well as the legal needs of our landlord and tenant clients and continually strive to assure both are addressed in strategy and execution. Shumaker's commercial landlord-tenant practice has the size and depth to represent commercial property owners and tenants in every type of transaction and dispute that impacts their business.

www.slk-law.com/Practices/Real-Estate/Commercial-Land-lord-Tenant

Jaime Austrich represents national commercial landlords in all facets of their business, from complex contract and land use disputes to evictions and collections. Jaime has extensive experience representing domestic and foreign corporations, including REITs and publicly traded companies, in complex commercial disputes and insurance claims. Jaime also regularly represents fiduciaries and beneficiaries in significant trust and estate litigation.

Jay B. Verona represents a variety of institutional and individual clients, and both debtors and creditors in a wide array of commercial and real estate bankruptcy cases. Jay also represents parties involved in many other types of real estate and business litigation matters, including foreclosure prosecution and defense, commercial landlord-tenant disputes, and contract disputes. Additionally, he assists commercial lenders and borrowers in negotiating modifications and workouts of the lender-borrower relationship. Jay also frequently serves as a mediator in connection with bankruptcy, commercial and real estate disputes.

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